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## Church Employers and the Small Business Health Care Tax Credit

**To:** Church Benefits Association Member Organizations  
**From:** Church Alliance Core Lawyer Working Group -  
Health Care Reform Sub-Committee  
**Date:** January 6, 2011

### I. Introduction

The Patient Protection and Affordable Care Act (PPACA) established a small business health care tax credit (Tax Credit) as an incentive for small employers to provide health insurance coverage to their employees. Qualified small employers (those with 25 or fewer "full-time equivalent" employees and average wages less than \$50,000), including tax-exempt organizations, may be eligible for the Tax Credit if they contribute a uniform percentage of at least 50% toward the cost of their employees' health insurance (there is a limited exception to this uniformity requirement for 2010). For tax-exempt organizations, the Tax Credit can be up to 25% of premiums paid and will take the form of a refundable credit against the amounts the employer is required to withhold from its employees' wages for federal income taxes and Medicare tax, plus the employer share of Medicare taxes (the credit is therefore also limited by these amounts).

In December, 2010, the Internal Revenue Service (IRS) published final guidance on the Tax Credit which included specific information about the eligibility of small church employers providing coverage under self-funded church plans.<sup>2</sup> Small churches and church-related employers can qualify for the Tax Credit whether they obtain coverage through their denomination's self-funded church health plan maintained by their denomination's benefit board, a stand-alone church plan, or through an insurance company. The IRS guidance also addressed how to handle clergy compensation in determining eligibility for and the amount of the credit available.

1 Employer contributions to health reimbursement arrangements (HRAs), health savings accounts (HSAs), and health flexible spending accounts (FSAs) are not eligible premiums for purposes of computing the Tax Credit.

2 The IRS suggested in earlier guidance about the Tax Credit (Notice 2010-44) that eligible coverage had to be issued by an insurance company licensed under state law, thus precluding many churches covered in self-funded denominational plans from qualifying. However, on December 2, 2010, the IRS issued Notice 2010-82 announcing that the Tax Credit is available to churches and other small employers that obtain coverage through self-funded church health plans. The IRS acknowledged that the unique status that the Church Plan Parity and Entanglement Prevention Act (Public Law 106-244) confers on church health plans allows self-funded church health plans to be "qualifying health insurance coverage" for purposes of the Tax Credit.

The Tax Credit is available for Tax Year 2010 by filing the tax forms described below by May 15, 2011 (for employers on a December 31 fiscal year). The Tax Credit is available through 2013. Beginning in 2014, the maximum Tax Credit will increase to 35% of premiums paid by eligible tax-exempt organizations—but only for coverage obtained through the health insurance exchanges; and an employer may only use the Tax Credit for two years after 2014. Therefore, beginning in 2014, the Tax Credit may no longer be available to tax-exempt employers in self-insured church plans.

Many small church organizations who offer health insurance benefits to their employees are eligible for this Tax Credit. Because of the complexities associated with the credit, the Church Alliance's Core Lawyer Working Group prepared this summary of the Tax Credit provisions for Church Benefits Association members.

## II. Not Legal Advice

*This information is intended to be educational and informational for members of the Church Benefits Association; it should not be considered legal advice. Church employers considering the Tax Credit should consult with their own legal counsel and appropriate tax advisors.* This document was drafted in January 2011 and does not reflect any additional guidance issued on or after such date.

## III. How the Tax Credit Works

Small employers with no more than 25 full-time equivalent employees (FTEEs) and average employee wages of less than \$50,000 are eligible for the Tax Credits if they offer “qualifying health insurance coverage” (e.g., coverage from a licensed insurance company or a self-funded church plan) to their employees under a “qualifying contribution arrangement” (defined below). The amount of the credit for tax-exempts in 2010 through 2013 is equal to the applicable percentage up to 25% (as determined by the table in the Appendix) of the lesser of the following two costs:

- (1) **Actual Costs**: the total amount the employer contributes (not counting employee contributions) for qualified health insurance coverage, or
- (2) **Maximum Costs**: the total amount the employer would have paid if each employee taken into account in (1) were covered by a policy with a premium equal to the average premium for the small group market in the state (as determined by the Department of Health and Human Services (HHS) and published by the Internal Revenue Service (IRS) in Revenue Ruling 2010-13 (<http://www.irs.gov/pub/irs-drop/rr-10-13.pdf>). These premiums are also reprinted in the instructions to *Form 8941*. This limits the value of the credit for higher cost plans.

Because tax-exempt organizations do not pay federal income taxes, tax-exempt employers apply the Tax Credit, up to 25% of the premiums paid (subject to the maximum amount described above), as a refundable credit against certain payroll tax obligations, namely withholding of employee portions of Medicare taxes and federal income taxes, as well as the employer's share of Medicare tax obligations. **The Tax Credit is therefore limited for a tax-exempt employer to the amount of these payroll tax obligations for all employees of the employer.**

#### **IV. Credit Prorated**

The Tax Credit is prorated based on the number of employees and the average wages. The full amount of the Tax Credit is available only to an employer with 10 or fewer FTEEs and whose employees have average wages less than \$25,000. The Tax Credit is phased-out as the FTEE count and average wages increase. No tax credit is available for employers with more than 25 FTEEs or whose average wage per employee exceeds \$50,000. See *Appendix A* for a chart that illustrates this phase out.

#### **V. Full-Time Employees and Average Wages**

Unless specifically excluded, all employees of the employer during the year for which the Tax Credit is being claimed are taken into account in computing an employer's FTEEs, annual average wages, and premiums paid--including former employees who terminated employment during the year and employees who do not enroll in their employer's health insurance plan (whether or not they are covered under another plan).

An employer calculates its number of FTEEs by dividing the total hours worked by all employees during the year by 2,080. Employers may round down to the nearest whole number (not less than 1) of FTEEs, so 6.99, for example, becomes 6. For this purpose, the maximum number of hours that are counted for any single employee is 2,080. Notice 2010-82 and the FAQs state that employers may apply different methods of calculating employees' hours of service for different classifications of employees, e.g., counting actual hours, using a days-worked or a weeks-worked equivalency, as long as the classifications are reasonable and consistently applied.

Wages, for the purposes of the Tax Credit, are those wages subject to Social Security payroll taxes (FICA). As discussed further below, wages paid to clergy are excluded from this calculation because their wages are not subject to FICA. An employer calculates its average wage by dividing the total wages paid to all employees (excluding wages paid to clergy) by the number of FTEEs (including FTEEs who are clergy), rounded down to the nearest \$1,000. Seasonal workers are not taken into account in determining FTEEs or average wages unless the seasonal worker works for the employer on more than 120 days during the tax year. (The premiums paid for seasonal workers are included in the total premium amount used for computing the credit.)

#### **VI. Special Rules for Clergy**

Clergy are generally considered self-employed for Social Security (FICA) and Medicare tax purposes. Depending on the facts and circumstances, clergy may be considered employees for purposes of the Tax Credit. Churches need to determine whether the clergyperson serving the church in question satisfies the requirements of the common law test for determining worker status. This is the same test that a church employer follows to determine whether the clergyperson is an employee subject to *Form W-2* reporting or an independent contractor subject to *Form 1099* tax reporting. If the church employer is reporting the clergyperson's wages on a *Form W-2*, the clergyperson is most likely an employee for purposes of the Tax Credit.

The common law test involves a number of factors including, but not limited to, (1) degree of control exercised by the principal (the church) over work details, (2) which party invests in facilities, (2) the opportunity for profit or loss, (3) the right to discharge, (4) the permanency of the relationship, and

(5) the relationship the parties believe they are creating. For an example of how a court might analyze the facts and circumstances of a clergyperson's employment status for the purposes of this

Tax Credit, one can read the opinion of the U.S. Court of Appeals for the Fourth Circuit in *Weber v. Commissioner* (60 F.3d 1104).

If, under the common law test, the clergyperson is considered self-employed, he or she is not taken into account for the Tax Credit. If, under the common law test, he or she is considered an employee, then the clergyperson is counted in the employer's employee count and the premiums paid for coverage of the clergyperson are counted toward the Tax Credit.

In addition, even when counted as an employee for the purposes of the Tax Credit, a clergyperson's compensation is not included, i.e., it is excluded, from the employer's calculation of average wages, because it is not subject to FICA. This exclusion may actually benefit some churches by resulting in a lower overall average wage, because clergy wages are excluded from the calculation but clergy are included in the calculation of the number of FTEEs.

#### **Clergy Withholding**

Regardless of the clergyperson's employment status, churches do not pay Medicare taxes on behalf of clergy or withhold Medicare taxes from their pay, and many churches do not withhold federal income taxes from clergy compensation. The Tax Credit is limited to the aggregate amount of withholding of federal income and Medicare taxes plus the employer portion of Medicare taxes. In some cases, clergy may wish to voluntarily have their churches withhold federal income taxes from their compensation to increase the utility of the Tax Credit. SECA tax payments are not available for the Tax Credit.

#### **VII. Qualifying Arrangement**

The employer must make a non-elective contribution (e.g., a direct employer contribution, not employee contributions through a cafeteria plan or otherwise) on behalf of each employee who is enrolled in coverage that is not less than 50% of the premium cost of the qualifying health insurance coverage. The rules vary depending on, among other things, whether the employer offers a single health insurance plan or more than one plan, the insurer (or church plan) uses composite billing or list billing, or whether the employer offers a more expensive tier of coverage than single coverage. Notice 2010-82 and the FAQs provide many examples to illustrate the application of these rules. But, for example, a church covering its clergyperson in a denominational church health plan and its lay employees in another qualifying arrangement, may qualify for the Tax Credit if the church makes uniform contributions.

The requirement applies to the premium for single (employee-only) coverage. If an employee is receiving coverage that is more expensive than single coverage, e.g., family coverage, the employer need only pay at least 50% of the premium for single coverage for that employee (even if it is less than 50% of the premium for the coverage the employee is actually receiving). The employer's contribution must also be a uniform percentage of the premium cost for all covered employees.

### **2010 Transition Relief**

The IRS issued transition relief, for 2010 only, so that employers that pay at least 50% of the premium for single coverage for each employee enrolled in coverage will not fail to maintain a qualifying arrangement merely because the employer does not pay a uniform percentage of the premium for each covered employee.

### **VIII. Employers Aggregated**

All employers who are part of the same “controlled group” are considered one employer for purposes of the Tax Credit. The rules rely on the controlled group rules in Internal Revenue Code §§ 414(b), (c), and (m). It is not clear exactly how these rules apply to churches and their affiliated organizations. If a church or church-affiliated employer is corporately affiliated with or shares day-to-day operational and financial control with another church or church-affiliated employer, e.g., a day care, the two employers might be treated as one under these rules, making it more difficult to qualify for the Tax Credit.

### **IX. Claiming the Credit**

Eligible tax-exempt organizations will first use *Form 8941* to calculate their refundable Tax Credit, and then will claim the Tax Credit on Line 44f of *Form 990-T*. Many churches do not typically file a *Form 990-T* because that form is primarily filed by organizations liable for the tax on unrelated business income. However, *Form 990-T* must now be used by any eligible tax-exempt organization to claim the Tax Credit, regardless of whether the organization is subject to the tax on unrelated business income. Employers wishing to claim the Tax Credit for 2010 must submit a *Form 990-T* by no later than May 15, 2011.

**Step 1:** Determine whether your tax-exempt organization is eligible for the Tax Credit by completing the following four steps:

- A. Calculate the number of FTEEs (see V and VI, above). If this number is 25 or fewer, go to B.
- B. Calculate the average wages of your employees (see V and VI, above). If the average wages are less than \$50,000, go to C.
- C. Based on the number of FTEEs and average wages, use the table in the Appendix to determine the applicable Tax Credit percentage (which cannot exceed 25% through 2013).
- D. Determine whether you have a “qualifying arrangement” (see VII, above).

**Step 2:** Calculate the Tax Credit (refer to III, above, for further information). Use *Form 8941* to assist you with this calculation. Remember that your Tax Credit may be limited by two factors (1) the actual federal income tax and Medicare taxes withheld and remitted, and (2) the average premium for the small group market in your state (as determined by HHS).

**Step 3:** Submit a claim for the calculated Tax Credit on Line 44f of *Form 990-T*. Generally, the 2010 *Form 990-T* should be filed by May 15, 2011.

### **An Example**

A local church has one clergy person. Let's assume the clergy person is considered an employee under the common law test, i.e., she receives a *Form W-2* from the church. The church also has 2 full-time lay employees and 2 part-time lay employees. The clergy person is paid \$60,000. Employee 1 is paid \$35,000, employee 2 is paid \$25,000, and employee 3 and 4 are each paid \$12,500. The church has enrolled its clergy person and 2 full-time employees in its denominational church health plan. The church pays 75% of the single employee-only premium, which is \$8,000 per employee, on behalf of each employee. The church pays \$18,000 for the coverage (\$6,000 per employee). The church is located in Illinois.

#### Calculate the FTEEs for the church

*Hours Worked:* Employee 1 (2,080); Employee 2 (2,080), Employee 3, (1,040), Employee 4 (1,040), Clergy person 1 (2,080). Total hours: 8,300.

*FTEEs:* 4 (8,300 hours ÷ 2,080 hours)

#### Calculate average wages

*Wages:* \$35,000 + \$25,000 + \$12,500 + \$12,500 = \$85,000 aggregate wages. The clergy person's wages are not counted.

*Average Wages:* \$85,000 ÷ 4 = \$21,250 per FTEE, rounded down to \$21,000. The clergy person is counted as an employee in the denominator, even though his or her wages are not included. According to the table in the Appendix, the church is eligible for a credit of 25%.

#### Calculate premiums paid and Tax Credit

*Employer Health Care Costs:* \$18,000 (\$6,000 x 3). Premiums paid to cover the clergy person are counted.

*Average Illinois Premium:* \$5,198. This limits the amount of premiums paid that can be counted toward the Tax Credit. The church can only claim 75% of \$5,198 (what it would have paid if the coverage were average Illinois coverage) per employee. \$5,198 x 75% = \$3,898.50 x 3 = \$11,695.50 maximum premium limit.

*2010 Tax Credit:* \$2,923.88 (25% x \$11,695). This amount is refundable as a credit as long as the church has withheld at least that much from employee wages combined with what the church has paid in employer Medicare taxes.

The worksheets contained in the Instructions for *Form 8941* may also be helpful to employers who are trying to determine the amount of credit they may be able to claim.

**IRS Resources**

<i>Small Business Health Care Tax Credit News</i>	<a href="http://www.irs.gov/newsroom/article/0,,id=220809,00.html?portlet=6">http://www.irs.gov/newsroom/article/0,,id=220809,00.html?portlet=6</a>
<i>Notice 2010-82</i>	<a href="http://www.irs.gov/pub/irs-drop/n-10-82.pdf">http://www.irs.gov/pub/irs-drop/n-10-82.pdf</a>
FAQs	<a href="http://www.irs.gov/newsroom/article/0,,id=220839,00.html">http://www.irs.gov/newsroom/article/0,,id=220839,00.html</a>
<i>Form 8941(2010 final version)</i>	<a href="http://www.irs.gov/pub/irs-pdf/f8941.pdf">http://www.irs.gov/pub/irs-pdf/f8941.pdf</a>
Instructions to <i>Form 8941</i>	<a href="http://www.irs.gov/pub/irs-pdf/i8941.pdf">http://www.irs.gov/pub/irs-pdf/i8941.pdf</a>
<i>Form 990-T (2010 draft version)</i>	<a href="http://www.irs.gov/pub/irs-dft/f990t--dft.pdf">http://www.irs.gov/pub/irs-dft/f990t--dft.pdf</a>
News Release	<a href="http://www.irs.gov/newsroom/article/0,,id=231928,00.html">http://www.irs.gov/newsroom/article/0,,id=231928,00.html</a>
<i>Notice 2010-44</i>	<a href="http://www.irs.gov/pub/irs-drop/n-10-44.pdf">http://www.irs.gov/pub/irs-drop/n-10-44.pdf</a>
<i>Revenue Ruling 2010-13 (Small Market Average Premiums)</i>	<a href="http://www.irs.gov/pub/irs-drop/rr-10-13.pdf">http://www.irs.gov/pub/irs-drop/rr-10-13.pdf</a>

**Appendix**  
***Small Business Tax Credit, Nonprofit Firms in 2010-2013***

	<b>Average wage</b>					
<b>Firm size</b>	<b>Up to \$25,000</b>	<b>\$30,000</b>	<b>\$35,000</b>	<b>\$40,000</b>	<b>\$45,000</b>	<b>\$50,000</b>
<b>≤ 10</b>	25%	20%	15%	10%	5%	0%
<b>11</b>	23%	18%	13%	8%	3%	0%
<b>12</b>	22%	17%	12%	7%	2%	0%
<b>13</b>	20%	15%	10%	5%	0%	0%
<b>14</b>	18%	13%	8%	3%	0%	0%
<b>15</b>	17%	12%	7%	2%	0%	0%
<b>16</b>	15%	10%	5%	0%	0%	0%
<b>17</b>	13%	8%	3%	0%	0%	0%
<b>18</b>	12%	7%	2%	0%	0%	0%
<b>19</b>	10%	5%	0%	0%	0%	0%
<b>20</b>	8%	3%	0%	0%	0%	0%
<b>21</b>	7%	2%	0%	0%	0%	0%
<b>22</b>	5%	0%	0%	0%	0%	0%
<b>23</b>	3%	0%	0%	0%	0%	0%
<b>24</b>	2%	0%	0%	0%	0%	0%
<b>25</b>	0%	0%	0%	0%	0%	0%