DEPARTMENT OF TAXATION
2011 Fiscal Impact Statement

1. Patron W. Roscoe Reynolds

2. Bill Number SB 1442

House of Origin:
X **Introduced**
_____ **Substitute**
_____ **Engrossed**

Second House:
_____ **In Committee**
_____ **Substitute**
_____ **Enrolled**

3. Committee Senate Finance

4. Title Income Tax: Small Employer Health Insurance Tax Credit

5. Summary/Purpose:

This bill would allow an individual and corporate income tax, bank franchise tax, insurance premiums tax or public service corporation tax credit for eligible small employers who make contributions towards their employees' health insurance premiums. The credit would be equal to thirty percent of the federal health insurance tax credit, not to exceed $5,000 for any taxable year. Any unused credits may be carried over until (i) the full amount of the credit is used or (ii) the expiration of the seventh year after the year that the credit was first allowed, whichever is sooner.

This bill would be effective for taxable years beginning on or after January 1, 2011.

6. Budget amendment necessary: No.

7. Fiscal Impact Estimates are: Preliminary. (See Line 8.)

8. Fiscal implications:

Administrative Impact

TAX has not assigned any administrative costs to this bill because the changes required by a single bill such as this can be implemented as part of the annual changes to our systems and forms. As stand-alone legislation, TAX considers implementation of this bill as "routine," and does not require additional funding.

TAX will provide specific administrative costs on any legislation that is not "routine." Additionally, TAX will review all state tax legislation likely to be enacted prior to the passage by each house. If the aggregate number of routine bills likely to pass either house is unusually large, it is possible that additional resources will be required. If so, TAX will identify the costs at that time.

Revenue Impact

This bill would have an unknown, but potentially significant, revenue loss. The federal credit is dependent upon many factors, including the number of employees, average wages, and premiums paid, which make it difficult to estimate the magnitude of the revenue impact. However, data on employee coverage and premiums paid suggest that the credit could be claimed by a large number of employers and result in a significant revenue loss.

The number of Virginia employers that would qualify for the state small employer health insurance tax credit beginning in 2010 is unknown. The most recent data is from 2009, which suggests that there were 113,979 private sector establishments with 24 or fewer employees. Of those with 10 to 24 employees, 65.5 percent offered health insurance, while 27.6 percent of those with fewer than 10 employees did.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Federal Law

The Patient Protection and Affordable Care Act of 2010 created an income tax credit for eligible small employers, including tax-exempt organizations, which make non-elective contributions towards their employees' health insurance premiums under an arrangement that meets certain requirements. A qualified small business employer is an employer with no more than 25 full-time equivalent employees with an average annual salary of no more than $50,000.

For taxable years 2010 through 2013, the maximum credit amount is 35% of an eligible small employer's premium payments or 25% of the premium payments if the eligible small employer is tax-exempt. For taxable years beginning after 2013, the maximum credit increases to 50% for eligible small employers and 35% for tax-exempt eligible small employers. The amount of an employer's premiums that are taken into consideration for purposes of calculating the credit cannot exceed the average premium for the small group market in the state in which the employer offers coverage.

For a tax-exempt employer, the amount of the credit cannot exceed the total amount of income tax and Medicare (i.e., Hospital Insurance) tax that the employer is required to withhold from employees' wages for the year, and the employer share of Medicare tax on employees' wages for the year.

In order to be eligible for the federal tax credit, the employer must meet three requirements. First, the eligible small employer must have less than 25 full-time equivalent employees. In order to be eligible for the maximum credit, the employer must have no more than 10 full-time equivalent employees. Second, the average salary of these employees must be less than $50,000. In order for the eligible small employer to be eligible for the maximum credit, the average annual salary must not exceed $25,000.

Third, in order to qualify for the tax credit under the Act, the employer must pay an amount equal to a "uniform" percentage of not less than 50% of the premium cost of the health insurance coverage.

Because premiums vary widely by state or location, the IRS has capped the amount of employee and family insurance premiums eligible for the tax credit. For Virginia, the cap is $4,890 for employee coverage and $11,338 for family coverage. If the employer's cost for coverage in Virginia exceeds those premiums, it would use those caps and not its actual premium rate.

The following examples demonstrate how the federal credit is calculated for the maximum credit amount.

> Example 1. An eligible small employer has 9 full-time equivalent employees with average annual wages of $23,000 for the 2010 taxable year. The employer pays $72,000 in health insurance premiums for those employees, and does not exceed the average premium for the small group market in the employer's state. The total 2010 credit equals $25,200 (35% x $72,000).
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> Example 2. A tax-exempt eligible small employer has 10 full-time equivalent employees with average annual wages of $21,000 for the 2010 taxable year. The employer pays $80,000 in health insurance premiums for those employees, and does not exceed the average premium for the small group market in the employer's state. The total amount of the employer's income tax and Medicare tax withholding plus the share of the Medicare tax is $30,000. The initial amount of the credit equals $20,000 (25% x $80,000). The employer's credit is equal to the lesser of the withholding and Medicare taxes ($30,000) or the initial amount of the credit ($20,000). Therefore, the total 2010 credit equals $20,000.

The federal credit also contains a "phase-out" that reduces the credit amount when the number of full-time equivalent employees or the average annual salary during the taxable year exceeds the number employees or average annual salary necessary to claim the maximum tax credit. If the number of full-time equivalent employees exceeds the maximum amount allowed, the initial amount of the credit is multiplied by a fraction, in which the number of employees in excess of the maximum number of employees allowed is the numerator and 15 is the denominator. If the average annual wages exceed the maximum allowed, the credit is calculated by multiplying the initial credit amount by a fraction, in which the excess amount is the numerator and $25,000 is the denominator. The phase-out reduces the amount of the credit for eligible small employers, but not below zero.

The following example demonstrates how the federal phase-out is calculated if the number of full-time equivalent employees exceeds 10 employees or the average annual wages exceed $25,000.

Example 3. An eligible small employer has 12 full-time employees and average annual wages of $30,000 for the 2010 taxable year. The employer pays $96,000 in health insurance premiums for its employees, and does not exceed the average premium for the small group market in the employer's state. The initial amount of the credit determined before any reduction is $33,600 (35% x $96,000). The credit reduction for the full-time equivalent employees in excess of 10 equals $4,480 ($33,600 x 2/15), and the credit reduction for the average annual wages in excess of $25,000 equals $6,720 ($33,600 x $5,000/$25,000). The total credit reduction is $11,200 ($4,480 + $6,720). Therefore, the total 2010 credit equals $22,400 ($33,600 - $11,200).

Proposal

This bill would allow an individual and corporate income tax, bank franchise tax, insurance premiums tax or public service corporation tax credit for eligible small employers who make contributions towards their employees' health insurance premiums. The credit would be equal to thirty percent of the federal health insurance tax credit, not to exceed $5,000 for any taxable year. Any unused credits may be carried over until (i) the full amount of the credit is used or (ii) the expiration of the seventh year after the year that the credit was first allowed, whichever is sooner.

"Eligible small employer" would mean the same as defined under § 45R(d) of the IRC.

Any credits granted to a partnership, limited liability company, or electing small business corporation (S corporation) shall be allocated to the individual partners, members, or shareholders, respectively, in proportion to their ownership or interest in such business entities.

This bill would be effective for taxable years beginning on or after January 1, 2011.

cc : Secretary of Finance

Date: 1/26/2011 TG
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