

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

**TESTIMONY BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES**

**HEARING ON SMALL BUSINESS HEALTH INSURANCE TAX CREDIT
NOVEMBER 15, 2011**

Good morning Chairman Boustany, Ranking Member Lewis and Members of the Subcommittee. My name is Patricia Thompson. I am a CPA and Chair of the Tax Executive Committee of the American Institute of Certified Public Accountants (“AICPA”). My testimony today is based on our members’ experiences working with small business clients. I am the Tax Partner at Piccerelli, Gilstein & Company, LLP, a CPA firm in Providence, Rhode Island, and have been with the firm for over 32 years. I would like to thank this Subcommittee for the opportunity to appear at today’s hearing on the implementation and effectiveness of the small business health insurance tax credit.

The small business health insurance tax credit, enacted as part of the Patient Protection and Affordable Care Act¹, was designed to encourage small businesses and small tax exempt organizations to offer health insurance coverage to their employees for the first time or help them afford coverage they already have. The AICPA does not have a position supporting or opposing this tax incentive. However, in my testimony today, I plan to focus on the technical aspects of the credit and address specific provisions of the credit from complexity and transparency perspectives. I also will share real life examples of challenges small employers faced this year in either determining whether they were eligible for the credit or calculating the credit itself.

SOUND TAX POLICY

The AICPA has a longstanding tradition of advocating for sound tax policy. In that regard, the AICPA has developed tax policy concept statements and published material on fundamental tax reform. One significant guiding principle of good tax policy is simplicity. The tax law should be simple so that taxpayers can understand the rules and can comply with them correctly and in a cost-efficient manner. The guiding principles for tax simplification are:

- (1) Seek simplest approaches. Once tax lawmakers identify desired tax policy or revenue objectives, the simplest and most transparent approaches to implementation should be sought.
- (2) Minimize compliance burdens. Compliance costs, in terms of both time and money, should be minimized and should be commensurate with the resources and abilities of the affected taxpayers. Higher compliance costs may be appropriate for complex business and investment transactions, but not for small businesses and small tax exempt organizations.
- (3) Reduce frequency of tax law change. Change in and of itself increases complexity in the short run, even if the change will produce long-term simplification. Tax laws should be changed only to address changes in revenue needs, to implement significant changes in tax policy, or to alleviate existing complexities and inconsistencies.

¹ Pub. L. No. 111-148, 124 Stat. 119 (2010).

- (4) Use consistent concepts and definitions. Inconsistencies in legal concepts and definitions should be eliminated in existing law and avoided in the drafting of new laws.
- (5) Consider administrative burdens. The ability of tax agencies to administer, provide guidance on, and enforce the law must be considered in the development of legislation and administrative guidance.
- (6) Avoid limited applicability. Tax rules that apply to a limited set of taxpayers or for only a short period of time should be avoided.

Transparency, another guiding principle of good tax policy, is an important partner with tax simplification. Transparency is the basic notion that taxpayers should know, namely, (1) that a tax or tax incentive exists and (2) how and when the tax or tax incentive applies to them. The more complex a tax system is, the less transparent it tends to be. Complexity obscures how, when, and on whom a tax is imposed (or a tax incentive is available), which increases confusion, frustration, and the perception that the tax system is unfair. In addition, obscurity in the tax law may cause harm by making it difficult for taxpayers and their tax advisers to plan transactions and comply with the law. With regard to the health insurance tax credit, unintentional misstatements in the credit may result when the provision's applicability is not clear.

Listed below are the guiding principles for transparency:

- (1) Make the promulgation of a good tax system a priority. Transparency is expected to achieve a fair tax law, improved compliance and a healthy economic environment.
- (2) Implement transparent approaches. Taxpayers should be able to understand their true tax and have confidence in calculating their tax liability.

Increasing the transparency of the tax law should:

- (1) Result in a system that is fairer, and is perceived by taxpayers as being fairer;
- (2) Enhance the efficiency of administering the tax system;
- (3) Increase taxpayer and tax practitioner certainty in tax planning and compliance;
- (4) Reduce tax return error rates;
- (5) Provide a stimulus for growth by making economic decision-making more efficient; and
- (6) Reduce the direct and indirect costs of complying with and administering a complex and nontransparent tax system, freeing up resources for productive activities.

GENERAL COMMENTS

Based on our members' experiences working with small businesses, there are a number of areas in the new Internal Revenue Code (Code) section 45R – Employee health insurance expenses of small employers – where our simplicity and transparency principles are not followed. These areas warrant your attention in order to provide an effective incentive for small employers to provide health insurance coverage to their employees. We understand the challenges Congress faces as it tackles the complex issues inherent in drafting tax legislation and appreciate your diligence in trying to do the right thing for taxpayers.

We understand a social objective has been identified – the need to reduce the number of uninsured individuals. Once this was identified, the simplest and most transparent approaches to implementation should have been sought. Small businesses, or their professional advisors, are increasingly spending more time preparing tax-related forms and schedules resulting in significant increases in cost for complying with the laws. Complex or multistep calculations should not be required. Tax recordkeeping should closely emulate normal business practices. The language used in definitions, explanations, and eligibility requirements should be understandable by the target group of taxpayers. Uncertainties and an inability to understand the tax laws should be avoided to reduce anxiety and frustration by taxpayers.

The small business health insurance tax credit was not viewed by most small employers as an incentive to provide health insurance coverage to their employees last year. In order for an incentive to be effective, taxpayers must know of its existence, know whether it applies to them and how it applies to them. Since most small employers did not know until the end of the year (or after the year ended when their income tax returns were prepared) whether or not they qualified for the credit, there was no incentive for them to provide health insurance coverage. Since many of the variables (such as, the number of full-time equivalent employees and the hours worked per employee) are difficult to estimate early in the year, it was pointless for employers or their tax practitioners to begin testing eligibility or potentially calculating the credit. Only in situations where the employer employed less than ten full-time employees did it make sense to evaluate, before the end of the year, the benefit of purchasing health insurance and taking advantage of the credit. The reason for this is explained in more detail below.

ISSUES ENCOUNTERED

The Internal Revenue Service (“IRS”) should be complimented on providing guidance on the application of the credit and also on informing taxpayers and tax professionals on the availability of the credit. However, even with this guidance, many tax professionals and taxpayers found the credit to be quite complex. The complexity of the credit results from the various components of the credit as follows:

- Definitions used to determine eligibility for the credit. The definition of eligible small employer, full-time equivalent employees, average annual wages, and employee are not straightforward or consistent with other provisions of the Code.
- Definition of eligible small employer. An eligible small employer was based on the number of full-time equivalent employees (FTEs), the average annual wages and the health insurance arrangement in place. This definition was confusing and hard to apply. It is also inconsistent with the definition of small business used in various other Code sections. Examples of the definition of small business include the following:
 - Research credit for contract research expenses under Code section 41 defines a small business as any person if the annual average number of employees employed by that person during either of the two preceding calendar years was 500 or fewer.
 - Archer Medical Savings Account under Code section 220 defines the term as any employer if such employer employed an average of 50 or fewer employees on business days during either of the two preceding calendar years. The provision

continues to allow certain growing employers to retain treatment as small employer even though the average number of employees exceeds 50.

- Credit for pension plan startup costs under Code section 45E uses the same definition in Code section 408(p)(2)(i) which is any employer that had no more than 100 employees who received at least \$5,000 of compensation from the employer for the preceding year. Section 408(p)(2)(i) relates to employers eligible to use Savings Incentive Match Plan for Employees (SIMPLE) retirement accounts.
- The Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) continuation requirements also provide a small employer exception. A small employer is one that normally employed fewer than 20 employees during the preceding year.
- Phase out of the credit based on number of employees and average annual wages. The credit is phased out once the full-time equivalent employee count exceeds ten and the average annual wages exceeds \$25,000. The credit is completely eliminated when the employer has either 25 full-time equivalent employees or if the average annual wages exceeds \$50,000. The full credit is allowed if the eligible small employer has ten or fewer full-time employees and the average annual wages do not exceed \$25,000. These phase-outs made the credit difficult to apply and required numerous calculations before determining the amount of the credit available.
- Calculating the number of employees. A determination first has to be made as to which employees are counted. Self-employed business owners, more than 2% shareholders, 5% owners and these individuals' family members are not considered employees. Part-time employees and leased employees are eligible. Because the eligibility rules are based in part on the number of FTEs, not the number of employees, employers that use part-time workers may qualify even if they employ more than 25 individuals.
- Calculating the employee hours of service is needed to determine the number of FTEs. Often the number of annual hours worked by employee is not readily available especially for a fiscal year taxpayer. A detailed analysis of each employee's hours is needed to arrive at the actual hours required to meet this requirement. Hours in excess of 2,080 are not included. For employers that experience high turnover or hire seasonal workers, this requirement is particularly troublesome. IRS issued Notice 2010-44, Tax Credit for Employee Health Insurance Expenses of Small Employers, which provides guidance on how to determine the number of hours of service. The Notice provides three methods to determine the total number of hours of service as follows:
 - Determine actual hours of service from records of hours worked and hours for which payment is made or due (payment is made or due for vacation, holiday, illness, incapacity, etc.);
 - Use a days-worked equivalency whereby the employee is credited with eight hours of service for each day for which the employee would be required to be credited with at least one hour of service for services performed and for certain periods when no services are performed such as vacation; or
 - Use a weeks-worked equivalency whereby the employee is credited with 40 hours of service for each week for which the employee would be required to be credited with at least one hour of service for services performed and for certain periods when no services are performed such as vacation.

- Determining which qualified health plan offered by the small business is eligible for the credit. Each qualified health plan needs to be evaluated separately to determine if the eligible small employer makes non-elective contributions on behalf of each employee of a uniform percentage, but not below 50%, of the premium cost of the qualified health plan. Qualified health insurance plans include health insurance, dental or vision, long term care, Medicare supplemental health insurance among others. It is possible that some health plans are eligible while other plans are not.
- Determining whether or not the 50% coverage is met. For 2010, as long as the employer paid at least 50% of single coverage, the requirement was met even if the employer actually provided more expensive coverage, such as family coverage, and contributed less than 50% of the more expensive coverage.
- Determining the premiums eligible for the credit. The eligible premium is the smaller of the actual premium paid by the employer or the average premium for the small group market in which the employer offers health insurance coverage. The IRS provides the average premium for the small group market based on single and family coverage. Employers conducting business in multiple states are required, for each employee, to determine the premium by state and by type of coverage.
- Treating multiple employers as a single employer for purposes of this credit. Many small business employers may not have to be treated as a single employer for any other purposes of the Code resulting in a one-time calculation for purposes of this credit.

For many small employers, tax compliance costs were created without an offsetting benefit. As stated by one of my colleagues, “many times there was a lot of work for not a lot of return.” It was not uncommon this year for tax preparers to have spent up to 20% of the time necessary to prepare an entire small business return just on the credit calculation, only to learn that the client did not qualify for the credit. As such, many small employers felt the entire process was a fruitless effort or wasted expense.

RECOMMENDATIONS

The AICPA recommends making tax simplification and transparency in regard to the small business health insurance tax credit a priority. Complexity is often overlooked in drafting legislation because negative impacts on the tax system are often less obvious to lawmakers trying to solve “today’s” problems and only become apparent in the long run. Many tax professionals believe that legislation is needed to ensure the continued viability of the small business health insurance tax credit. We believe a simpler provision is possible and necessary to allow the credit to be used as an incentive for small employers to purchase health insurance or continue providing health insurance to its employees. Seeking a simpler approach to determine eligibility for the credit would minimize the small business taxpayers’ compliance burden. Many small businesses find tax compliance challenging as they lack the resources to comply with the rules. Also, a taxpayer would more likely be able to determine the impact of purchasing health insurance for its employees. Based on the current legislation, there is no easy way to quickly evaluate whether or not a small business would be eligible for this credit. Qualification is based on FTEs and average compensation. A small business does not have these items readily available. An accumulation of information and complex calculations were required this year to determine if a credit would be available. Many times the

small business, or most often their advisor, gathered all of the required information, ran through the calculations and determined they were not eligible, or were only partially eligible, for the credit because of the average annual wages paid to their employees or the employee count.

The AICPA recommends that you consider changing the definition of a small business to either base the definition on gross receipts or employee count from the prior year or the average of the prior two years, or increase the full time equivalent employee count number. Special consideration should also be given to small exempt organizations when defining gross receipts since some of their gross receipts include "unearned income," such as charitable contributions received.

A small business' gross receipts could be based on the prior year's gross receipts or the average of the prior three years gross receipts. Basing the definition on prior year gross receipts or wages would increase simplicity and transparency since employers would not need to gather any information on its number of current year full-time equivalent employees or its average annual wages. Using prior year information would be readily available allowing the taxpayer to be able to calculate early in the year the tax savings by purchasing health insurance for its employees. The employer would merely use the amount already reported on its tax return to the IRS.

We also suggest that the phase-out calculations for the employee count and the annual salary be eliminated. Phase-outs create difficulties in estimating a taxpayer's benefit from the economic choice of purchasing or continuing to provide health insurance to its employees. The interactive provisions of employee count and annual salary would also be eliminated.

Alternatively, if changing the definition of small business is not an option, consider raising the average annual salary and the employee count number.

The AICPA also recommends that you address the two-year requirement starting in 2014. Having the provision apply to a taxpayer for only a two-year period starting with the first year the taxpayer provides coverage to its employees adds confusion and obscures the law's effect. In addition, the requirement would add an administrative burden to the IRS as it would have to monitor whether or not the taxpayer is taking the credit for more years than they are eligible. If the provision will continue to be limited to two years after 2013, consider giving the IRS "math error" authority to be able to automatically change a taxpayer's return if it is determined that the credit was taken beyond the two years.

One potential consequence of seeking the simplest approach may be reduced precision. Under current law, simple general rules are often followed by definitions of specific terms used, as well as exceptions to the general rule and limitations. This is deemed necessary to anticipate all possible scenarios and close potential loopholes. Unfortunately, this level of detail tends to introduce significant complexity. Although simpler and less precise approaches may raise or lower taxes for an unintended few, less detail would simplify the tax law and reduce administrative and compliance burdens for many small businesses.

CLOSING REMARKS

We appreciate your efforts in examining some of the difficulties that small businesses and small tax exempt organizations face in navigating through the rules on the small employers' health insurance tax credit. The complexity of the credit has left taxpayers perplexed about how the tax law applies to them. Many small businesses spent more time or cost on the preparation of the income tax returns this year in order to calculate their potential health insurance credit only to learn they received a minimal tax benefit, if any at all.

We encourage you to review our publications [AICPA's Tax Policy Concept Statement #1: Guiding Principles for Good Tax Policy](#), [AICPA's Tax Policy Concept Statement #2: Guiding Principles for Tax Simplification](#) and the [AICPA's Tax Policy Concept Statement #3: Guiding Principles for Tax Law Transparency](#) to assist you in testing any new proposals against the principles of good tax policy.

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Thank you, again, for the opportunity to testify. I would be happy to answer any questions you may have.