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View From McDermott: Employer Pay-or-Play Mandates Under Health-Care Reform

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This fall, open enrollment is well underway for individuals and small employers under the state and federally facilitated marketplace exchanges created by the Affordable Care Act.

As exchange coverage becomes available, many employers are in the process of evaluating whether, or at what level, to continue to offer health insurance benefits to their employees. Some employers are staying the course and offering robust medical plan choices to their employees. Others are turning to private health exchanges for solutions and still others are deciding that their employees may be better off obtaining subsidized coverage in the state or federally facilitated marketplace exchanges.

A large part of this decision turns on whether an employer will incur tax penalties for failure to offer adequate coverage to its employees and whether its employees will, in fact, be better off obtaining coverage elsewhere.

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The Affordable Care Act added Section 4980H to the Internal Revenue Code of 1986, as amended (the Code).[1] Code Section 4980H requires employers to provide a minimum level of health-care coverage to full-time employees or risk a tax penalty.

The Section 4980H requirements are frequently referred to as either the ''pay or play'' or ''employer shared responsibility'' requirements (hereafter, the Pay or Play Rules). On Jan. 2, 2013, the Internal Revenue Service published proposed regulations regarding the Pay or Play Rules, which are the subject of this article.[2] Final regulations are pending.[3]

Earlier this summer, employers were granted a much-needed reprieve from compliance when the IRS announced a one-year enforcement delay of the Pay or Play Rules until 2015.[4] Under this transition relief, no penalties under the Pay or Play Rules will be assessed on employers for 2014 and, effectively, employers are not required to provide health-care coverage to full-time employees until 2015 to avoid potential tax penalties. This transition relief does not apply, however, to prevent the imposition of a tax penalty on certain individuals who do not have adequate coverage.[5] The individual penalty for failure to obtain adequate coverage in 2014 is generally equal to the greater of $95 per individual or 1 percent of income, and increases for 2015 and 2016.[6]

It is important to note that the Affordable Care Act does not require employers to offer health coverage to their employees, but penalizes large employers who fail to do so. Thus, employers are faced with an important business decision: whether to (a) offer a minimum level of employer-sponsored health coverage to full-time employees that will avoid the imposition of tax penalties, or (b) offer inadequate or no coverage and face poten-

[1] Affordable Care Act § 1513.
[2] 78 Fed. Reg. 217 (Jan. 2, 2013).
[3] The IRS also plans to publish frequently asked questions regarding employer shared responsibility that will be available on its website at http://www.irs.gov/uac/Newsroom/Questions-and-Answers-on-Employer-Shared-Responsibility-Provisions-Under-the-Affordable-Care-Act.
[4] IRS Notice 2013-45.
[5] IRS Notice 2013-45, Q&A 4.
[6] Treas. Reg. § 1.5000A-4.

tial liability for what may be significant tax penalties. The purpose of this article is to provide employers with the tools necessary to understand the law and to make this important decision.

Which Employers Are Subject to the Pay or Play Rules?

The Pay or Play Rules apply to ''applicable large employers.'' An ''applicable large employer'' is defined as an employer who employed an average of at least 50 full-time employees during the prior year.[7] This threshold will also be met if the employer has an equivalent amount of full-time and part-time employees. A full-time employee is defined as an employee who is employed on average at least 30 hours of service per week.[8] The 30-hour full-time employee standard under the Pay or Play Rules has been particularly controversial as most employers typically use a higher number of hours (32 or 40) to define full-time employment. Legislation has been introduced in both the U.S. House of Representatives and Senate which would change the requirement to 40 hours per week and change the method of calculating full-time equivalent employees[9], but many obstacles remain to passage of such legislation.

Under the Pay or Play Rules, if an employer is part of a controlled group with another company as defined in Code Section 414, the companies are combined to determine whether they collectively meet the definition of an applicable large employer.[10] Even if several companies constitute an applicable large employer and are subject to the Pay or Play Rules, the amount of any tax penalty is determined separately for each company in the controlled group; related companies and their employees are not taken into account for purposes of the penalty calculations.

What Constitutes Affordable Coverage and Minimum Value?

Under the Pay or Play Rules, an employer who does not offer health coverage to substantially all of its full-time employees (and their dependents) that is affordable and provides a minimum value of health benefits, may be subject to a tax penalty. Health coverage is affordable when the employee portion of the self-only premium for the employer's lowest cost coverage that provides minimum value does not exceed 9.5 percent of the employee's annual household income.[11] Because an employer may not be able to determine an employee's annual household income, the proposed rules allow employers to treat coverage as affordable if an employee's health-care premiums do not exceed 9.5 percent of the employee's (a) Form W-2, Box 1 wages from that employer, (b) monthly wages equal to the employee's applicable hourly rate of pay multiplied by 130 hours or the employee's monthly salary, as applicable, or (c) the federal poverty level for a single individual.

A health plan provides minimum value only if the plan pays for at least 60 percent of the total allowed costs under the plan.[12] Coverage must also be offered to an employee's dependent children up to age 26, but spousal coverage is not required under the proposed rules. An employer may use one of three methods to determine minimum value.[13] The IRS has prepared a minimum value calculator that employers can use to determine whether a plan meets the minimum value requirement.[14] Employers can also determine minimum value using a safe harbor checklist.[15] The preamble to the proposed regulations provides that plan designs meeting the following specifications are proposed as safe harbors for determining minimum value if the plan covers all of the benefits included in the minimum value calculator:

- A plan with a $3,500 integrated medical and drug deductible, 80 percent plan cost-sharing, and a $6,000 maximum out-of-pocket limit for employee cost-sharing;
- A plan with a $4,500 integrated medical and drug deductible, 70 percent plan cost-sharing, a $6,400 maximum out-of-pocket limit, and a $500 employer contribution to an HSA; and
- A plan with a $3,500 medical deductible, $0 drug deductible, 60 percent plan medical expense cost-sharing, 75 percent plan drug cost-sharing, a $6,400 maximum out-of-pocket limit, and drug copayments of $10/$20/$50 for the first, second and third prescription drug tiers, with 75 percent coinsurance for specialty drugs.[16]

Finally, a health plan with nonstandard features can obtain an actuarial certification that the plan provides minimum value.[17]

How Is Full-Time Employee Status Determined?

A full-time employee is defined as an employee who works at least 30 hours per week[18] during the prior year. The proposed regulations treat 130 hours of service in a month as the monthly equivalent of 30 hours of service per week. Any hours worked outside of the United States are not included in this calculation. To determine full-time employee status, employers must track all hours of services worked for which payment is made or due. This includes any payment made or due for vacation, holiday, illness, incapacity, layoff, jury duty, military duty, or leave of absence, and likely includes periods for which employees are paid to be on call or available for the employer. For salaried employ-

[7] Code § 4980H(c)(2).
[8] Code § 4980H(c)(4).
[9] See the Save American Workers Act (H.R. 2575), introduced in the House on June 29, 2013, and the Forty Hours is Full Time Act (S. 1188), introduced in the Senate on June 19, 2013.
[10] Code § 4980H(c)(2)C)(i).
[11] Code § 36B(c)(2)(C); Treas. Reg. § 1.36B-2(c)(3)(v)(A)(1).
[12] 45 C.F.R. § 156.145(a); *see also* Prop. Treas. Reg. § 1.36B-6(a).
[13] *See* IRS Notice 2012-31; 78 Fed. Reg. 25,909 (May 3, 2013).
[14] *See* http://www.cms.gov/cciio/resources/regulations-and-guidance/index.html.
[15] 45 C.F.R. § 156.145(a)(2). *See also* Prop. Treas. Reg. § 1.36B-6(d)(2).
[16] 78 Fed. Reg. 25,909 (May 3, 2013).
[17] 45 C.F.R. § 156.145(a)(3).
[18] Code § 4980H(c)(4).

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ees, hours of service may be based on actual hours worked or an equivalent, such as 8 hours per workday or 40 hours per week, provided that the result of using the equivalent does not understate the number of hours worked by the employee in a way that would cause the employee to not be treated as full-time.

The proposed regulations give employers the option to determine full-time employee status for ongoing employees by establishing a ''standard measurement period'' that is between three to 12 months long, and looking at hours worked during that period. An ''ongoing employee'' is defined as an employee who has been employed by an applicable large employer member for at least one complete standard measurement period. Each ongoing employee who works an average of 30 hours per week during the standard measurement period is treated as a full-time employee during the subsequent ''stability period.'' The stability period is generally the same length as the standard measurement period, but must be at least six months long and no shorter than the standard measurement period. For example, if an employee is determined to be a full-time employee during the standard measurement period, then that employee must be treated as full-time for the duration of the subsequent stability period, even if that employee works less than 30 hours per week during the stability period.

Employers have flexibility to vary the standard measurement period, so long as the period selected is consistent for all employees in the same category. Additionally, employers may choose to use an administrative period of up to 90 days between the standard measurement period and stability period to determine employee eligibility and to notify and enroll that employee in health coverage.

Special rules apply to determining employee hours during periods of special unpaid leave. Special unpaid leave includes periods of unpaid leave subject to the Family and Medical Leave Act of 1993 or the Uniformed Services Employment and Reemployment Rights Act of 1994 and on account of jury duty.[19] When computing an employee's average hours for special unpaid leave during the standard measurement period, the employer will need to either (a) ignore periods where no hours were worked, or (b) credit hours to employees based on the average number of hours worked by the employee during the remainder of the measurement period. Both options are designed to benefit the employee and should generally result in the same number of average hours for the employee during the measurement period. This treatment for special unpaid leave only applies to continuing employees and not to new hires or to employees who are rehired but treated as terminated and rehired, as described below. Special rules also apply to employment breaks of at least four consecutive weeks for employees of certain educational organizations.

An employer may treat a rehired employee or an employee resuming service as a new employee rather than a continuing employee after a break in service in two situations. The first situation is when the employee had no hours of service for at least 26 weeks. Second, the employer may select a shorter period of no less than four weeks under which a rehired employee will be treated as a new employee if the employee's break in service with no credited hours of service is at least four weeks long and is longer than the employee's period of service immediately preceding the break in service. When an employee is treated as a new employee, the employer may ignore hours of service prior to the employee's break in service when determining full-time employee status and will not need to consider any periods of special unpaid leave.

New employees who are expected to work an average of at least 30 hours per week at the time they are hired must be provided health coverage within the employee's initial three months of employment to avoid potential tax penalties. Not all new employees, however, are expected to work an average of 30 hours per week or remain employed for three months. These employees may be classified as either variable or seasonal employees. A new employee is a variable employee if the employer cannot reasonably determine if the employee will work an average of 30 hours per week. A seasonal employee is an employee who works on a seasonal basis as determined by the Department of Labor. Until further guidance is issued, employers may apply a reasonable, good faith interpretation to determine which employees qualify as seasonal workers.

An employer determines if a variable or seasonal employee is a full-time employee using a measurement period of three to 12 months. In this case, however, the period is called an ''initial measurement period.'' If the variable or seasonal employee works an average of 30 hours per week during the initial measurement period, then that employee will be considered a full-time employee during the subsequent stability period. The stability period for variable or seasonal employees must be the same length as the stability period for ongoing employees. The employer may use an administrative period of up to 90 days to determine full-time employee status and to provide eligible employees an opportunity to enroll. The combined initial measurement period and administrative period, however, may not extend beyond the last day of the first calendar month beginning on or after the one-year anniversary of the employee's start date. If the employer determines that the variable or seasonal employee is not a full-time employee, then the employer will not need to treat that employee as full-time during the stability period unless the employee is determined to be a full-time employee during the standard measurement period applicable to ongoing employees and the stability periods overlap.

When Is an Employer Liable for Tax Penalties if it Chooses to Offer Health Coverage?

An employer subject to the Pay or Play Rules will not be liable for any tax penalty if it offers minimum essential health coverage that is affordable and that provides minimum value to at least 95 percent of its full-time employees and none of the remaining 5 percent of full-time employees receive a ''cost sharing reduction'' or ''premium tax credit'' through an exchange (collectively, exchange subsidy). Exchange subsidies are available to reduce the cost of health insurance coverage for certain individuals. A premium tax credit is available to certain individuals whose household income is between 100 percent and 400 percent of the federal poverty level (between $23,550 and $94,200 for a family of four in 2013), who are enrolled in a state health insurance exchange, who are not eligible for Medicaid and who do not receive coverage from an employer that is affordable and

[19] Prop. Treas. Reg. § 54.4980H-3(e).

provides minimum value. On the other hand, an employer may be liable for a tax penalty if it offers coverage that is either not affordable or does not provide minimum value, and one of its full-time employees receives an exchange subsidy (the offer penalty).

The amount of any offer penalty is calculated on a monthly basis and equals the number full-time employees who receive an exchange subsidy that month multiplied by $250 (or $3,000 annually). The amount of the offer penalty cannot exceed the amount of the no-offer penalty described below.

When Is an Employer Liable for Tax Penalties if it Chooses to Not Offer Health Coverage?

If an employer subject to the Pay or Play Rules chooses to not offer health coverage to its employees, then it is liable for a tax penalty if at least one full-time employee receives an exchange subsidy (the no-offer penalty). The amount of the no-offer penalty is calculated on a monthly basis and equals the total number of full-time employees (minus the employer's allocable share of 30 employees of the applicable large employer) multiplied by $166.67 (or $2,000 annually).

When Will Tax Penalties Be Assessed?

Applicable large employers are not responsible to calculate and pay applicable penalties.[20] The IRS will calculate any penalty on an annual basis through a combination of employer and individual reporting and will inform the employer of the assessed tax penalty. If the IRS decides that an employer is required to pay a tax penalty after providing the employer with an opportunity to respond, the IRS will send a notice and demand for payment. Employers have the opportunity to respond to the notice and demand for payment before a penalty is formally assessed.

Examples

Offer Penalty. Assume that Applicable Large Employer A has 5,000 full-time employees during each month of 2014 and is not a member of a controlled group. Applicable Large Employer A offers minimum essential health coverage that is affordable and that provides minimum value to 95 percent of these full-time employees, but 50 of the full-time employees who are not eligible for coverage receive a premium tax credit. Applicable Large Employer A is subject to an offer penalty for 2014 equal to $150,000 (50 * $3,000). Although it would not apply here, the offer penalty would be capped at $9,940,000 ((5,000-30) * $2,000) to avoid a larger penalty than may apply under the no-offer penalty because Applicable Large Employer A offered health coverage to its full-time employees.

No-Offer Penalty. Assume that Applicable Large Employer B has 5,000 full-time employees during each month of 2014 and is not a member of a controlled group. Applicable Large Employer B chooses not to offer health-care coverage to its full-time employees and 50 full-time employees receive a premium tax credit. Applicable Large Employer B is subject to a no-offer penalty for 2014 equal to $9,940,000 ((5,000-30) * $2,000).

What Actions Should An Employer Take?

The delay of the Pay or Play Rules is certainly helpful for employers as they will not face penalties in 2014 for failure to provide adequate coverage to full-time employees. However, employers should take this opportunity to assess whether they will continue to offer health insurance coverage to their employees in the future, and if so, how such coverage should be designed so as to avoid or minimize penalties in 2015. While the Pay or Play Rules are still in proposed format, the IRS has indicated that final rules will be issued before the end of 2013 and it is not likely that the final rules will deviate significantly from the proposed regulations. Because significant tax penalties may be imposed, employers should carefully consider the impact of these rules.

To prepare for compliance, employers will need to identify and categorize employees (full-time, part-time, seasonal, etc.), identify which look back and standard measurement period to use and put procedures in place for tracking hours. For example, if an employer wants to use a 12-month look back period and a 90-day administrative period for 2015 coverage, hours tracking should have already begun in October of 2013. Other possible scenarios employers will be looking at in 2014 include whether or not to continue to offer coverage in 2015 and to which populations of employees, weighing the applicable penalties against the cost of providing coverage, and for certain employers, whether to offer scaled down coverage that will avoid the no-offer penalty but still permit employees to obtain coverage from the Exchanges at a subsidized rate.

[20] The preamble to the proposed regulations in 78 Fed. Reg. 217 (Jan. 2, 2013) provides that ''Any assessable payment under section 4980H is payable upon notice and demand and is assessed and collected in the same manner as an assessable penalty under subchapter B of chapter 68 of the Code.''

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