
# Benefits Alert

Legal developments affecting employee benefits

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## Prompt action required by employers on health care reform: IRS issues "play or pay" regulations

*By Kate Ulrich Saracene, Tonie Bitseff and Thomas J. McCord*

The deadline for compliance with many provisions of the federal health care reform law known as the Affordable Care Act (the "ACA") is now less than a year away. The Internal Revenue Service (IRS) has recently issued proposed regulations defining key terms in the new "Employer Shared Responsibility" requirements of the ACA. These requirements, often referred to as "play or pay" provisions, impose tax penalties on employers with 50 or more employees who do not offer affordable health coverage meeting certain minimum requirements to their full-time employees. It is vital that employers review their health benefit plans now and begin tracking employee hours in light of the new law and regulations.

The Employer Shared Responsibility provisions discussed in the proposed regulations generally go into effect on January 1, 2014. Employers will use information about the employees they employ during 2013 to determine whether they employ enough employees to be subject to these new provisions in 2014, and which of their employees must be offered health coverage.

### Employer shared responsibility: play or pay

One of the ACA's principal goals is to increase the accessibility of health care and decrease the number of individuals who are uninsured. Starting in 2014, employers employing at least 50 "Full-Time Equivalent" employees in the prior year will be deemed "Large Employers" subject to the Employer Shared Responsibility provisions of the ACA. Under these provisions, if employers do not offer health coverage that provides a minimum value of benefits and satisfies certain affordability requirements to their full-time employees, they are subject to an Employer Shared Responsibility nondeductible tax penalty in the event at least one of their full-time employees receives a premium tax credit for purchasing individual coverage on one of the new state-based Affordable Insurance Exchanges ("Exchanges"). In light of these penalties, employers will need to carefully consider whether it is more advantageous for them to "play" by offering affordable health coverage satisfying the minimum value requirements, or to "pay" the ACA's penalties for failure to comply.

**Employer penalties.** Two types of non-deductible tax penalties may be imposed on Large Employers that do not offer affordable health coverage to their full-time employees and their children under age 26. The penalties are expressed as annual penalties that will be adjusted for inflation in subsequent years, but the penalties will be calculated and paid on a pro-rated monthly basis.

The first penalty is imposed if an employer fails to meet the requirement that it offer health coverage to substantially all of its full-time employees and their biological, step, adopted, or foster children under age 26 (the proposed regulations do not require that coverage be offered to employees' spouses or any other type of dependent). If an employer fails to offer health coverage to substantially all of its full-time employees and their children, and the employer has at least one full-time employee certified to receive a subsidy from the federal government through an Exchange (as either a premium tax credit or a cost sharing reduction), then the employer will be required to pay an annual tax of $2,000 per full-time employee per year, but disregarding the first 30 full-time employees. A covered employer will pay the penalty based on its entire full-time employee headcount, even counting those employees who are actually covered by the employer's health plan and who do not receive a government subsidy. The proposed regulations provide limited relief from the statutory requirement to offer coverage to "all" full-time employees, by clarifying that "all" full-time employees means "substantially all" full-time employees, and allowing up to 5% of the employer's full-time workforce to remain uncovered (or 5 employees if 5 is more than 5%) without triggering the penalty. In other words, the employer needs to offer health coverage to at least 95% of its full-time employees to avoid this penalty. This provision is intended to give employers leeway for inadvertent errors in determining which employees are full-time and must be offered coverage.

The second penalty is imposed on Large Employers that *do* offer health insurance coverage to at least 95% of their full-time employees (and their children under age 26), if that coverage does not satisfy the ACA's tests for "Minimum Value" and "Affordability." This type of employer will be subject to a tax of $3,000 per year per full-time employee, but only based on the number of full-time employees who actually procure health coverage through an Exchange and receive a federal subsidy. This penalty cannot be greater than the penalty that would have applied if the employer did not provide health coverage at all.

**The proposed regulations define what is a "full-time employee," what is a "Large Employer," and what coverage is "Affordable" and provides "Minimum Value" for purposes of these penalties. Those explanations follow.**

**Full-time employee.** "Full-time employee" is defined as an employee who averages 30 "Hours of Service" for the employer per week, or 130 Hours of Service per month. Hours of Service include not only hours worked by the employee, but also include those hours for which an employee was paid when no work is performed because of vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty, or leave of absence.

For employees who are not paid on an hourly basis, employers may apply a days-worked equivalency of eight hours per day or a weeks-worked equivalency of 40 hours per week, if this method does not substantially understate an employee's Hours of Service. Hours of Service should be credited for employees paid on commission or other non-salary non-hourly basis (such as credit hours for adjunct faculty) using a reasonable method that does not have the effect of re-characterizing a full-time position as part-time.

Employees who are reasonably expected to be employed on average 30 Hours of Service per week at the time of hire must be treated as full-time employees and offered health coverage by the end of the employee's initial three full calendar months of employment (where the term "calendar month" refers to one of the 12 full months named in the calendar, such as January, February, or March). However, for seasonal employees and employees whose hours vary so that the employer cannot reasonably determine whether they are expected to be employed on average 30 Hours of Service per week, the proposed regulations allow employers to use a "look-back" period to determine whether such an employee is a full-time employee, an option that is discussed in more detail under Safe Harbor for Determining Full-Time Status, below.

**Large employers**. All employers (including for-profit, nonprofit, and government entity employers) that employ at least 50 "Full-Time Equivalent" employees are considered "Large Employers" subject to the Employer Shared Responsibility provisions. Employers will determine each year, based on their current number of employees, whether they will be considered a covered Large Employer for the following year. For example, if an employer employed an average of at least 50 Full-Time Equivalents on business days during 2013, it will be considered a Large Employer for 2014. A Full-Time Equivalent is a full-time employee, or an equivalent combination of full-time and part-time employees. As described above, a full-time employee is an individual employed on average at least 30 Hours of Service per week. Full-time equivalence is determined for a given month by aggregating all part-time employees' service hours that month (up to 120 for each part-time employee) and dividing that number by 120. Employers should average their number of employees across the months in the year to see whether they meet the Large Employer threshold. The averaging can take account of fluctuations that many employers may experience in their work force across the year.

*Special rules for seasonal businesses*. For purposes of determining Large Employer status, seasonal worker headcounts can be backed out of the equation in some circumstances. An employer whose Full-Time Equivalent count meets or exceeds 50 during only 120 or fewer days during the measurement year, can then subtract out the number of seasonal workers who only worked less than or equal to 120 days that year. Four calendar months may be treated the same as 120 days for this purpose, and the four calendar months or 120 days need not be consecutive. The regulators have not yet finalized the definition of "seasonal worker" for these rules, but existing guidance makes it clear that this group is limited to those employees whose work is exclusively performed at certain seasons or periods of the year and which, from its nature, may not be continuous or carried on throughout the year, such as retail workers employed exclusively during holiday seasons, or agricultural workers. Employers are instructed to apply a reasonable good faith interpretation of the term to apply the concept by analogy to other occupations.

*Aggregation of related employers.* The ACA defines a "Large Employer" as including any group of employers under common control that together employ at least 50 Full Time Equivalents during the preceding calendar year. The ACA adopts the same controlled group and affiliated service group rules that are used for aggregating employers for other tax purposes. Those rules generally provide that where businesses share at least 80% common ownership, or where certain service organizations have joint activity, common management, or control, that the businesses are considered a single employer.

The proposed regulations provide that, although Large Employer status is determined on an aggregated basis, the determination of whether an employer is subject to an Employer Shared Responsibility penalty, and the amount of any such penalty, is determined on a member-by-member basis. In other words, the penalty is limited to the entity (the "Large Employer Member") that directly employs the affected individuals. The regulations also clarify that the penalty reduction for the first 30 full-time employees is shared by all of the members of the Large Employer, and that the 30 employees must be divided ratably in proportion to the member's Full Time Equivalents. For example, if a Large Employer has two member employers, one of which provides health coverage to its full-time employees and one of which does not, then only the member that does not provide coverage will pay a penalty. The penalty will be based on the member's own full-time employee headcount, and will be reduced by its pro-rated share of the 30-employee reduction.

Where an employee is employed by more than one Large Employer Member, then an Hour of Service with any one member counts as an Hour of Service with respect to all members.

**Minimum value and affordability**. As explained above, an employer that offers health coverage to its full-time employees will avoid paying the $2,000 penalty on all of its full-time employees, but the employer cannot avoid the second type of penalty unless the health coverage offered satisfies regulatory standards for "Minimum Value" and "Affordability."

The "Minimum Value" standard requires that the plan pay for at least 60% of the total allowed costs for benefits covered under the plan. To determine if the health coverage provides Minimum Value, the IRS and the Department of Health and Human Services will provide a Minimum Value calculator. Employers or insurers will be able to input certain information about the plan, such as deductibles and co-pays, into the calculator and get a determination as to whether the plan provides Minimum Value.

The "Affordability" standard requires that an employee's share of the premium cost for self-only coverage under the employer plan cannot exceed 9.5% of the employee's household income. If an employer offers multiple health care coverage options, the Affordability test applies to the lowest-cost option available to the employee that also meets the Minimum Value requirement. Because employers generally will not have information about their employees' household incomes, the proposed regulations provide a number of "safe-harbors" that allow an employer to avoid the penalty even if the employee receives a subsidy through an Exchange. Utilizing the Affordability safe harbors, employers can use any of the following measures as a proxy for household income: (1) the employee's W-2 wages, (2) the employee's current monthly pay rate, or (3) the federal poverty line. An employer may use these optional safe harbors for all its employees or any reasonable classification on a uniform and consistent basis.

The first optional safe harbor permits the employer to compare the employee's contribution to the wages reported in Box 1 of Form W-2. Application of this safe harbor is determined after the end of the calendar year, and W-2 wages are adjusted for employees working less than a full-year. A downside of the W-2 safe harbor is that elective pre-tax salary reductions, such as voluntary cafeteria plan and 401(k) contributions, do not appear in Box 1, and thus require a larger employer subsidy than would be required if measured against the employee's salary.

To address this concern, the regulators offer an alternative "rate of pay safe harbor." This safe harbor is met if the employee's monthly contribution amount is not more than 9.5% of the employee's monthly salary (if exempt) or hourly rate of pay times 130 hours (if paid on an hourly basis). The downside is that it does not count all hours worked for full-time hourly employees.

A final safe harbor is met if the employee cost for the lowest cost coverage that provides Minimum Value is not more than 9.5% of the most recently reported federal poverty line for a single individual as of the first day of the applicable plan year.

**Termination of coverage due to nonpayment or late payment of premiums.** An employer will not be subject to a penalty for failing to offer health coverage to a full-time employee for a month if the employee's coverage is terminated due to the nonpayment or late payment of premiums. This exemption may continue through the end of the coverage period (typically the plan year) in which the termination of coverage occurred. However, an employer is not permitted to terminate coverage for such reasons unless it has complied with procedures equivalent to the COBRA procedures for nonpayment or late payment of premiums, including a 30-day grace period and special rules with respect to timely payments that are not significantly less than the amount required to be paid.

## Safe-harbor for determining full-time status

**Using "Measurement Periods" and "Stability Periods" to determine full-time status**. The proposed regulations allow employers to use a "look-back" period to determine whether certain employees work full-time. This method is generally only available for seasonal employees and those employees whose hours vary and for whom it cannot be reasonably determined whether they are expected to be employed on average 30 Hours of Service per week.

To use this method, the employer must assess whether the variable-hour or seasonal employee averaged 30 or more Hours of Service per week during the "Measurement Period." If so, the employee is treated as a full-time employee for the "Stability Period," a period of time following the Measurement Period where the employee would need to be offered coverage regardless of the employee's Hours of Service during that period, so long as he remained employed.

The length of the Measurement Period is selected by the employer, and must be at least three but not more than 12 consecutive months long. The employer generally must apply its Measurement Periods and Stability Periods on a uniform and consistent basis. The employer may, however, use Measurement Periods and Stability Periods that differ either in length or in their starting and ending dates for the following categories of employees: (1) collectively bargained vs. non-collectively bargained employees, (2) each group of collectively bargained employees covered by a separate collective bargaining agreement, (3) salaried employees vs. hourly employees, and (4) employees whose primary places of employment are in different states. Each Large Employer Member can also set its own Measurement Periods and Stability Periods.

Employers may take time in between the end of the Measurement Period and the beginning of the Stability Period to determine which employees are eligible for coverage and to notify employees of such determinations. This time, known as an "Administrative Period," may last up to 90 days, and must overlap with the prior Stability Period so as to provide continuous coverage to eligible employees. The Stability Period must begin immediately after the end of the Measurement Period and any applicable Administrative Period.

The look-back Measurement Period rules are similar for new employees and ongoing employees, but there are some important differences between the two groups.

*Ongoing employees*. The Measurement Period for ongoing employees is referred to as a "Standard Measurement Period."

- The employer selects the months in which the Standard Measurement Period starts and ends.
- Once an employee has been employed for at least one Standard Measurement Period, the employee is considered an "ongoing employee" and his eligibility for coverage as a full-time employee is subject to the Standard Measurement Period rules.
- If the employee averages 30 or more Hours of Service per week during the Standard Measurement Period, then the employee must be treated as a full-time employee and offered health coverage for the entire duration of the Stability Period that follows, which must be at least as long as the Standard Measurement Period itself, and cannot be less than six months.
- If an employee was not employed an average of at least 30 Hours of Service per week during the Standard Measurement Period, then the employer may treat the employee as not a full-time employee during the Stability Period that follows, so long as the Stability Period is no longer than the Standard Measurement Period.

*New employees*. The Measurement Period for new employees is referred to as an "Initial Measurement Period." Whether new employees are subject to the Initial Measurement Period rules depends on whether they are reasonably expected to be full-time on their start date. New variable-hour or seasonal employees remain subject to these rules until they have worked for an entire Standard Measurement Period and become an ongoing employee.

- If the employer cannot determine that the new employee is reasonably expected to average at least 30 Hours of Service per week, or if the employee is a seasonal employee, the employer can wait to offer coverage to the employee until after he has averaged 30 Hours of Service per week during an "Initial Measurement Period."
- The Initial Measurement Period can begin on any date between the new employee's start date and the first day of the first calendar month following the employee's start date.
- If the new employee averages 30 or more Hours of Service per week during the Initial Measurement Period, then the employee must be treated as a full-time employee and offered health coverage for the entire duration of a Stability Period, which must be the

same length as the Stability Period for ongoing employees following a Standard Measurement Period.

- If the new employee averages less than 30 Hours of Service per week during the Initial Measurement Period, then the employee does not need to be offered health coverage during the subsequent Stability Period, but this period of no coverage cannot be longer than the Initial Measurement Period plus one month, and must end before the beginning of the first standard Stability Period for which the employee would be an ongoing employee. If the employee averages at least 30 Hours of Service per week during the overlapping or immediately following Standard Measurement Period, the employee must be treated as a full-time employee for the entire Stability Period that corresponds to that Standard Measurement Period.

- There is a special rule for the Administrative Period associated with an Initial Measurement Period, providing that the two periods combined may not extend beyond the last day of the first calendar month beginning on or after the one-year anniversary of the new employee's start date. Thus, an employer could not utilize a full 12-month Initial Measurement Period and a full 90-day Administrative Period.

- Any period between a new employee's hire date and the start of the Initial Measurement Period counts toward the 90-day limit on the length of the Administrative Period. For example, if the employer begins the Initial Measurement Period on the first day of the first month following a new employee's start date, the period between the employee's start date and the first day of the next month must be taken into account in applying the 90-day limit on the Administrative Period.

**Statutory leaves of absence and other employment breaks.** When applying the safe-harbor, special rules apply to calculating average hours for employees taking statutory leaves of absence and for employees of educational institutions. When computing average hours during a look-back Measurement Period, an employer must either (1) exclude any periods of unpaid Family and Medical Leave (FMLA) or military leave under the Uniformed Services Employment and Reemployment Rights Act (USERRA), or (2) credit the employee with Hours of Service for such leave periods at a rate equal to the employee's average weekly Hours of Service during the weeks in the Measurement Period that are not part of the unpaid leave period. Educational institutions must also apply similar rules to employment break periods of four or more weeks under the academic calendar, but are not required to credit the employee with more than 501 such hours for such employment breaks during any calendar year.

The proposed regulations also describe the limited circumstances under which an employee who is rehired after termination of employment, or who resumes service after a period of absence, may be treated as a new employee. In the event the employee ceased providing services for at least four weeks, the individual may be treated as a new employee if the number of weeks he was not providing services exceeded the number of weeks of his period of employment immediately preceding the service interruption. Otherwise, an individual can be treated as a new employee only if he had no Hours of Service for a period of at least 26 consecutive weeks immediately preceding the resumption of services. These rules do not apply to absences that are unpaid leave under the FMLA or USERRA.

**Changes in employment status.** The regulations provide that a new variable-hour or seasonal employee who has a change in employment status during an Initial Measurement Period to a regular full-time position must be treated as a full-time employee no later than the first day of the fourth month following the change in employment status (or sooner if he averaged 30 Hours of Service per week during the Initial Measurement Period, and the Stability Period associated with the Initial Measurement Period begins prior to that date). This change in employment status rule only applies to new variable-hour and seasonal employees. A change in employment status for an ongoing employee does not change the employee's status as a full-time employee or non-full-time employee during the Stability Period. The regulations do not address how to handle a change in employment status of an employee whose hours do not vary.

**Use of payroll periods.** The regulations contain special rules for using payroll periods to calculate Measurement Periods where the payroll period is weekly, bi-weekly, or semi-monthly. For example, an employer using the calendar year as a Measurement Period could exclude the entire payroll period that included January 1 (the beginning of the year) if it included the entire payroll period that included December 31 (the end of that same year).

## Transitional relief

The proposed regulations provide transitional relief in a number of areas to provide employers with time to implement the required changes. A summary of the key provisions of that relief follows.

**Dependent coverage.** If an employer is taking steps to offer dependent coverage to employees' children under age 26, the employer will be treated as providing health coverage during plan years that begin on a date in 2014, even if the employer does not yet offer coverage that would cover these dependents. Such coverage must be in place by plan years that begin in 2015.

**Variable-hour employees.** Until January 1, 2015, the determination of whether a new non-seasonal employee is a variable-hour employee may be based on the likelihood that the particular employee's employment will terminate during the Initial Measurement Period, where there are objective facts and circumstances specific to the new employee demonstrating that his employment is reasonably expected to be of limited duration. This determination cannot be based on employer expectations regarding aggregate turnover. Effective January 1, 2015, except in the case of seasonal employees, employers will be required to assume that the new employee will continue to be employed by the employer for the entire Initial Measurement Period. This rule will effectively convert many temporary employees to full-time employee status.

**Fiscal plan years.** For an employer that as of December 27, 2012, already offers health coverage through a plan that operates on a fiscal year, transition relief is available until the first day of the fiscal plan year that begins after January 1, 2014. During the transition, the employer will not be subject to a penalty for any employees who are eligible to participate in the plan under its terms as of December 27, 2012 (whether or not they take the coverage). Additionally, if (a) the fiscal year plan (including any other fiscal year plans that have the same plan year) was *offered* to at least one-third of the employer's employees (full-time and part-time) at the most recent open enrollment period or (b) the fiscal year plan actually *covered* at least one quarter of the employer's employees, then the employer also will not be subject to the Employer Shared Responsibility penalty with respect to any of its full-time employees until the first day of the fiscal plan year starting in 2014, provided that those full-time employees are offered Affordable coverage that provides Minimum Value no later than that first day of that year. So, for example, if during the most recent open enrollment period preceding December 27, 2012, an employer offered coverage under a fiscal year plan with a plan year starting on July 1, 2013, to at least one-third of its employees, the employer could avoid liability for a payment if, by July 1, 2014, it expanded the plan to offer coverage satisfying the Employer Shared Responsibility provisions to the full-time employees who had not been offered coverage. For purposes of determining whether the plan covers at least one quarter of the employer's employees, an employer may look at any day between October 31, 2012, and December 27, 2012.

**Shortened period to determine large employer status**. The regulators recognize that employers intending to adopt a 12-month Measurement Period, and in turn a 12-month Stability Period, will face time constraints in doing so this year. Consequently, solely for purposes of Stability Periods beginning in 2014, employers may adopt a transition Measurement Period that is shorter than 12 months but that is no less than six months long, and which begins no later than July 1, 2013, and ends no earlier than 90 days before the first day of the plan year beginning on or after January 1, 2014. For example, an employer with a calendar year plan could use the Measurement Period from April 15, 2013, through October 15, 2013, and then have the remainder of the calendar year to analyze the results, determine whether it needs to offer a plan, and, if so, choose and establish a plan and enroll participants.

**Multiemployer plans.** The proposed regulations contain a transition rule that applies through 2014 for contributions made by employers participating in a multiemployer plan. Under this transition rule, an employer will not be treated as failing to offer health coverage to a full-time employee and will not be subject to a penalty if (i) the employer is required to make a contribution to a multiemployer plan with respect to the full-time employee pursuant to a collective bargaining agreement or a related participation agreement, (ii) coverage under the multiemployer plan is offered to the full-time employee (and the employee's dependents), and (iii) the coverage offered to the full-time employee is Affordable and provides Minimum Value. For purposes of measuring Affordability, employers may compare the employee's share of the cost for self-only coverage to the wages reported to the multiemployer plan, which may be determined based on actual wages or an hourly wage rate under the applicable collective bargaining agreement.

**Cafeteria plan election changes.** Most employees pay their share of health insurance premiums on a pre-tax basis through a Code Section 125 cafeteria plan. Generally, cafeteria plan elections must be made before the start of the plan year, and are irrevocable during the plan year unless an employee experiences a qualifying election change event. The regulators recognize that employees whose employers sponsor fiscal year plans may want to drop coverage at the beginning of 2014 in order to participate in an Exchange, or conversely, may want to enroll for coverage through the employer's plan in order to avoid an individual tax penalty beginning in 2014. The regulators have therefore provided transition relief from the cafeteria plan election rules for employer-provided health plans. This transition relief permits employees to revoke, modify, or commence salary reductions for health coverage offered through a cafeteria plan with a fiscal year plan beginning in 2013 (and does not apply to any other qualified benefit offered through a cafeteria plan). Under this transition rule, employers may amend their plans to permit employees to prospectively revoke, modify, or commence health plan elections on a prospective basis once during that plan year, without regard to whether the employee experienced a change in status event described in the cafeteria plan regulations. Employers may amend their plans to add this rule so long as the amendment is made by December 31, 2014, and is effective retroactively to the first day of the 2013 cafeteria plan year.

## Open issues and expected guidance

The proposed regulations provide welcome guidance, but there are still many questions as to what the Employer Shared Responsibility will look like. The proposed regulations may only be relied on until final regulations are issued, but a reasonable period of time to comply with any additional restrictions contained in the final regulations is expected.

The proposed regulations reserve for further guidance or request comments on a number of issues. For example, they provide a transitional rule for multiemployer plans, but otherwise request guidance on multiemployer plan rules and treatment. Similarly, application of the aggregation rules for determining Large Employer status will be based on a "good faith interpretation" for government and church plans until further guidance is issued. Until safe harbors or presumptions are provided to assist new employers, a new employer will be a Large Employer if it is "reasonably expected to employ at least 50 full-time employees during the current calendar year. Comments are also invited with respect to application of the rules to staffing agencies, and the preambles indicate that the regulators are planning to address potential employer abuse in utilizing staffing agencies in the final regulations. We also expect further guidance addressing how to credit Hours of Service for employees paid on commission or other non-salary non-hourly basis (such as credit hours for adjunct faculty), and that additional guidance will be forthcoming with respect to seasonal employees, and employment break periods for employers that are not educational institutions.

The proposed regulations simply leave certain issues unaddressed, such as how certain employer contributions to the cost of health insurance, like wellness incentives and cafeteria plan flex credits, are treated for purposes of determining whether an employee's contribution exceeds 9.5% of household income.

Employers will need to begin planning and tracking hours now to comply with the rules by 2014, but will also need to expect changes and revisions as the agencies work through the compliance challenges and issues.

For more information, please contact your Nixon Peabody attorney or:

- Kate Ulrich Saracene at 585-263-1438 or ksaracene@nixonpeabody.com
- Tonie Bitseff at 415-984-8294 or tbitseff@nixonpeabody.com
- Thomas J. McCord at 617-345-1337 or tmccord@nixonpeabody.com