TUGGLE DUGGINS

ATTORNEYS AT LAW

HEALTH CARE REFORM WHETHER TO PLAY OR PAY (Detailed Summary)

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WHETHER TO PLAY OR PAY
(Detailed Summary)

On December 28, 2012, the Treasury Department and the IRS issued proposed regulations on the employer shared responsibility provisions of the Patient Protection and Affordable Care Act ("ACA"). This is sometimes known as the employer coverage mandate or the "play or pay" provisions. In November 2012, we provided a summary of these play or pay provisions based on the guidance issued up to that point.

The proposed regulations modify and clarify several provisions of our prior summary and we have revised the questions and answers below accordingly. Importantly, the proposed regulations provide welcomed relief for employers offering coverage to at least 95% but less than 100% of their full-time employees and also provide favorable rules on how penalties will be calculated and assessed in controlled groups and other related employer situations.

These Q&A's are in four sections. Section A addresses which employers will be considered large employers subject to play or pay. Section B covers the penalty assessed when an employer fails to offer group health coverage to substantially all of its full-time employees (this summary uses the term penalty as opposed to tax but the terms are interchangeable). Section C describes the penalty assessed when an employer offers group health coverage to substantially all of its full-time employees but that coverage does not meet the minimum value and/or affordability standards of the ACA. Section D addresses miscellaneous provisions and transitional rules.

Of course, the rules regarding play or pay are complex and these Q&A's are intended as just a very general guide. We are here to assist with the details as they apply to any specific employer.

A. <u>Only Large Employers are Subject to Play or Pay.</u>

A1. What is a large employer?

Answer: A large employer is one that employs, on average, at least 50 full-time employees (or combination of full-time and full-time equivalent employees) on business days during the preceding calendar year. A large employer can be any sort of business entity: C-Corp., S-Corp., LLC, non-profit, partnership or sole proprietorship with common law employees.

A2. How are affiliated employers treated?

Answer: All entities in an employer's controlled group, affiliated service group or under common control will be treated as a single employer in making the determination of large employer status. These are all concepts imported from the qualified retirement plan rules. The rules for determining controlled groups and affiliated service groups can be complex with attribution of stock among entities and individuals, certain stock being excluded from the determination, as well as examining the business relationships between service organizations. As a general notion, however, "breaking up" an employer into a number of smaller entities with common ownership would not work to avoid status as a large employer.

A3. How are new employers and predecessor employers treated?

Answer: A new employer will be a large employer if it reasonably expects to employ an average of at least 50 full-time employees (or combination of full-time and full-time equivalent employees) on business days during the current calendar year. Further guidance is expected on what "reasonably expects" means and the preamble to the proposed regulations requests comments on whether any safe harbors or presumptions should be adopted to assist a new employer in determining whether it is a large employer.

Also, the ACA states that in making this large employer determination, predecessor entities must be included. Further guidance is expected on what is a predecessor employer/entity but the preamble to the proposed regulations note that rules for identifying predecessor/successor employers have been developed in the employment tax context and it is anticipated that similar rules will apply in determining if an employer is a successor.

A4. Who is an employee?

Answer: The proposed regulations state that a "common law" analysis is used to determine who is an employee and specifically provide that sole proprietors, partners, and 2% or more owners of an S Corporation will **not** be treated as "employees." Although not stated explicitly, members of an LLC taxed as a partnership will also presumably be excluded from this definition of "employee." This may be an important clarification for certain professional practices that have a large number of partners or LLC members taxed as partners. Excluding those partners may mean that an employer will not have the requisite combination of 50 full-time employees or full-time equivalent employees to make that employer a large employer.

In the preamble to the regulation, the Treasury Department and IRS warn that there will be "anti-abuse" rules in any final regulations to prevent employers from using staffing agencies to avoid penalties. The preamble notes the IRS' awareness of certain structures where employers might use a staffing agency which would purport to employ a worker for only part of a week, such as 20 hours, and then the employer would directly employ the same individual directly for the remaining hours of the week. Similarly one staffing agency might purport to employ a worker and supply that worker to an employer for only part of a week, such as 20 hours, while a second staffing agency would purport to employ and provide the same individual to the employer for the remainder of the week. Commenting on these arrangements, the preamble notes that "only in rare circumstances, if ever" would the employer under these fact patterns not employ the individual under the common law standard as a full-time employee and that these arrangements would fall under the anti-abuse rule.

A5. Who is a "full-time employee" for purposes of determining large employer status?

Answer: A full-time employee is determined on a month to month basis and is a person who is employed on average 30 "hours of service" per week. Employers may use a 130 hours of service per month as an alternative standard. Since this is a month to month test, an employee could be a full-time employee for some months but not others. For those months the employee was not a full-time employee, he or she would be included in the calculation of full-time equivalent employees discussed below.

Hours of service include (1) each hour for which an employee is paid, or entitled to payment, for the performance of duties for the employer; and (2) each hour for which an employee is paid, or entitled to payment by the employer on account of a period of time during which no duties are performed due to vacation, holiday, illness, incapacity, disability, layoff, jury duty, military duty or leave of absence.

For employees not paid on an hourly basis, employers are permitted to calculate the number of hours of service under any of the following three methods: (1) counting actual hours of service; (2) using a days-worked equivalency method where 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; or (3) using a weeks-worked equivalency of 40 hours of service per week for each week for which the employee would be required to be credited with at least one hour of service. Employers may use different methods of crediting service for non-hourly employees based on job classifications.[1]

All hours of service in a controlled group or affiliated service group must be included in determining full-time status.

Hours of service do not generally include hours worked outside of the United States.

The preamble notes that special rules may be adopted in the future regarding hours of service for employees compensated on a commission basis, adjunct faculty, transportation employees (pilots) and other analogous positions. Until further guidance is given, an employer must use a "reasonable method" for calculating hours of service for these employees.

[1] The proposed regulations, however, prohibit use of the days-worked or weeks-worked equivalency method if the result would be to substantially understate an employee's hours of service. As an example, an employer may not use a days-worked equivalency in the case of an employee who generally works three 10-hour days per week, because the equivalency would substantially understate the employee's hours of service as 24 hours of service per week.

The proposed regulations clarify that the guidance that was previously issued and also contained in the proposed regulations regarding the safe harbor for determining full-time employees in the context of determining how to calculate any play or pay penalty (discussed in Q&A B6 below) ***cannot*** be used in making the determination of whether an employer is a large employer.

A6. Who is a "full-time equivalent employee"?

Answer: Solely for purposes of determining whether an employer is a large employer, part-time employees are included in a calculation to determine the number of full-time equivalent employees ("FTEs"). For each month, an employer would total the hours of service for all employees who are not full-time employees and divide by 120. The result is the number of FTEs for the month. FTE's are then added to the full-time employees for the month in determining the yearly average. Again, these rules can be complex, especially for employees who alternate between working more or less than thirty hours of service per week during the year.

Also, seasonal workers are initially considered in the calculation of full-time employees and FTEs, but in certain cases an employer can exclude seasonal workers if the employer exceeded 50 employees on 120 days (three calendar months) or fewer in the calendar year due solely to those seasonal workers. Under prior guidance, this exclusion for seasonal workers in determining whether an employer is a large employer follows the definition of a seasonal worker used in other Department of Labor contexts but the exclusion will include retail workers employed exclusively through the holiday seasons. The proposed regulations also now allow employers to use any other "reasonable good faith interpretation" for seasonal worker in applying this exception.

The proposed regulations use two different terms—"seasonal worker" and "seasonal employee." The term "seasonal worker" is used only in the context of determining whether an employer is a large employer. For employers that use the safe harbor method for determining full-time status of employees ***for purposes of determining any penalty*** the term "seasonal employee" is used as discussed in Q&A B6 below and this definition may be broader than the seasonal worker exclusion.

Also, remember that the FTE rules are solely for the purpose of determining whether an employer is a large employer covered by play or pay and not used to determine any penalty. Only full-time employees are included in the actual penalty calculation. For example, an employer may have 25 employees who work full-time and 500 employees who work 25 hours per week. That employer would be a large employer because of the FTE rule but would not owe any penalty related to the 500 part-time employees. Recently, the press has reported that some large restaurant chains are considering a strategy of limiting employee work-weeks to less than 30 hours so that the employee never achieves full-time status.

A7. So, how do I make this calculation to determine whether I am a large employer?

Answer:
(1) Calculate the total hours of service (but not more than 120 hours per employee) for all employees who are not full-time employees for a month;
(2) Divide the total hours of service from Step 1 by 120. The result is the number of FTEs for the calendar month. Do not drop any fractional amounts;
(3) For each month add the total number of full-time employees and FTE employees;
(4) Add the numbers in Step 3 for each month to reach a yearly total; and
(5) Divide the yearly total by 12. Disregard any fractions. If the result is 50 or more, the employer is generally a large employer with the possible exception of the seasonal worker rule discussed in Q&A A6 above.

Also see Q&A D4 with regard to special optional transitional rule for determining full-time employees for 2013 which will be used in making a large employer determination for 2014.

B. <u>Penalty for Large Employers Who Do Not Offer Coverage to Substantially All Full-Time Employees.</u>

B1. What is the penalty for a large employer who fails to offer minimum essential coverage to substantially all full-time employees (and their dependents)?

Answer: There is a non-deductible penalty if a large employer does not offer minimum essential coverage to substantially all full-time employees (and their dependents) through an employer plan. The employer must pay an annual penalty of $2,000 for each full-time employee (less the first 30), if at least one full-time employee receives a federal tax credit or cost sharing reduction ("subsidy") through an Exchange. For purposes of this summary, this will be called the "No Offer Penalty". While we express the No Offer Penalty as an annual amount, it is actually determined on a monthly basis which would be the number of full-time employees the employer employed for the month (minus up to 30) multiplied by 1/12 of $2,000.

As mentioned above, the FTE rule does not apply in determining the amount of the No Offer Penalty and there is no penalty for failing to offer coverage to part-time employees.

B2. What does "substantially all" mean?

Answer: An employer will be considered to offer coverage to substantially all of its full-time employees and their dependents even if it fails to offer coverage to 5% or fewer of those employees (or, if greater, 5 employees). This was an important clarification in the proposed regulations.

Even though an employer will not be responsible for the "No Offer Penalty" in an instance where coverage is offered to 95% of its full-time employees and their dependents, the employer would still owe "Inadequate Coverage Penalty" discussed in Section C of this summary if a full-time employee is not offered coverage and receives a subsidy for coverage through an Exchange.

B3. Who is a dependent?

Answer: A dependent only includes an employee's child up to the age of 26 and does not include spouses. For plans that do not cover children, the proposed regulations provide a transition rule and those employers have until 2015 to add dependent coverage. Also, remember to avoid the "No Offer Penalty" the only requirement is that minimum essential coverage be offered to full-time employees and their dependents without respect to the employees' cost of that coverage. Cost, however, is factored in for the Inadequate Coverage Penalty discussed in Section C below. But, even then, that cost relates to single or self-only coverage and not dependent coverage.

B4. What is minimum essential coverage?

Answer: Generally any employer group major medical coverage will be determined to be minimum essential coverage. If an employer ***only*** offers limited scope dental or vision benefits, only coverage through on-site medical clinics, or only certain types of hospital indemnity of fixed indemnity insurance it will not be providing minimum essential coverage. But generally any type of group major medical coverage—insured or self-insured—will count as minimum essential coverage. Please remember, however, that while offering minimum essential coverage through an employer plan to substantially all full-time employees will exempt an employer from the No Offer Penalty discussed in this Section B, that employer could still be subject to the Inadequate Coverage Penalty described in Section C below if that coverage also does not provide a "minimum value" as well as being "affordable".

B5. Which employees are eligible for a federal tax credit or cost sharing subsidies?

Answer: Employees who obtain individual coverage through an Exchange and meet the following criteria will be eligible for a subsidy either in the form of a federal tax credit or cost sharing subsidy.

a) The employee's household income from the taxable year is 100% to 400% of the poverty line for the employee's family size.
b) The employee is not eligible for Medicaid or other government sponsored healthcare.
c) The employee is not offered minimum essential group medical coverage through an employer sponsored plan that provides both minimum value and is affordable.

Exchanges are mechanisms intended to make it easier for individuals and small businesses to find, compare, and buy health insurance. If a state does not establish an Exchange, then the federal government will establish an Exchange for the state.[2]

B6. Who is a full-time employee for penalty purposes?

Answer: In August 2012, the IRS issued guidance on an optional "safe harbor" for determining who will be a full-time employee for purposes of assessing the play or pay penalty. This guidance was intended to avoid a month to month determination of full-time status. That guidance was then incorporated into the proposed regulations.

For the safe harbor, the proposed regulations use "measurement periods" and "stability periods" and have different rules for ongoing employees, new employees expected to work full-time and new employees whose hours may vary or who may only be employed seasonally. There is also an optional "administrative" period. These rules are very complex but are summarized below.

1. Ongoing Employees

For ongoing employees an employer using the safe harbor method would select a "standard measurement period" which must be at least 3 but not more than 12 months. An ongoing employee would be one who has worked for at least one standard measurement period. If the ongoing employee averages 30 hours per week during this standard measurement period, he or she will be a full-time employee for the "stability period". The stability period must be the greater of 6 consecutive months or the length of the standard measurement period. Generally, the same measurement and stability period must apply to all ongoing employees with exceptions that would permit different periods based on the following distinctions: salaried and non-salaried employees; collectively bargained and non-collectively bargained employees; collectively bargained employees covered by separate bargaining agreements; and, employees in different states.

An administrative period is the optional period that may come after the standard measurement period and before the stability period and cannot exceed 90 days. The administrative period must overlap with the prior stability period to ensure that an ongoing full-time employee would retain coverage.

[2] There is currently disagreement over whether employees who participate in federally established Exchanges can receive a federal subsidy. The IRS' current position is that they can. This position has been challenged in court and the outcome could have an effect on, not only which employees receive a federal subsidy, but could also affect the calculation of any play or pay penalty since one of the prerequisites to trigger the penalty is that at least one full-time employee receive a federal subsidy.

2. New Employees Expected to Work Full Time

For new employees, who are expected (as of their start date), to work full-time, no penalty will apply solely because an employer does not offer coverage to the full-time employees during their first three calendar months of employment. The preamble to the proposed regulations suggest that further guidance may be forthcoming on when an employee is "reasonably expected" to work full-time including whether the employee is replacing an employee who is a full-time employee or whether the hours of service of ongoing employees in the same or comparable positions actually vary.

3. New Variable Hour or Seasonal Employees

If a new employee's hours are going to vary between full-time and part-time, or if the employee is hired seasonally, then there are different measurement and stability period rules that apply. The determination of whether an employee is hired "seasonally" for this purpose is currently subject to a reasonable good faith interpretation. As noted above, the term seasonal employee is not necessarily the same as a seasonal worker for determining whether an employer is a large employer. The preamble to the proposed regulations note, however, that it is not a reasonable good faith interpretation to treat an employee of an educational organization, who works during the active portions of the academic year, as a seasonal employee. The preamble to the regulations also state that the Treasury and the IRS may, in the future, adopt a specific employment time limit for treating an employee as seasonal.

Effective as of January 1, 2015, and except in the case of seasonal employees, an employer will be required to assume that an employee will continue to be employed by the employer for the entire initial measurement period. Accordingly, for variable hour employees, the employer will not be permitted to take into account the likelihood that the employee's employment will terminate before the end of the initial measurement period.

Under the safe harbor, a new seasonal and/or new variable hour employee will have an "initial measurement period" that will be a period of between 3 and 12 months. The initial measurement period begins on any date between an employee's start date and the first day of the next calendar month. The initial measurement period and the administrative period combined cannot be more than thirteen months.

If the employee averages 30 hours per week during the initial measurement period he/she will be treated as a full-time employee for the stability period. That stability period must be the same length as that for ongoing employees (which cannot exceed 12 months). Also, this stability period must not be more than 1 month longer than the initial measurement period and must not exceed the remainder of the standard measurement period (plus any associated administrative period) in which the initial measurement period ends. According to the proposed regulations, the purpose of this provision is for employers that wish to use a 1 year stability period and also use an administrative period that exceeds 1 month. For example, an employer could use 12 month stability period, an 11 month initial measurement period and a

2 month administrative period and still comply with the general rule that the initial measurement period and administrative period combined cannot exceed 13 months.

If a new variable hour or seasonal employee is determined not to be a full-time employee during the initial measurement period, the employee is treated as a part-time employee during the stability period that follows the initial measurement period.

The optional administrative period cannot exceed 90 days and can come before or after the initial measurement period.

The proposed regulations give the following two examples of acceptable initial measurement and administrative periods for new variable hour or seasonal employees for an employer using a 12 month stability period.

Example 1 *(12-Month Initial Measurement Period Followed by 1+ Partial Month Administrative Period). For new variable hour employees, Employer B uses a 12-month initial measurement period that begins on the start date and applies an administrative period from the end of the initial measurement period through the end of the first calendar month beginning on or after the end of the initial measurement period. Employer B hires Employee Y on May 10, 2015. Employee Y's initial measurement period runs from May 10, 2015, through May 9, 2016. Employee Y has an average of 30 hours of service per week during this initial measurement period. Employer B offers coverage to Employee Y for a stability period that runs from July 1, 2016 through June 30, 2017.*

Example 2 *(11-Month Initial Measurement Period Followed by 2 + Partial Month Administrative Period). (i) Facts. Same as Example 1, except that Employer B uses an 11-month initial measurement period that begins on the start date and applies an administrative period from the end of the initial measurement period until the end of the second calendar month beginning after the end of the initial measurement period. Employer B hires Employee Y on May 10, 2015. Employee Y's initial measurement period runs from May 10, 2015, through April 9, 2016. Employee Y has an average of 30 hours of service per week during this initial measurement period. Employer B offers coverage to Employee Y for a stability period that runs from July 1, 2016 through June 30, 2017.*

As with ongoing employees, the same measurement and stability period must apply to all new variable hour or seasonal employees but with the same exceptions that apply to ongoing employees (distinctions such as hourly/salaried, collectively bargained, etc.).

For seasonal employees, using a longer initial measurement period may mean that there is less chance that employees will be full-time. For example, if a seasonal employee only works 4 months and the employer uses an 11 month initial measurement period, then that employee might not average 30 hours per week over the entire initial measurement period even if he or she puts in far more than 30 hours per week while employed. Also, in many instances the seasonal employee may have terminated employment before the end of the initial measurement period.

4. Other Rules/Changes in Status/Rehires

A variable hour/seasonal employee determined to be a full-time employee during an initial measurement period must be treated as a full-time employee for the entire associated stability period even if the employee is determined not to be a part-time employee during the overlapping or immediately following standard measurement period. In that case, the employer may treat the employee as a part-time employee only after the end of the stability period associated with the initial measurement period. On the other hand, if the employee is determined not to be a full-time employee during the initial measurement period, but is determined to be a full-time employee 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 even if it overlaps a portion of the new employee stability period.

The proposed regulations also provide that a new variable hour or seasonal employee who has a change in employment status during an initial measurement period must be treated as a full-time employee as of the first day of the fourth month following the change in employment status or, if earlier, under the ordinary rules for new variable hour seasonal employees discussed above. A change in employment status is a change in such a way that, if the employee had first begun employment in the new position or status, the employee would have reasonably been expected to be employed on average at least 30 hours of service per week. The change in employment status rule only applies to new variable hour and seasonal employees during the initial measurement period. A change in employment status for an ongoing employee does not change the employee's status as a full-time employee or part-time employee during the stability period.

When an employee is rehired or returns from unpaid leave, the proposed regulations address the issue of whether the employee may be treated as a new employee. If the period for which no hours of service are credited is at least 26 consecutive weeks, an employer may treat a returning employee as a new employee. The employer may also choose to apply a "rule of parity" for periods of less than 26 weeks. Under the rule of parity, an employee may be treated as having terminated employment and having been rehired as a new employee if the period with no credited hours of service is at least 4 weeks long and is longer than the employee's period of employment immediately preceding that period with no credited hours of service. For example, under this optional rule of parity if an employee works 3 weeks, terminates employment, and is rehired by that employer 10 weeks after terminating employment, that rehired employee may be treated as a new employee because the 10-week period of no credited hours of service is longer than the immediately preceding 3-week period of employment. This rule is only applicable for determining full-time employee status for purposes of penalties and not for other purposes, such as determining whether an employer is a large employer. There are also additional requirements that apply to employment break periods for employees of educational organizations as well as for unpaid leave due to FMLA, USERRA and jury duty.

The IRS has requested comments concerning treatment of short-term employees, the possibility of special rules for high turnover positions and employees of temporary agencies.

Finally, see Q&A D3 for an optional transitional rule regarding 2013 measurement period for determining full-time employees for the 2014 stability period.

Again, these rules are very complex and we would be glad to assist employers in any calculations.

B7. What is an offer of coverage?

Answer: In order for there to be an offer of coverage the employee must be given an effective opportunity to elect to enroll (or decline to enroll) in the coverage no less than once during the plan year. Whether an employee has an effective opportunity is determined based on all the relevant facts and circumstances, including adequacy of notice of the availability of the offer of coverage, the period of time during which acceptance of the offer of coverage may be made, and any other conditions on the offer.

The proposed regulations provide that if coverage is not provided because an employee has failed to pay a premium, the employer will still be treated as offering that employee coverage.

B8. How are controlled groups and affiliated service groups treated for purposes of the No Offer Penalty?

Answer: As mentioned above, the determination of whether an employer is a "large employer" is based on the controlled group and affiliated service group rules. Importantly, the proposed regulations clarify that if the penalty is triggered, it is calculated and assessed on each member of the controlled group or affiliated service group and not based on the entire controlled group or affiliated service group. No member of a controlled group or affiliated service group is liable for the other member's penalty. The 30 employee reduction or credit for the No Offer Penalty is then allocated pro-rata among the controlled group based on the number of full-time employees.

This distinction is an important modification from our prior version of this summary. Take for example two employers, A and B, who are in a controlled group. Employer A has 270 full-time employees and offers minimum essential coverage to those employees (and their dependents) through an employer plan. Employer B has 30 full-time employees and offers no coverage. Both employers are large employers based on the controlled group rules. But, the No Offer Penalty in this instance would only be calculated based on Employer B's full-time employees. Based on the number of full-time employees, 27 employees of the 30 employee reduction or credit would be allocated to Employer A and 3 would be allocated to Employer B. A would not be responsible for a No Offer Penalty and B would be responsible for an annual penalty of $54,000 [(30-3)*$2,000). Compare this result to $540,000 penalty that would have been assessed if the penalty were calculated on the entire controlled group [(300-30)*$2,000].

B9. What are some examples of the No Offer Penalty?

Example 1: Harry owns 100% of three separately incorporated restaurants (A, B, and C) and also owns 100% of a management company (D) for those restaurants. The companies employ a total of 40 full-time employees, 16 who work for D, the management company, and 8 who work for each of A, B, and C. The companies also employ 100 employees working 20 hours per week. Harry does not offer any group health plan in any of his companies. At least one full-time employee from each of A, B, C and D seeks coverage from an Exchange and receives a federal subsidy.

Analysis: Harry's companies will all be treated as a single entity for purposes of determining large employer status. All of the companies will be treated as large employers even though some companies employ less than 50 employees and even though there are only 40 full-time employees combined. This is because of the controlled group rules combining Harry's companies and because of the FTE rule which would result in Harry's companies having over 50 combined full-time employees and FTEs.

Since a full time employee has sought coverage through an Exchange and received a federal subsidy for each of A, B, C and D, each of these companies will be liable for a No Offer Penalty. The part-time employees are not included in any penalty calculation. Also, for the "No Offer" penalty, Harry gets a 30 full-time employee reduction or "credit". That credit is allocated among the various companies pro-rata based on the number of full time employees with A, B, and C receiving a 6 employee credit each and D receiving a 12 employee credit. Accordingly, A, B, and C will each owe an annual penalty of $4,000 [(8-6) X $2,000)]. D will owe an annual penalty of $8,000 [(16-12) X $2,000]. Thus the total penalty for all employers combined would be $20,000 but each employer would only be responsible for its penalty and not the penalty for the other controlled group members.

Example 2: The facts are exactly the same as Example 1 except that Harry offers a fully insured health plan to all full-time employees of D, the management company, that is both affordable to all full-time employees and has a minimum value.

Analysis: Under Example 2 only A, B, and C would owe the penalty of $4,000 each and D would owe no penalty since while large employer status is determined on a controlled group basis the penalty is determined on an employer by employer basis. Also, note that ACA provides for certain non-discrimination rules for fully insured health plans similar to those already imposed on self-insured health plans. Those rules are not yet in effect pending regulations and certain "grandfathered" plans are exempt from these rules. But, once regulations are issued this design could also mean additional penalties for a discriminatory health plan might be imposed against D even though a No Offer Penalty would not.

C. Penalty for Large Employers Who Offer Coverage That Does Not Provide Minimum Value and/or is not Affordable.

C1. Can penalties still be imposed on large employers who provide substantially all of their full-time employees minimum essential coverage?

Answer: Yes, a penalty may be assessed if the coverage does not provide a minimum value, or if it is not affordable, or if a full-time employee is in the 5% or less who is not offered coverage. In each of these instances, the penalty is only triggered if the full-time employee receives federally subsidized coverage through an Exchange. For purposes of this summary this will be called the “Inadequate Coverage Penalty.”

If a large employer offers all of its full-time employees coverage that provides a) minimum essential coverage, b) minimum value, and c) is affordable to all full-time employees then the employer will not owe any play or pay penalty. This is because employees who are offered employer provided coverage that meets these standards are ineligible for the federal subsidy. Thus, even if such a full-time employee declines such coverage offered by an employer and seeks coverage through an Exchange, neither the No Offer Penalty nor the Inadequate Coverage Penalty will be triggered since neither that employee seeking coverage nor any full-time employee of that employer will be entitled to a federal subsidy.

C2. What is minimum essential coverage?

Answer: See Q&A B4 above. Almost all employer sponsored group coverage will be minimum essential coverage.

C3. What is minimum value?

Answer: The ACA provides that a plan does not provide “minimum value” if “the plan’s share of the total allowed costs of benefits provided under the plan is less than 60 percent of such costs”. Making this determination would typically require an actuary or similar professional. Because of the complexity of this calculation, the IRS has proposed the use of a minimum value calculator that the IRS would develop along with Health and Human Services (HHS). Large employers could enter criteria such as cost-sharing features (deductibles, co-pays, co-insurance) and core benefit categories to determine whether the plan provides minimum value. As another alternative, the IRS has suggested the use of designed based safe harbor checklists. The final approach would be an actuarial certification which would be used mainly by plans with “non-standard” features. In all of these approaches, a current year employer HSA contribution and amounts newly made available under an HRA for the current year are included in the minimum value calculations.

C4. When is coverage affordable?

Answer: Coverage is affordable if the employee's contribution toward self-only coverage does not exceed 9.5% of the employee's "household income". Of course the questions many employers will have are: How do I determine an employee's household income? I have multiple plans, does coverage have to be affordable for all plans? The IRS has attempted to address these questions in prior guidance with a "W-2 safe harbor" that was incorporated into the proposed regulations. The proposed regulations also offer other safe harbors.

Under the W-2 safe harbor, employers can simply take an employee's W-2 income for a year and determine whether that employee's share of contributions for self-only coverage exceeds 9.5% of that employee's W-2 income. So, at the end of 2014 an employer using this safe harbor would take the employee's 2014 W-2 wages and determine whether the employee contribution for self-only coverage exceeded 9.5% of this amount. If they did not, then the coverage was affordable for that employee for 2014. HSA and HRA contributions made by employers would ***not*** factor into affordability because those contributions generally cannot be used for employee contributions.

The 9.5% calculation is made with respect to single or "self-only" coverage. Under current guidance as long as the 9.5% standard is met for self-only coverage, an employer could charge the full amount for any additional coverage of spouses and dependents and the coverage would still be "affordable". Although it is not entirely clear how the calculation for dependent coverage would work under the current guidance, the following example would appear to be a reasonable interpretation.

Example: An employer offers coverage where the total cost is $4,500 per year for self-only coverage and an additional $6,000 per year for family coverage for a total of $10,500 for family coverage. The employer requires employees to pay $2,375 per year for self-only coverage and the full amount for any additional dependent coverage such as family coverage. Thus, someone who elects family coverage must pay $8,375 for such coverage. Is this coverage affordable under the W-2 safe harbor for someone who has W-2 income of $25,000 a year?

Analysis: Under a reasonable interpretation of current guidance, this coverage would be affordable for this employee for an employer using the W-2 safe harbor for affordability. While the total employee contribution is $8,375 the employee contribution for self-only coverage is just 9.5% of the employee's W-2 income ($25,000 * 9.5%=$2,375). Thus, in this instance, coverage that costs one third of an employee's total W-2 income could still be considered "affordable".

If an employer offers more than one plan, then affordability is based on self-only coverage for the least costly employer plan that provides minimum value.

Under the W-2 safe harbor, if an employee is not a full-time employee for the entire calendar year, the W-2 safe harbor is applied by adjusting the employee's W-2 wages to reflect the period when the employee was offered coverage, and then comparing those adjusted wages to the employee share of the premium during that period.

The proposed regulations also adopt a rate of pay safe harbor under which the employer would (1) take the hourly rate of pay for each hourly employee who is eligible to participate in the health plan as of the beginning of the plan year, (2) multiply that rate by 130 hours per month, and (3) determine affordability based on the resulting monthly wage amount. An employee's monthly contribution amount (for the self-only premium of the employer's lowest cost coverage that provides minimum value) is affordable if it is equal to or lower than 9.5% of the computed monthly wages (the employee's applicable hourly rate of pay x 130 hours). For salaried employees, monthly salary would be used. An employer may not use this safe harbor with respect to employees where the employer reduced wages during the year.

Finally, the proposed regulations provide for a safe harbor if the self-only cost of coverage does not exceed 9.5% of the most recently published federal poverty level for a single individual.

C5. How is the Inadequate Coverage Penalty Calculated?

Answer: If coverage does not provide a minimum value and/or is unaffordable then the employer must pay a penalty of the ***lesser of*****:** (1) $3,000 per full-time employee who goes to the Exchange and receives a federal subsidy; or (2) $2,000 for each full-time employee (less the 30 full-time employee credit) (the same as the No Offer Penalty). Eligibility of employees for the federal subsidy is addressed in Q&A B5, the definition of full-time employee is addressed in Q&A B6 and the application of the controlled group rules is addressed in Q&A B8.

Again, while we express the Inadequate Coverage Penalty as an annual amount, it is actually a monthly amount. The amount of the payment for the month equals the number of full-time employees who receive a federal subsidy for that month multiplied by 1/12 of $3,000. The amount of the payment for any calendar month is capped at the number of the employer's full-time employees for the month (minus up to 30) multiplied by 1/12 of $2,000.

C6. What are some examples of the Inadequate Coverage Penalty?

Example 1: Charlie owns 100% of two day care centers (A and B). He has 40 full-time employees working at each A and B for a total of 80 full-time employees. He has 25 part-time employees working 25 hours per week at each A and B for a total of 50 part-time employees. Charlie offers a group health plan to all of his employees that has minimum value and for which self-only coverage costs a total of $5,000 per year. Charlie charges both part-time and full-time employees 50% of the cost of self-only coverage, or $2,500, and Charlie pays the remaining 50%. Charlie has 15 full-time employees at A and 10 full-time employees at B making less than $26,315.79 in W-2 wages. He has 25 full-time employees at A and 30 full-time employees at B making more than $26,315.79. Of those full-time employees making less than $26,315.79, 6 at A and 9 at B go to the Exchange for coverage and receive a federal subsidy. The remainder of the employees making less than $26,315.79, however either elect the plan that Charlie is offering or are covered under their spouse's plan and do not go to the Exchange. Five of the employees making over $26,315.79 also go to the Exchange and 30 part-time employees go to the Exchange and receive a federal subsidy. Charlie uses the W-2 safe harbor as to affordability.

Analysis: In this Example, $26,315.79 is used as a cut-off point because 9.5% of $26,315.79 is $2,500-- the amount Charlie is charging employees for self-only coverage. The coverage offered is therefore unaffordable for those making less than $26,315.79.

Charlie is a large employer because it does not matter how many employees are in each of his corporations. All of the corporations are in a controlled group and are large employers with 80 full-time employees and a number of FTEs in the controlled group as well.

The first step in determining the Inadequate Coverage Penalty for each controlled group member is to calculate what the penalty would be if A and B were subject to the No Offer Penalty and then determine whether the alternative Inadequate Coverage Penalty calculation penalty would be less. Since both A and B have an equal number of full-time employees, the 30 employee "credit" would be allocated equally among them (15 employees each). The No Offer Penalty calculation for both A and B would be [(40-15) X $2,000] or $50,000 each.

For the alternative calculation of the Inadequate Coverage Penalty, only those receiving subsidized coverage through the Exchange are included. But, there is no penalty for part-time employees who go to the Exchange. There is also no penalty for employees who are offered minimum value and affordable coverage who go to the Exchange because they are ineligible for the federal subsidy. Thus, only the 6 full-time employees at A and 9 full-time employees at B who make less than $26,315.79 go to the Exchange and are entitled to a federal subsidy are included in the alternative Inadequate Coverage Penalty calculation.

For A that penalty calculation would be $18,000 (6 X $3,000) which is less than $50,000 so A's Inadequate Coverage Penalty is $18,000.

For B the penalty calculation would be $27,000 (9X $3,000) which is less than $50,000 so B's Inadequate Coverage Penalty would be $27,000.

Example 2: The facts are the same as Example 1, except that Charlie only has 40 full-time employees (20 in each A and B) with 20 making over $26,315.79 (10 in each A and B) and 20 making less than that amount (10 in each A and B). Seven full-time employees of A and

8 full-time employees of B that make less than $26,315.79 go to the Exchange and receive a federal subsidy.

Answer: Both A and B are large employers because the 50 part-time employees will be converted to FTEs and Charlie's companies, on a controlled group basis, will have more than fifty combined full-time employees and FTEs.

Like in Example 1, it is irrelevant whether those who work part-time and those who earn more than $26,315.79 go to the Exchange for coverage. They will not count in the $3,000 alternative calculation for the Inadequate Coverage Penalty.

The first step, however, is to determine what A and B would owe if each were subject to the No Offer Penalty. Once again, the 30 employee credit would be allocated among A and B equally since they have the same number of full-time employees. The No Offer Penalty calculation for A would be $10,000 [(20-15) X $2,000). The alternative Inadequate Coverage Penalty calculation would be $21,000 (7 X $3,000). Since $10,000 is less than $21,000, A's Inadequate Coverage Penalty would be $10,000.

The No Offer Penalty calculation for B would also be $10,000 [(20-15) X $2,000). The alternative Inadequate Coverage Penalty calculation would be $24,000 (8 X $3,000). Since $10,000 is less than $24,000, B's Inadequate Coverage Penalty would be $10,000.

In both of these examples Charlie would presumably measure the cost of offering affordable coverage to all full-time employees on a tax deductible basis (presumably setting the employee contribution at 9.5% of the lowest paid full-time employee's W-2 compensation) with the cost of the non-deductible Inadequate Coverage Penalty.

D. Miscellaneous and Transition Issues

D1. Can we rely on the proposed regulations?

Answer: Yes. Employers may rely on these proposed regulations for guidance pending the issuance of final regulations or other guidance. If future regulations or guidance is more restrictive it will be applied without retroactive effect and employers will be provided with sufficient time to come into compliance with the final regulations.

D2. Are there special effective dates for Fiscal Year Plans?

Answer: Yes. If a large employer maintains a non-calendar year plan as of December 27, 2012, transition relief applies with respect to employees who would be eligible for coverage, as of the first day of the first fiscal year of that plan that begins in 2014 (the 2014 plan year) under the eligibility terms of the plan as in effect on December 27, 2012. If employees are offered affordable, minimum value coverage no later than the first day of the 2014 plan year, no penalty will be assessed with respect to employees for the period prior to the first day of that 2014 plan year. Further relief is also provided for employers that have a significant percentage of their employees eligible for or covered under one or more fiscal year plans.

D3. Are there special transition rules for 2014 in determining full-time employees for penalty purposes?

Answer: Yes. Employers that intend to utilize the look-back measurement method for determining full-time status for 2014, described in Q&A B6, will need to begin their measurement periods in 2013 to have corresponding stability periods for 2014. Given that employers intending to adopt a 12-month measurement period and a 12-month stability period will face time constraints in doing so, the proposed regulations allow employers to adopt a transition measurement period that is shorter than 12 months but that is no less than 6 months long and that 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 (90-days being the maximum permissible administrative period). For example, an employer with a calendar year plan could use a measurement period from April 15, 2013 through October 14, 2013 (6 months), followed by an administrative period ending on December 31, 2013.

D4. Are there any transition rules regarding determination of large employer status for 2014?

Answer: Yes. For many employers, their status as a large employer will be evident without the need for an actual employee calculation. However, for employers near the 50 full-time employee/FTE threshold a calculation will be required. The proposed regulations provide a transition rule that allows an employer the option to determine its status as a large employer for 2014 by reference to a period of at least 6 consecutive calendar months, as chosen by the employer, in the 2013 calendar year rather than an entire year.

D5. How will play or pay penalties be assessed and collected?

Answer: The proposed regulations state that the IRS will follow procedures that ensure employers receive certification that one or more employees have received a federal subsidy and are provided an opportunity to respond before the issuance of any notice and demand for payment. If it is determined that an employer is liable for a play or pay penalty after the employer has responded to the initial IRS contact, the IRS will send a notice and demand for payment. That notice will instruct the employer on how to make the payment. Employers will not be required to include the play or pay penalty on any tax return that they file.

D6. Are there any reporting requirements?

Answer: Yes. Beginning in 2015, for coverage provided on or after January 1, 2014, there will be reporting requirements for employers. The Treasury Department and the IRS intend to publish separate proposed regulations implementing this reporting requirement.

We hope these Q&A's can assist you in understanding the "play or pay" penalties of ACA but again if you have any questions, do not hesitate to contact Kenneth Johnson at (336) 271-5264.