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Overview and Practical Implications of Proposed Rules Requiring Employers to Offer Health Coverage or Pay a Penalty

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On January 2, 2013, the Internal Revenue Service proposed regulations interpreting the employer "play or pay" requirements under the Patient Protection and Affordable Care Act (PPACA). It also issued a set of 23 explanatory play or pay questions and answers (Q&As). The play or pay requirements apply to "large employers" (defined below) for plan years beginning in 2014, meaning January 1, 2014 for calendar-year plans. Small employers are exempt from the play or pay rules, but will need to carefully monitor their workforce to assure ongoing exemption.

Part I of this Client Alert provides an overview of the play or pay requirements as implemented by the proposed regulations and Q&As. Part II of this Client Alert highlights several practical implications for employers.

I. Overview

A. General

Beginning in 2014, Section 4980H of the Internal Revenue Code (Code) requires each large employer to either offer at least 95% of its "full-time" employees (defined below) health coverage or pay a monthly penalty if at least *one* full-time employee who is not offered coverage enrolls in an insurance exchange and receives a federal subsidy (discussed below) to help pay for coverage in the exchange. Beginning in 2015, this requirement extends to the "dependents" (defined below) of full-time employees.

The amount of the monthly penalty varies depending on whether the employer offers health coverage for that month. If the employer does not offer coverage, the monthly penalty is 1/12 times $2,000 times each full-time employee employed by the employer for that month (less the first 30) *and is not limited to the number of full-time employees who are not offered coverage or who receive the federal subsidy*. If coverage is not provided for an entire year, the maximum penalty is $2,000 per each full-time employee less the first 30.

If the employer offers coverage but the coverage is either not "affordable" or does not provide "minimum value" (defined below), the monthly penalty is 1/12 times $3,000 times for each full-time employee who receives the federal subsidy for that month but capped at the number of the employer's full-time employees for that month less the first 30 multiplied by 1/12 of $2,000. The cap is designed

to ensure that the payment for an employer that offers coverage cannot be larger than the payment it would owe if it did not offer coverage. Beginning in 2015, this penalty also applies if an employer offers affordable, minimum value coverage to at least 95 percent but not 100 percent of its full-time employees and their dependents and one or more of the full-time employees who is not offered coverage receives the federal subsidy.

If the employer is part of a group of trades or businesses considered a single employer under Code Sections 414(b), 414(c), 414(m) or 414(o), both penalty provisions are applied separately to each related member and the first-30-employee exclusion is allocated ratably among all related members based on the number of full-time employees employed by each related group member.

The federal subsidy works in the following manner. Beginning in 2014, a taxpayer whose household income is between 100% and 400% of the federal poverty line ($23,050–92,200 for a family of four in 2012) will be eligible to receive a federal subsidy (either through a refundable income tax credit or cost-sharing reduction) to purchase insurance coverage on an insurance exchange if the taxpayer (i) is not eligible for government coverage such as Medicare, Medicaid or CHIP, and (ii) is not eligible for employer-provided coverage or is eligible only for employer provided coverage that is not "affordable" (defined below) or that does not provide "minimum value" (defined below). The amount of the subsidy will vary based on where the taxpayer's household income falls within the previously described income threshold.

B. Large Employer

To be considered a large employer, the employer must employ at least 50 "full-time employees" or "full-time employee equivalents" (FTEs) (both defined below). This determination is made by aggregating all trades or businesses treated as a single employer under Code Section 414(b), 414(c), 414(m) and 414(o). Whether an employer is a large employer is calculated by first determining the number of full-time employees and FTEs for each calendar month in the preceding calendar year, and then dividing that total by 12 -- and rounding up to the next whole number. For 2014 only, transition relief permits an employer to make this determination based on any six consecutive-month period during 2013, in which case the total gets divided by 6 instead of 12. If the employer is a large employer based on prior year data, that determination applies for the entire subsequent year.

The number of FTEs is determined by calculating the aggregate number of monthly hours of service of all employees who worked less than full-time (but not more than 120 hours for any employee) and dividing that number by 120.

If the sum of full-time employees and FTEs exceeds 50 for 120 days or less during the preceding year, and the employees in excess of 50 who were employed during that 120-day or shorter period are "seasonal workers," the employer is not considered a large employer.

C. Full-time Employees

A full-time employee means, with respect to a calendar month, a "common law employee" (for tax purposes) who averaged 30 or more hours of service per week or, if the employer elects, had 130 or more hours of service in the calendar month. Under this standard, a person is an "employee" when the person for whom the services are performed has the right to control and direct the individual who performs the services not only as to the result to be achieved by the work but also the details and means by which the result is achieved. Non-employee directors, sole proprietors, partners, 2-percent

or more shareholders in an S corporation, and leased employees (as defined in Code Section 414(n)(2)) are not treated as employees.

An "hour of service" is each hour for which the employee is paid or entitled to payment for the performance of services and each hour for which an employee is paid or entitled to payment by the employer when the employee is on a paid leave of absence. An hour of service for one member of a related group treated as a large employer is also treated as an hour of service for all other group members.

Hours of service do not include service if compensation for the service is not considered US source income. *This means that employees who work outside the United States will not be considered full time employees for purposes of either the penalty provisions or the large employer determination*.

For employees paid on an hourly basis, an employer must calculate hours of service based on records of hours worked and hours for which payment is made or due. For employees not paid on an hourly basis, the employer may use the method for hourly employees or one of two equivalency rules whereby an employee is credited with 8 hours of service for each day the employee is credited with one hour of service or is credited with 40 hours of service for each week in which the employee is created with at least one hour of service. An employer is permitted to use different methods for different classifications of non-hourly employees, provided the classifications are reasonable and consistently applied. An equivalency rule may not be used, however, if it would substantially understate an employee's hour of service in a manner that would cause that employee not be treated as full-time. The proposed regulations give an example of an employee who works three 10 hour days per week, concluding that the employer may not use the day equivalency method because it would give credit for only 24 hours of service per week.

The preamble to the proposed regulations states that the IRS intends to incorporate in the final regulations an anti-abuse rule to address situations involving temporary staffing agency structures. Under the anticipated rule, if an individual performs services as an employee of an employer, and also performs the same or similar services of that employer in the individual's purported employment at a temporary staffing agency or other staffing agency of which the employer is a client, then all the hours of service are attributed to the employer for purposes of applying Code Section 4980H.

D. Determining Full-time Status for Purposes of Offering Coverage

As mentioned in Part I.A. above, an employer's potential liability for the penalty is determined on a monthly basis. Determining full-time employee status on a real-time basis, however, could be problematic, especially for employees who are seasonal or not regularly scheduled to work full-time, e.g., employees could waffle in and out of coverage. To address this, the proposed regulations permit employers to use an optional "look-back measurement period" to determine whether an employee is full-time, in which case he or she must be treated as full-time for a subsequent "stability period" (determined as discussed later in this Part I.D). These rules apply only for the purpose of offering coverage to the large employer's full-time employees, and not for determining whether the employer is a large employer.

1. Existing Employees

For existing employees, the proposed regulations permit employers to use a look-back measurement period of 3 to 12 months to determine whether the employees had the requisite hours. If so, the employee is treated as a full-time employee for the entire stability period so long as the individual

remains employed. If not, the employee is not treated as full-time for the entire stability period, even if the employee increases his or her hours of service to a level that would otherwise be considered full time. The stability period must be at least six months and generally may not be shorter than the look-back measurement period. However, limited transition relief is provided in 2014 for employers who wish to implement a 12-month stability period but do not have enough time to administratively implement a 12-month measurement period in 2013.

An employer may use measurement and stability periods that differ in length or have different start and end dates for the following categories of employees: (1) collectively bargained employees and non-collectively bargained employees; (2) each group of collectively bargained employees covered by a separate collective bargaining agreement; (3) salaried employees and hourly employees; and (4) employees whose primary places of employment are in different states. Each separate entity within a controlled group may adopt its own rules. An employer may change its measurement and stability periods for subsequent years, but generally may not change them for periods that have already commenced except to avoid splitting employees' regular payroll periods.

Because employers may need time between the measurement period and the corresponding stability period to determine which employees are eligible for coverage and to notify and enroll the employees, employers may delay enrollment for an "administrative period" of not more than 90 days between the measurement period and the stability period. To prevent this administrative period from creating any gap in coverage, the administrative period must overlap with the prior stability period.

Example: *The employer chooses to use a 12-month stability period that begins January 1 and a 12-month measurement period that beings October 15. Employer uses an administrative period between the end of the standard measurement period (October 14) and the beginning of the stability period (January 1) to determine which employees worked full-time during the measurement period and, notify them of their eligibility for plan coverage for the stability period beginning January 1 and enroll the employees who elect coverage.*

2. New Employees

For new, non-seasonal employees who are reasonably expected to work full time as of their start date, coverage must be offered no later than 3 months after the employee's start date. For new seasonal employees or employees for whom it cannot be determined whether the employee is reasonably expected to work an average of at least 30 hours per week (variable hour employees), the employer may use an initial measurement period of 3 to 12 months and an administrative period of up to 90 days but the combined measurement and administrative period must end by the last day of the first calendar month beginning on or after the one-year anniversary of the employee's start date (totaling at most 13 months and a fraction of a month).

If a new seasonal or variable hour employee met the full-time threshold during that initial measurement period the employer must offer coverage for an initial stability period of at least six months and that is no shorter than the initial measurement period. If the employee has not met the threshold (and subject to the change in employment status exception described in the next sentence), the employer need not offer coverage for an initial stability period that is not more than one month longer than the initial measurement period and does not exceed the remainder of the measurement period for existing employees (plus any administrative period) in which the initial measurement period ends.

If a new variable hour or seasonal employee has a change in employment status that causes the employee to be reasonably expected to be employed on average at least 30 hours of service per

week, the employer is required to treat the employee a full-time employee no later than the first day of the fourth month following the change in status.

Once a new employee has been employed for an entire initial measurement period, the employee must also be tested for full-time status based on the next measurement period that begins after the employee's start date.

3. Breaks in Service

Special rules apply for dealing with employees who are terminated or otherwise not credited with hours of service and who then are subsequently rehired or otherwise credited with an hour of service. Such an employee may be treated as a new employee only if he or she was not credited with at least one hour of service for a period of at least 26 consecutive weeks (or, if less, a period of at least four consecutive weeks that exceeds the number of weeks of that employee's period of employment preceded the period in which no hours of service were credited). An employee who does not meet this threshold is treated as a continuing employee and retains, upon the employee's resumption of service, his or her prior status with respect to any applicable stability period (for example, if the continuing employee returns during a stability period in which the employee is treated as a full-time employee, the employee is treated as a full-time employee upon return and through the end of that stability period). If such an employee was entitled to coverage during that stability period, coverage must be reinstated as of the first day that the employee again is credited with an hour of service, or, if later, as soon as administratively practical.

If an employee goes on unpaid FMLA or USERRA leave and is not treated as a new employee under the immediately preceding paragraph, then for purposes calculating average hours of service for any measurement period, the employer must either exclude such leaves from the calculation or treat the employees as credited with hours of service during such leaves at a rate equal to the average weekly rate at which the employee was credited with hour of service during weeks in the measurement period that were not part of such leaves. Substantially similar rules apply to "employment break periods" of educational organizations (e.g., summer breaks when classes are not in session) and the proposed regulations invite comments on whether a similar rule should be adopted for employees in other industries.

E. Dependent Coverage

To avoid play or pay penalties, beginning in 2015, full-time employees must be offered coverage for dependent children who have not attained age 26. Spousal coverage and coverage for dependent children age 26 or older is not required.

F. Affordability and Minimum Value

To be considered "affordable," the employee's share of the premium for the employer's lowest cost self-only coverage cannot exceed 9.5 percent of the employee's adjusted household income for the taxable year. Because employers almost never would be able to know what that income is, the proposed regulations provide three safe harbor alternatives.

The first safe harbor is met if the required premium is a fixed amount (which may be expressed as a flat dollar amount or percentage of taxable wages) that does not exceed 9.5 percent of that employee's taxable wages (required to be reported in box 1 of Form W-2) from the employer for the calendar year (or for plans with fiscal plan years within the portion of each plan year during the

calendar year). If an employee is not offered coverage for an entire calendar year, the W-2 wages are pro-rated to reflect the period of coverage offered.

The second safe harbor is met if the required monthly premium does not exceed 9.5 percent of an amount equal to 130 hours multiplied by the employee's hourly rate of pay (or monthly salary for non-hourly employees) as of the first day of the coverage period (typically the plan year). An employer may not use this safe harbor if it has reduced the hourly wages of its hourly employees or monthly wages of salaried employees during the year (including by transferring the employee to another control group member that provides lower wages). The third safe harbor is met if the required monthly premium does not exceed 9.5 percent of 1/12th that year's Federal poverty line for a single individual in the state in which the employee is employed.

An employer's health plan fails to 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 those costs. The Department of Health and Human Services (HHS) has issued proposed regulation providing guidance for determining minimum value. These methodologies include a minimum value calculator that will be made available by HHS and the IRS.

G. Offering Coverage

To satisfy play or pay, at least once each plan year, an employer must give full-time employees an *effective* opportunity to elect to enroll or decline to enroll in the coverage. Whether an employee has an effective opportunity to enroll or decline coverage is based on all the relevant facts and circumstances. Providing mandatory coverage with no annual opt-out opportunity does not satisfy this requirement, but the preamble states this prohibition is limited to coverage that is either unaffordable or does not provide minimum value. It would be helpful for the final regulation to expressly incorporate this limitation.

H. Multiemployer Plans

The proposed regulations request comments for how the play or pay requirements should apply to employers who contribute to multiemployer plans. For 2014, transition relief is provided whereby an employer who contributes to a multiemployer plan will be deemed to have provided coverage to its full-time employee if (a) the employer is required to contribute to the multiemployer plan with respect to the full-time employee under a collective bargaining agreement or related participation agreement; and (b) the multiemployer plan offers affordable, minimum value coverage to the full-time employee (and the employee's dependents). In addition to the other affordability safe harbors, multiemployer plan coverage will be considered affordable if the employee's required premium does not exceed 9.5 percent of the wages reported to the multiemployer plan, which may be determined based on actual wages or an hourly wage rate determined under the applicable collective bargaining agreement.

II. Practical Implications for Employers

A. Deciding Whether to Play or Pay; Getting Ready to Play

Large employers that have not already done so should quickly decide between offering qualifying coverage in 2014 to at least 95% of their full-time employees, and not offering that coverage and accordingly preparing for the potential assessment of penalty taxes. Those large employers that wish to "play' need to begin planning and implementing the numerous measures necessary to do so, including deciding whether and how to use the safe harbors for determining full-time employees and affordability of employee premiums, and determining whether the coverage they expect to offer will

provide minimum value. Employers that wish to lower work hours for some employees to prevent them from being considered full-time should first consult with legal counsel to ascertain whether any such individuals could bring viable claims under Section 510 of ERISA.[1] Employers that intend to offer compliant coverage to most, but not at least 95%, of their full-time employees, should consider offering some coverage to the remainder (even if it is unaffordable or does not provide minimum value under the regulations) as that would reduce the employer's potential penalty exposure.[2]

B. Beware of Likely Increased Obligations for Employees on Leaves of Absence

The proposed regulations likely will expand coverage for employees on paid or unpaid leaves of absence, assuming the employer is going to "play." First, the proposed regulations equate paid leaves of absence to actual employment, and the preamble provides that this requirement applies regardless of the duration of the paid leave. The regulations broadly define paid leaves to include any period the employee is entitled to payment by the employer for "vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military leave or leave of absence (as defined in 29 CFR 2530.200b-2(a))."[3]

Second, if an employer relies on the look-back measurement periods to determine full-time employee status, the employer generally is required to offer coverage that continues for the entire corresponding stability period even if the employee goes on an unpaid leave provided the employee remains employed. Although the proposed regulations permit an employer to treat an employee who has been on unpaid leave for at least 26 weeks as a new employee if and when he or she resumes service, they do not address the employee's status while on unpaid leave (for example, whether the employee was still employed or could be considered terminated). Presumably employees who are put on terminal leaves with no expectation of resuming services could be considered terminated; the IRS has taken that view in other contexts (e.g., for Section 409A and certain tax-qualified retirement plan purposes). Until more guidance is issued on this issue, employer should be cautious.

If an employer is required to continue coverage to an employee during an unpaid leave, the employer may have an affordability problem because the employee will not be receiving any taxable wages from the employer during that period of employment. To avoid this problem, an employer could rely on one of the non-W-2 safe harbors or on the 5% de minimis exception (if it is already not excluding 5% of its full time employees) to address this and other leave situations.

C. Beware of Potential Increase In Worker Misclassification Exposure

Employers that employ more than a de minimis number of independent contractors should consider the potential increased exposure the play or pay requirement creates for misclassifying employees as independent contractors. This exposure would include temporary employees employed through third-party staffing agencies. In this regard, the preamble to the proposed regulations acknowledges that users of temporary staffing agency employees are often the common law employer of the employees, yet the regulations do not credit such employers for qualifying coverage provided by temporary staffing agencies.

D. Beware of Potential Drawback of Multiemployer Plans

In light of the limited transition relief available for multiemployer plans and the risk borne by contributing employers if the coverage does not satisfy that relief, contributing employers should monitor those plans and consider requiring representations that coverage will be affordable and provide minimum value and an indemnity from PPACA penalties that faulty plan coverage causes them to suffer.

CONCLUSION

The play-or-pay alternative under healthcare reform presents employers with far more than a technical compliance challenge for employee benefit plan administrators. The potential corporate costs and risks are C-suite issues. Nevertheless, a recent American Benefits Institute survey[4] by Verisight/McGladrey reports that "currently 26 percent of employers are undecided on whether they will continue or discontinue group health coverage in the next 24 months." Although most large employers are likely to "play" for 2014 while waiting to see whether the federal and state insurance exchanges provide a viable alternative, the high stakes associated with playing or paying warrant immediate and continued scrutiny. For those who play, risk management is essential because the penalties for noncompliance are potentially disastrous.

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[1] ERISA Section 510 prohibits employers from discriminating against any participant or beneficiary for the purpose of interfering with the attainment of any to right to which such participant or beneficiary may become entitled under the plan. Employers that implement workforce restructurings to avoid increased benefits costs are sometimes sued under Section 510 of ERISA.

[2] Employers with self-funded or non-grandfathered, fully-insured plans would also need to analyze the Code Section 105(h) nondiscrimination implications of such an approach. The IRS has yet to issue guidance interpreting the 105(h) nondiscrimination requirements for non-grandfathered, fully insured plans.

[3] The ERISA regulation cross-referenced in the proposed regulations applies to retirement plans and limits the amount of paid leave taken into account to no more than 501 hours. But given the statement in the proposed regulations, it appears the IRS did not intend to incorporate this aspect of the regulation. The ERISA regulation also excludes payments made under plans maintained solely to comply with workers compensation, unemployment compensation or disability insurance law, but includes payments made by third parties on the employer's behalf such as insurers and trusts. It would be helpful for the IRS to clarify in the final regulations whether these provisions of the ERISA regulation specifically apply to the play or pay requirement.

[4] See http://www.verisightgroup.com/Portals/0/Verisight_Executive_Summary_20122013.pdf.