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# Health Care Reform Management Alert Series

## How Will the Employer Penalty in 2014 Work? Employer Shared Responsibility Proposed Regulations Issued

**Issue 48**

*This is the forty-eighth issue in our series of alerts for employers on selected topics in health care reform. (Click here to access our general summary of health care reform and other issues in this series.) This series of Health Care Reform Management Alerts is designed to provide an in-depth analysis of certain aspects of health care reform and how it will impact your employer-sponsored plans.*

**[ ✓ ] Applies to grandfathered plans**

**[ ✓ ] Applies to new health plans and plans that lose grandfathered status**

Following several notices regarding potential approaches for the employer mandate provisions of the Patient Protection and Affordable Care Act (PPACA) and requests for comments, the IRS issued proposed regulations on how the employer mandate will work, which were published in the *Federal Register* this week. These proposed regulations largely confirm the IRS's previously proposed approaches for determining whether an employer is subject to the employer mandate and how to determine which employees are considered "full-time employees." But the proposed regulations do include a few changes, provide more detailed guidance, and include new guidance on the logistics of how the employer penalty would be calculated and paid.

Employers may rely on these proposed regulations pending issuance of final regulations. The IRS will take comments on these proposed regulations through March 18, 2013 and will hold a public hearing on these proposed regulations on April 23, 2013. The IRS has also issued *Questions and Answers* on the employer shared responsibility rules which provide an overview of some of the provisions in the proposed regulations.

This alert is broken into four parts. Part I briefly summarizes the proposed regulations' significant changes and modifications from previous guidance. Part II provides a more comprehensive overview of how employers determine whether they are subject to the mandate. Part III provides a more details how employers determine who is a "full-time employee" for purposes of the penalty. Finally, Part IV describes how the penalty is calculated.

### Part I - Overview of Changes

While this list is not intended to be comprehensive, here is a brief summary of some of the significant changes, modifications, clarifications, and transition relief provided in the proposed regulations:

- **"Large employer" determined using IRS aggregation rules, but penalty assessed on an employer-by-employer basis.** The proposed regulations provide that while employers must count all entities within their controlled group to determine whether they are a "large employer," the penalty for failure to offer affordable coverage that provides minimum value is assessed on an employer-by-employer basis. In other words, employers are not jointly liable when other employers within the controlled group fail to offer coverage. To prevent abuse though, the IRS clarified that

the permitted 30 employee deduction that may be taken before calculating the penalty must be spread ratably among all employers within the controlled group, based on each member's number of full-time employees.

- **Requirement to offer coverage to *all* full-time employees**. PPACA requires large employers to provide coverage to all full-time employees or pay a penalty (calculated by multiplying the employer's total # of full-time employees (minus 30), by $2,000). The proposed regulations provide that an employer will avoid this penalty as long as it provides coverage to at least 95% of full-time employees. This is significant because it lessens the burden of accurately tracking and offering coverage to every single full-time employee. In other words, if an employer miscalculates the full-time status of a couple of individuals, the employer will not be subject to this penalty. Note, though, that the employer may still be subject to a smaller penalty for those full-time employees who were left out (calculated by multiplying only those individuals who (a) worked on a full-time basis, (b) were not offered coverage, and (c) received a tax credit or subsidy through the exchanges, by $3,000).

- **Dependent coverage defined.** PPACA requires employers to provide coverage to full-time employees and their dependents. The new regulations define "dependent" to exclude spouses. In other words, an employer can comply with the mandate even if its plan (or the plan to which it contributes) excludes spouses, includes a spousal surcharge, or includes some form of working spouse rule.

- **Change in employment status.** Under the proposed regulations, a change in an ongoing employee's employment status during a stability period does not change the employer's obligation to provide coverage throughout that stability. For example, if an employee who was previously in a full-time position shifts into a part-time position during his or her stability period, that employee must still be offered coverage for the remainder of the stability period. There is one exception to this general rule, which applies to seasonal and variable hour employees who change employment status during their initial measurement period. If a seasonal or variable hour employee switches to position that is clearly full-time, that employee must be offered coverage by the start of the fourth month following the change, otherwise the employer could face a penalty.

- **Breaks-in-Service.** The new regulations permit employers to treat rehired employees as new hires if they incur a break-in-service that (a) is at least 26 weeks in length, or (b) if the break exceeds the length of prior employment, between 4 weeks and 26 weeks in length. If neither applies, then the employer cannot disregard prior service upon rehire. This means the employee must be credited for prior hours worked and the employer must start the measurement period where the employee left off rather than restarting with a new measurement period.

- **Measurement/stability period variations based on classification.** Prior guidance allowed employers to use different measurement/stability periods for different pre-approved classifications. The proposed regulations add a new permitted classification: each group of collectively bargained employees covered by a separate collective bargaining agreement.

- **Paid leave counts for purposes of determining "full-time" status.** Under prior guidance, the IRS noted that only 160 hours of paid leave must be counted when determining whether an employee works full-time during the measurement period. The proposed regulations remove this limit and require employers to count all paid leave in determining full-time status.

- **Counting hours worked by foreign employees.** For purposes of determining who is a full-time employee, employers may disregard hours of service worked outside of the United States. This rule is applicable both for purposes of determining whether an employer is subject to the mandate and for purposes of determining which employees are "full-time employees" and must, as a result, be offered coverage.

- **No penalty if employee fails to pay premium.** The proposed regulations generally provide that employers will not be penalized for dropping an employee from coverage if that employee fails to pay his or her premium.

- **Safe harbors for determining affordability.** The employer mandate requires employers to offer "affordable" coverage, meaning the premium for employee-only coverage cannot exceed 9.5% of that employee's household income. The IRS previously provided employers with a safe harbor approach, allowing them to set the employee-only premium based on Form W-2 income rather than household income. The new guidance creates two additional safe harbors that are described in greater detail in Part IV.

- **Transition relief.** The proposed regulations provide transition relief from many of the requirements intended to ease employers into the new rules throughout 2014. The various forms of transition relief are highlighted in call-out boxes in the body of the alert below.

## Part II - Am I Subject to the Mandate?

As reported in earlier Alerts (such as *Issue 45* ), beginning January 1, 2014, employers with at least 50 full-time employees, including full-time equivalents, will be required to pay a penalty if:

- they fail to offer minimum essential coverage to all full-time employees (and their dependents) and;
- a single full-time employee receives a tax credit or cost-sharing reduction through a health care exchange.

For-profit, non-profit and governmental employers that employ an average of at least 50 full-time employees including full-time equivalent employees (the "Threshold") are considered "large employers" for this purpose and, as a result, are subject to the employer shared responsibility rules. The determination of whether the employer is a large employer for a given year is generally based on all hours worked by all employees of the employer in the prior year.

**TRANSITION RELIEF: SHORTER DETERMINATION PERIOD FOR 2013.** FOR PURPOSES OF DETERMINING WHETHER AN EMPLOYER IS A LARGE EMPLOYER IN THE 2014 CALENDAR YEAR, AN EMPLOYER MAY USE A PERIOD OF SIX CONSECUTIVE CALENDAR MONTHS IN 2013 INSTEAD OF THE ENTIRE 2013 YEAR. THE EMPLOYER CAN SELECT WHEN THIS SIX-MONTH PERIOD BEGINS.

The proposed regulations confirmed that all employers with a common owner or which are otherwise related under the controlled group rules must be counted together for this large employer determination. If the combined total number for the group is over the Threshold, then each individual legal entity within the controlled group is considered a large employer subject to the employer shared responsibility rules. Each individual company is considered separately for purposes of the actual penalty assessment. However, the 30-employee reduction for purposes of calculating the penalty, discussed in Part IV, must be allocated ratably among the group based on the number of each legal entity's full-time employees.

Consistent with prior guidance, the proposed regulations provide special rules for determining large employer status when an employer has seasonal workers. Under the proposed regulations, if an employer's full-time employee count is only over 50 for a limited period during the year (either 120 days or four calendar months or less), and the employees pushing the employer over that Threshold during that period are seasonal workers, the employer would not be subject to the employer shared responsibility rules. "Seasonal workers" include workers whose employment is the kind exclusively performed at certain seasons or periods of the year, including (but not limited to) retail workers employed exclusively during holiday seasons. Until further guidance is issued, employers may rely on a reasonable, good faith interpretation of the seasonal worker definition under applicable Department of Labor regulations.

## Part III - What is a "Full-Time Employee?"

Once an employer has met the Threshold and is subject to the employer shared responsibility rules, whether it actually becomes subject to a penalty, and, if so, the amount, will turn on who is considered a full-time employee. As noted in Part II, under PPACA, employers must offer affordable minimum essential coverage to all full-time employees to avoid a penalty. The IRS previously issued guidance regarding how to determine who is a full-time employee and established certain safe harbors for determining whether employees whose hours vary from week to week are considered full-time. See Issues *20*, *34* and *43*. The proposed regulations largely adopt the approach from the prior guidance.

***Hours of Service Rules***

As a general rule, an employee who provides 30 hours of service per week (or 130 hours of service in a calendar month) is considered a full-time employee for these purposes under PPACA.

The proposed regulations follow the prior IRS guidance and provide that an employee's hours of service include hours when the employee actually performs duties, as well as hours for which the employee is paid but does not actually perform duties, such as vacation, jury duty, military duty, disability and leaves of absence. Under prior IRS guidance, however, the IRS had stated that only 160 hours needed to be counted for the paid leave for which the employee did not actually perform any duties. Under these proposed regulations, the IRS has removed this 160-hour limit. This means all periods of paid leave must be taken into account for purposes of determining whether an employee is a full-time employee for the employer shared responsibility provisions.

The full-time determination may be made based on actual hours worked or, for non-hourly workers, certain designated equivalency methods. The proposed regulations confirm that different hours-counting methods may be used for different classifications of non-hourly employees as long as the classification is reasonable, consistently applied, and does not substantially understate an employee's hours of service (e.g., applying a 8-hour/day equivalency method to employees who typically work three 10-hour days per week would not be permissible).

"Hours of service," for these purposes, generally do not include hours of service worked outside the United States. As a result, if a foreign employer has a large workforce in other countries, but employs less than 50 full-time employees in the United States, the foreign employer generally would not be subject to the employer shared responsibility provisions. Similarly, employees who work for a United States company, but perform all their work outside of the United States generally would not be considered full-time employees for purposes of the employer shared responsibility rules.

***Safe Harbor Look-Back Measurement Method for Determining Full-Time Employees***

Because the potential employer shared responsibility penalty is determined based on the number of the employer's full-time employees in a given month, and that number is subject to constant fluctuation, the IRS had proposed a safe harbor determination method. Under this method, an employee's status as a full-time employee would be determined by looking back at the employee's average hours during a measurement period and using that determination prospectively in the corresponding stability period. See *Issue 43*. The proposed regulations incorporate this approach with a few modifications. For example, the proposed regulations do permit certain adjustments in how the period is measured to take into account when the payroll period begins and ends.

**TRANSITION RELIEF: SHORTER LOOK-BACK MEASUREMENT PERIOD FOR 2013.** SOLELY FOR PURPOSES OF THE STABILITY PERIOD BEGINNING IN 2014 FOR DETERMINING FULL-TIME EMPLOYEE STATUS, EMPLOYERS MAY USE A LOOK-BACK MEASUREMENT PERIOD THAT IS SHORTER THAN 12 MONTHS EVEN IF IT PLANS ON USING A 12 MONTH LOOK-BACK MEASUREMENT PERIOD GOING FORWARD. THIS SHORT, TRANSITION LOOK-BACK MEASUREMENT PERIOD MUST BE AT LEAST 6 MONTHS LONG, MUST BEGIN NO LATER THAN JULY 1, 2013 AND END NO EARLIER THAN 90-DAYS BEFORE THE FIRST DAY OF THE 2013 PLAN YEARS.

The proposed regulations provide that an employer may apply different measurement and stability periods for (1) each group of collectively bargained employees covered by a separate collective bargaining agreement; (2) collectively bargained and non-collectively bargained employees; (3) salaried employees and hourly employees; and (4) employees whose primary places of employment are in different states.

The proposed regulations adopt the previously published safe harbor, discussed in Issue 43, for newly hired variable hour employees, which provides for a longer measurement period if, based on the facts and circumstances at the start date, it cannot be determined that the employee is reasonably expected to be employed on average at least 30 hours per week over the initial measurement period.

**TRANSITION RELIEF: VARIABLE HOUR EMPLOYEE DETERMINATION.** PRIOR TO 2015, WHEN DETERMINING WHETHER AN EMPLOYEE IS A "VARIABLE HOUR NEW HIRE," EMPLOYERS CAN CONSIDER THE FACT THAT THE NEWLY HIRED EMPLOYEE WILL ONLY WORK FOR A LIMITED TIME PERIOD DURING THE INITIAL MEASUREMENT PERIOD (BASED ON OBJECTIVE FACTS AND CIRCUMSTANCES SPECIFIC TO THE NEWLY HIRED EMPLOYEE AND NOT AGGREGATE TURNOVER RATES). BEGINNING IN 2015, THE EMPLOYER MUST ASSUME FOR THIS PURPOSE THAT THE EMPLOYEE WOULD CONTINUE TO WORK FOR THE ENTIRE INITIAL MEASUREMENT PERIOD, UNLESS THE EMPLOYEE IS A SEASONAL EMPLOYEE.

The proposed regulations provide new rules for changes in employment status, but they only apply to new variable hour or seasonal employees. Under these rules, if a variable hour or seasonal employee experiences a material change in the position of employment during the initial measurement period, that employee may be considered a full-time employee who is eligible for coverage within three months of the change. Notably, the change in employment status rules would not apply to an ongoing employee who had a material change in employment position.

The proposed regulations also include special rules related to rehired employees after a termination of employment or returning from service after an unpaid absence, including special rules for educational organizations. These rules are designed to prevent employers form terminating employees in order to delay offering health coverage to employees working full-time.

## Part IV - How Much is the Penalty?

As discussed in *Issue 45*, the employer penalty would be assessed starting in 2014:

- if the employer fails to offer its full-time employees (and their dependents) minimum essential coverage (the "No Coverage Penalty"); or
- if the employer offers its full-time employees health coverage, but the coverage is either considered unaffordable to that employee or does not provide minimum value (the "Inadequate Coverage Penalty).

In either case, the employer is not subject to the penalty unless at least one of the employer's full-time employees receives a premium tax credit to help pay for coverage on a health care exchange.

**TRANSITION RELIEF: OFF CALENDAR YEAR PLANS.** LARGE EMPLOYERS WITH OFF-CALENDAR YEAR PLANS AS OF DECEMBER 27, 2012 CAN WAIT UNTIL THE FIRST DAY OF THE 2014 PLAN YEAR TO OFFER AFFORDABLE, MINIMUM VALUE COVERAGE WITHOUT BEING ASSESSED A PENALTY FOR THE MONTHS IN 2014 PRECEDING THE START OF THEIR PLAN YEAR. IN ADDITION, TO HELP THESE PLANS SYNCHRONIZE WITH THE JANUARY 1, 2014 EFFECTIVE DATE OF THE INDIVIDUAL MANDATE AND EMPLOYER SHARED RESPONSIBILITY RULES, THESE EMPLOYERS MAY PERMIT CERTAIN MID-YEAR ELECTION CHANGES FOR HEALTH COVERAGE IN 2013. THESE CHANGES WOULD REQUIRE A CAFETERIA PLAN AMENDMENT BY DECEMBER 31, 2014.

The IRS previously suggested it was considering a tweak to the rule that would allow employers to offer coverage to "substantially all" of its full-time employees without triggering the No Coverage Penalty. In the proposed regulations, the IRS has provided a bright line 95% standard so that if an employer offers coverage to all but 5% (or, if greater, 5) of its full-time employees (and their dependents) it would be treated as offering coverage and could avoid the No Coverage Penalty. This relief applies to a failure to offer coverage to the specified number or percentage of employees (and their dependents), regardless of whether the failure to offer was inadvertent.

**TRANSITION RELIEF: EMPLOYER CONTRIBUTIONS TO MULTIEMPLOYER PLAN COVERAGE CAN SATISFY EMPLOYER'S SHARED RESPONSIBILITY REQUIREMENT.** THE IRS HAS REQUESTED ADDITIONAL COMMENTS ON THE INTERPLAY OF THE EMPLOYER SHARED RESPONSIBILITY RULES AND MULTIEMPLOYER PLANS, BUT THROUGH 2014, HAS PROVIDED THAT AN EMPLOYER WILL NOT BE TREATED AS FAILING TO OFFER COVERAGE FOR PURPOSES OF THE EMPLOYER PENALTY IF (I) THE EMPLOYER CONTRIBUTES TO A MULTIEMPLOYER PLAN FOR FULL TIME EMPLOYEES PURSUANT TO A COLLECTIVE BARGAINING AGREEMENT OR PARTICIPATION AGREEMENT; (II) COVERAGE UNDER THE MULTIEMPLOYER PLAN IS OFFERED TO THE FULL-TIME EMPLOYEE AND HIS OR HER DEPENDENTS; AND (III) THE COVERAGE IS AFFORDABLE AND PROVIDES MINIMUM VALUE.

The proposed regulations make clear that employers are not required to offer coverage to employees' spouses. Instead, the regulations limit the definition of "dependents" to children under 26 years of age.

**TRANSITION RELIEF: DEPENDENT COVERAGE NOT REQUIRED IN 2014.** IF ANY EMPLOYER TAKES STEPS DURING THE 2014 PLAN YEAR TO OFFER COVERAGE TO FULL-TIME EMPLOYEE'S DEPENDENTS, IT WILL NOT BE LIABLE FOR PENALTIES SOLELY BECAUSE IT FAILED TO OFFER DEPENDENT COVERAGE IN THE 2014 PLAN YAER.

Be aware that the employer's obligation is only to offer the required coverage. The proposed regulations provide that if an employee enrolls in coverage but fails to pay the employee's share of the premium on a timely basis, the employer is not required to provide coverage for the unpaid period and the employer is treated to as having offered coverage for the remainder of the coverage period. The proposed regulations, however, generally adopt the 30-day grace period for payment under COBRA continuation coverage and rules with respect to (1) timely payments that are not significantly less than the amount required to be paid and (2) responding to requests by health care providers for confirmation of coverage during the grace period.

***The Inadequate Coverage Penalty***

The Inadequate Coverage penalty may occur because (1) the coverage is unaffordable for the employee, (2) the coverage does not provide minimum value or (3) the employer offers coverage to at least 95% but less than 100% of its full-time employees (and to those employees' dependents).

Coverage will be considered affordable if the employee's required contribution for self-only coverage does not exceed 9.5% of the employee's household income for the taxable year. Consistent with prior guidance, the proposed regulations include a Form W-2 safe harbor providing an employer may rely on the employee's Form W-2 wages for that calendar year in making the affordability determination for purposes of the employer shared responsibility penalty. Application of this safe harbor is determined after the end of the calendar year and is on an employee-by-employee basis. The proposed regulations also include, however, two new safe harbors for the affordability test: the Rate of Pay safe harbor and the Federal Poverty Line safe harbor.

***Rate of Pay Safe Harbor***

Under the Rate of Pay safe harbor, an 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. Specifically, the 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. For salaried employees, monthly salary would be used instead of hourly salary multiplied by 130. An employer may use this safe harbor only if the employer did not reduce the hourly wages or monthly wages of the employees during the year.

***Federal Poverty Line Safe Harbor***

Under the Federal Poverty Line safe harbor, employer-provided coverage offered to an employee is affordable if the employee's cost for self-only coverage under the plan does not exceed 9.5% of the Federal Poverty Level for a single individual. This safe harbor gives a baseline premium that can be applied across the board. For example, for 2013 single-only premiums that do not exceed $1,061.15 annually (9.5% of $11,170, which is the Federal Poverty Level for a single person) would be affordable.

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