IRS Guidance Helps Employers Estimate Play or Pay Penalty

This is the twenty-sixth issue in our health care reform series of alerts for employers on selected topics in health care reform. (Our general summary of health care reform and other issues in this series can be accessed by clicking *here*.) This series of Health Care Reform Management Alerts is designed to provide a more in-depth analysis of certain aspects of health care reform and how it will impact your employer-sponsored plans.

The IRS recently released clarifying guidance that should make it easier for employers to control health care costs starting in 2014 when the employer "play or pay" mandate kicks in.

The Play or Pay Penalty

Beginning in 2014, large employers (those employing 50 or more full-time equivalent employees) will be subject to a penalty if one or more full-time employee receives a tax credit or cost-sharing reduction (a "Subsidy") because (a) the employer doesn't offer coverage, or (b) the coverage offered by the employer either does not provide minimum value or is unaffordable to the employee. For more information on determining whether you are a large employer, click *here*.

Failure to Offer MEC

A large employer that fails to offer minimum essential coverage (MEC) to all full-time employees must pay an excise tax of $2,000 per full-time employee.

Failure to Offer Affordable MEC

A large employer that offers MEC that is not "affordable" will be subject to an excise tax of $3,000 per employee who receives a Subsidy through the exchanges. While this is a larger dollar amount than the tax for failure to offer MEC, this tax is only multiplied by the number of employees who receive a Subsidy, rather than by all full-time employees.

The Subsidy

The Subsidy was introduced as part of the Affordable Care Act in order to make health coverage affordable. A taxpayer is eligible for the Subsidy if the taxpayer (or a family member) is both enrolled in a plan offered on the health benefit exchanges and not eligible for MEC elsewhere. No subsidy is available for individuals (or families) with household income that exceeds 400% of the Federal poverty level.

The IRS recently issued proposed regulations relating to the Subsidy, and these regulations shed light on various issues pertaining to the play or pay penalty.

Employer Confusion

Employers only pay a penalty if at least one employee receives a Subsidy. Employees only receive a Subsidy if they are not eligible for MEC. Employer-provided MEC must be affordable and provide minimum value. So, if employers provide coverage that is affordable and of minimum value, they will not pay a penalty.

Under the Affordable Care Act, minimum value means that the plan's share of the total cost of benefits must be at least 60 percent. Affordable means that an employee's required contribution "with respect to the plan" (i.e., premium payment) cannot exceed 9.5 percent of the individual's household income. The statutory language regarding the affordability test created two problems for employers:

1. The Affordable Care Act did not specify whether affordability (i.e., premium contribution not to exceed 9.5% of household income) was measured using the premium for employee-only coverage or the premium for the coverage the employee actually elected (e.g., employee plus one, family, etc.). Employers often subsidize employee-only coverage more heavily than family coverage. So, if the IRS calculated the penalty using the premium for the coverage the employee actually elected, the likely result would be that more employers would face greater penalties for offering coverage deemed "unaffordable" by the IRS.
2. "Affordable" coverage is measured by comparing the employee's share of the premium cost to the employee's "household income." While most employers know how much they pay employees, they have no way of calculating an employee's household income. As a result, it would be difficult for employers to price employees' premium to avoid the penalty.

IRS Guidance Clarifies Affordability Test and Announces Expected Safe Harbor

The new proposed regulations provide a favorable interpretation of the affordability test. The proposed regulations clarify that the "affordability" test (for purposes of the tax credit) will be calculated by determining whether the premium contribution for self-only coverage (as opposed to family or other coverage) exceeds 9.5 percent of the taxpayer's household income. This means employers can avoid the play or pay penalty by charging a self-only premium that is less than 9.5% of an employee's household income (even if the family premium exceeds 9.5% of household income).

For example, assume an employee has $30,000 a year in household income. The employer covers at least 60% of the actuarial value of coverage. Employees must pay a premium of $2,400 for employee-only coverage (8% of household income) and $3,000 for family coverage (10% of household income). The employer will be deemed to have offered the employee affordable coverage, even if the employee elects family coverage.

Further, the preamble indicated that future proposed regulations will provide an affordability safe harbor for employers. Under this anticipated safe harbor, an employer will not be subject to the play or pay penalty if it offers its full-time employees (and their dependents) the opportunity to enroll in MEC and the employee portion of the self-only premium for the employer's lowest-cost coverage does not exceed 9.5 percent of the employee's W-2 wages, as opposed to the employee's household income. Employers who follow this safe harbor will not be assessed a penalty even if an employee receives a Subsidy through the exchanges.

The proposed safe harbor will provide employers with a workable and predictable method of providing affordable coverage. This is merely a safe harbor. If the employee's contribution exceeds 9.5% of the employee's W-2 wages, but the premium is still less than 9.5% of the employee's household income, the employer will still be deemed to have offered affordable coverage.

On September 13th, the IRS issued Notice 2011-73, asking for comments on the proposed safe harbor by December 13, 2011. The Notice indicates that each employer would determine whether it has met the safe harbor after the end of the calendar year by comparing each employee's W-2 wages to that employee's premium for the year. However, the Notice provides that an employer could also use the safe harbor prospectively by structuring its plan so that the each employee's contribution would not exceed 9.5 percent of wages.

For example, assume an employer knows the lowest-paid full-time employee makes $30,000 in W-2 wages per year. If the employer (a) covers at least 60% of the actuarial value of coverage, and (b) sets the employee-only premium for health coverage at $2,850 (i.e., 9.5% of W-2 wages) the employer will not be liable for the play or pay penalty.

What This Means For Employers

Given this recent guidance, employers should be able to better to design their plans to avoid a penalty, or calculate and predict their potential tax liability starting in 2014 when the employer mandate begins. Once the safe harbor is issued, employers may want to consider designing a benefit option that provides minimum value and does not require an employee premium payment that would exceed 9.5% of any full-time employee's W-2 wages (in essence, a "bare bones" plan). Employers will still face the decision of whether to stop offering coverage entirely, send all employees to the exchanges for health insurance, and simply pay the penalty for all full-time employees.

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