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IRS Issues Proposed Rule on ACA Play or Pay Requirements

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Full implementation of healthcare reform under the Affordable Care Act (ACA) is less than a year away. The most important aspect of the new system for employers is the "employer shared responsibility" or "play or pay" requirements. Under these requirements, "large" employers must offer "minimum essential" coverage to full-time employees and their dependents or pay a penalty. Even employers that offer coverage may pay a penalty if that coverage does not provide "minimum value" or if it is not "affordable."

On December 28, 2012, the Internal Revenue Service (IRS) released its much-anticipated proposed regulations governing the employer shared responsibility provisions of the ACA. These proposed regulations address the application of new section 4980H of the Internal Revenue Code (IRC), which was added by the ACA. The IRS also has released a set of questions and answers that provide additional detail on these requirements.

While the proposed rule generally incorporates various provisions of previously issued guidance materials,[1] it provides additional detail and direction for employers as they address the play-or-pay provision. According to the proposal, employers may rely on the proposed regulations for guidance until a final rule or other materials are issued.

This article summarizes the proposed regulations and the opportunities and challenges that the play-or-pay requirements present for employers.

Applicable Large Employers Subject to the Employer Shared Responsibility Provisions

Only applicable large employers are subject to the employer shared responsibility requirement. The ACA defines an applicable large employer with respect to a calendar year as an employer that, during the prior calendar year, employed an average of at least 50 full-time employees. To calculate the number of full-time employees for this purpose, an employer has to look at: (1) actual full-time employees; and (2) the number of full-time equivalent employees (FTEs) represented by the employer's part-time employees. The statute defines a full-time employee as one working 30 or more hours a week, calculated on a monthly basis.

1 *See* IRS Notices 2011-36 (May 23, 2011) (Definitions of employer, employee, and hours of service), 2011-73 (Oct. 3, 2011) (Affordability of coverage), 2012-17 (Feb. 27, 2012) (Determining full-time employee), and 2012-58 (Oct. 9, 2012) (Interim guidance).

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The determination of whether an employer is a large employer, subject to the shared responsibility provisions for a given year, is based upon the actual hours of service of employees in the prior year (using the "hours of service" rules described below), although the rule does include transition relief allowing use of a shorter look-back period in 2013 for purposes of determining large employer status for 2014. An employer may determine whether it is an applicable large employer for 2014 by determining whether it employed an average of at least 50 full-time employees on business days during any consecutive six-month period in 2013. Employers average their number of employees across the months in the year to see whether they meet the large employer threshold. Thus, for the first year that the employer shared responsibility requirement applies, some employers with variable workforces will have the opportunity to make the requirement inapplicable by selecting the six-month period during which their employee or employee-hour counts were low.

- **Common law employee standard:** As outlined in IRS Notice 2011-36, the proposed rule uses the common law standard to define an employee. The IRS notes that, under the common law standard, an employment relationship exists 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 accomplished by the work, but also as to the details and means by which that result is accomplished. The IRS rejected suggestions to use an alternative standard for determining employee status.

- **Aggregation rules:** All entities treated as a single employer under IRC section 414(b), (c), (m), or (o) with respect to retirement plans are treated as a single employer for purposes of determining large employer status. Therefore, companies under common control are combined together for purposes of determining whether they employ at least 50 full-time employees (or an equivalent combination of full-time and part-time employees). If the combined total meets the threshold, then each separate company is subject to the play-or-pay provision.

- **Foreign employers and employees:** The proposed rule addressed the question of whether foreign employees working for foreign entities are excluded in determining status as an applicable large employer, and in determining any potential liability under the play-or-pay penalty. For purposes of determining whether an employer meets the 50 full-time employee (or full-time employees and FTEs) threshold, an employer generally must take into account only work performed in the United States. Therefore, employees working overseas generally will not have hours of service, and will not qualify as full-time employees either for purposes of determining an employer's status as an applicable large employer or for purposes of determining and calculating any potential liability under section 4980H. A large foreign corporation with a small U.S. presence (under 50 employees) would not be subject to section 4980H.

Determining Full-Time Employees

Even though the hours of part-time workers are counted for purposes of determining whether an employer is a "large" employer, the play-or-pay penalty only applies with respect to full-time employees. Therefore, the determination of whether or not an employee is full-time versus part-time is critical.

- **Hours of service:** For the purposes of section 4980H, a full-time employee is an employee who was employed on average at least 30 hours of service per week. Taking the advice of a commenter, the IRS used the term "hours of service" in the proposed rule instead of "hours worked" because the former is a statutory term and includes not only hours when work is performed but also hours for which an employee is paid or entitled to payment even when no work is performed. In keeping with Notice 2011-36, the proposed regulations use a 130-hour standard as a monthly equivalent of 30 hours per week.

For purposes of determining hours of service, the proposed rule incorporates the guidance set forth in Notice 2011-36 providing that an employee's hours of service include the following: (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 (including disability), layoff, jury duty, military duty, or leave of absence. In response to comments, the proposed rule omitted Notice 2011-36's 160-hour limit on paid leave, so all periods of paid leave must be taken into account.

The proposal provides rules for hourly employees and non-hourly employees, generally consistent with the approach outlined in Notice 2011-36. As noted above, the proposed rule provides that hours of service generally do not include hours of service worked outside the United States. This rule applies without regard to the residency or citizenship status of the individual.

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The rule addresses the special issues presented by educational institutions by providing an averaging method for employment break periods that generally would result in an employee who works full-time during the active portions of the academic year being treated as a full-time employee. The IRS also included specific hours of service requirements for: employees compensated on a commission basis; adjunct faculty; transportation employees; and temporary staff members, among other special employment situations. Until further guidance is issued, employers of employees in these positions must use a "reasonable method for crediting hours of service that is consistent with the purposes of section 4980H." The IRS concludes that a method of crediting hours would not be reasonable if it took into account only some of an employee's hours of service with the effect of re-characterizing as non-fulltime an employee in a position that traditionally involves more than 30 hours of service per week. For example, it would not be a reasonable method of crediting hours to fail to take into account travel time for a travelling salesperson compensated on a commission basis, or, in the case of an instructor, such as an adjunct faculty member, to take into account only classroom or other instruction time and not other hours that are necessary to perform the employee's duties, such as class preparation time.

- **Measurement/stability period:** The proposal codifies the "look back" method for determining the full-time status of ongoing as well as variable hour and seasonal employees. The proposed regulations define "variable hour employees" as those employees as to whom, at the time of hire, the employer cannot determine whether they will work on average for at least 30 hours a week. While this approach provides some much-needed flexibility and predictability for employers, it is nonetheless administratively challenging.
    - **Ongoing employees: As in the prior guidance that introduced the "look back" method, the proposed regulations provide rules for new employees and "ongoing" employees.** For ongoing employees, an employer would determine each employee's full-time status by looking back at a defined measurement period (the "standard measurement period") of three to 12 months to determine full-time status for a subsequent "stability period." If an employee worked an average of 30 hours per week during the standard measurement period, the employer would treat the employee as full-time during the subsequent stability period, the duration of which would be at least the greater of six consecutive calendar months or the length of the standard measurement period. If an employee did not work an average of 30 hours per week during the standard measurement period, the employer would treat the employee as not full-time during the subsequent stability period, which may be no longer than the associated standard measurement period. Although these rules permit differing stability periods depending on the results of the measurement period, most employers are using consistent stability periods for all variable hour employees. The employer determines the months in which the standard measurement period starts and ends, provided that the determination must be made on a uniform and consistent basis for all employees in the same category.
    - **Different categories of employees:** Employers may use measurement periods and stability periods that differ either in length or in their starting and ending dates for the following categories of employees: (1) each group of collectively bargained employees covered by a separate collective bargaining agreement; (2) collectively bargained employees and non-collectively bargained employees; (3) salaried employees and hourly employees; and (4) employees located in different states.
    - **New employees:** An employer is not subject to the play-or-pay penalty for failing to offer new employees coverage for the first three months of employment. For new variable hour employees and new seasonal employees, an employer may determine whether a new employee is a full-time employee using an initial measurement period of between three and 12 months that begins on any date between the employee's start date and the first day of the first calendar month following the employee's start date. The stability period for such employees must be the same length as the stability period for ongoing employees.
    - **Seasonal Employees:** Although through at least 2014 employers are permitted to use a reasonable, good faith interpretation of the term "seasonal employee" for purposes of this notice, the IRS notes that final regulations may provide a specific time limit.
    - **Status changes and rehires:** A new variable hour or seasonal employee who has a change in employment status during an initial measurement period is treated as a fulltime employee as of the first day of the fourth month following the change in employment status or, if earlier and the employee averages more than 30 hours of service per week during the initial measurement period, the first day of the first month following the end of the initial measurement period (including any optional administrative period applicable to the initial measurement period). If an employee does not earn an hour of service for 26 consecutive weeks and is rehired, his or her status (as a full-time, variable, or seasonal employee) will be re-determined at the time of rehire.

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- **Administration periods:** Employers have the option of using administration periods of up to 90 days between the measurement period and stability period to determine which ongoing employees are eligible for coverage, and to notify and enroll employees. The employer can use an administrative period of up to 90 days for new variable hour and seasonal employees, which may not extend beyond the last day of the first calendar month beginning on or after the one-year anniversary of their start date.
- **Payroll periods:** The IRS recognized the problem associated with reconciling payroll periods with the measurement period and that an adjustment may be needed at the beginning and end of the measurement period. The proposed regulations address this by permitting adjustments for cases in which the measurement period begins or ends in the middle of a payroll period.
    - For payroll periods that are one week, two weeks, or semi-monthly in duration, an employer is permitted to treat as a measurement period a period that ends on the last day of the payroll period preceding the payroll period that includes the date that would otherwise be the last day of the measurement period, provided that the measurement period begins on the first day of the payroll period that includes the date that would otherwise be the first day of the measurement period.
    - For example, an employer using the calendar year as a measurement period could exclude the entire payroll period that included January 1 (the beginning of the year) if it included the entire payroll period that included December 31 (the end of that same calendar year), or, alternatively, could exclude the entire payroll period that included December 31 if it included the entire payroll period that included January 1.
- **Transition Relief:** Employers that intend to utilize the look-back measurement method for determining fulltime status for 2014 will need to begin their measurement periods in 2013 to have corresponding stability periods for 2014. The IRS acknowledges that employers intending to adopt a 12-month measurement period, and in turn a 12-month stability period, will face time constraints in doing so. Therefore, solely for purposes of stability periods beginning in 2014, employers may adopt a transition measurement period that is shorter than 12 months but that is no less than 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).

- **Anti-abuse rules:** The preamble to the proposed rule notes: "The Treasury Department and the IRS are aware of various structures being considered under which employers might use temporary staffing agencies (or other staffing agencies) purporting to be the common law employer to evade application of section 4980H." The agency states that final rules are anticipated to include anti-abuse rules to address such situations. For example, "if an individual performs services as an employee of an employer, and also performs the same or similar services for 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 section 4980H."

How the Play-or-Pay Penalty Is Assessed

Applicable large employers will be required to offer to their full-time employees (and their dependents) "minimal essential" health benefit coverage or pay a penalty if any full-time employee receives a federal subsidy to purchase insurance through a health exchange. This penalty will be $2,000 for each full-time employee in excess of 30 employees. Covered employers that do offer minimum essential coverage, but fail to provide minimum value (*i.e.*, the plan's share of the total allowed costs of benefits provided under the plan is not at least 60% of those costs) or provide coverage deemed unaffordable (*i.e.*, the cost of coverage exceeds 9.5% of the employee's compensation), will pay the lesser of $2,000 for each full-time employee (minus 30) or $3,000 for each full-time employee who receives a premium tax credit to enable them to purchase coverage through the future health insurance exchanges.

- **95 percent standard: The proposed regulations provide some unanticipated flexibility to employers.** The proposed rule states that an employer will satisfy its obligation to offer "minimum essential coverage" to its full-time employees (and their dependents) if it offers such coverage to all but 5 percent of its full-time employees (provided that an employee is treated as having been offered coverage only if the employer also offers coverage to that employee's dependents, as discussed below). The rule

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specifically permits this failure to offer coverage to up to 5% of the full-time employees to be intentional (although employers need to be cautious that the failure does not run afoul of an employee nondiscrimination prohibition). An employer with fewer than 100 full-time employees can exclude as many as 5 individual full-time employees under this rule, even though that would be more than 5%.

- **Dependent coverage:** The proposed regulations provide that employers must offer "minimum essential coverage" to full-time employees *and their "dependents"* to avoid paying a penalty. The proposed regulations define an employee's dependents as a child (as defined in IRC section 151(f)(1)) who is under 26 years of age. The term "dependent" does not include an employee's spouse. Thus, the proposed regulations recognize the growing trend among employers not to extend coverage to spouses, particularly those who can access coverage from their own employers. For those employers who do not currently provide dependent coverage, the IRS acknowledges that expanding their health plans to add dependent coverage will require substantial revisions to their plans and to their procedures for administration of the plans. To provide employers sufficient time to implement these changes, the IRS is providing transition relief with respect to dependent coverage for plan years that begin in 2014. Accordingly, any employer that takes steps during its plan year that begins in 2014 toward satisfying the section 4980H provisions relating to the offering of coverage to full-time employees' dependents will not be liable for any assessable payment under section 4980H solely on account of a failure to offer coverage to the dependents for that plan year.
- **Calculation of the penalty:** The penalty is calculated for each calendar month. For employers not offering minimum essential coverage, the amount of the payment for the month equals the number of full-time employees the employer employed for the month (minus up to 30) multiplied by 1/12 of $2,000. If the employer is related to other employers in the controlled group, then the 30-employee exclusion is allocated ratably (based on each employer's number of full-time employees) among all the related employers. The payment for the calendar year is the sum of the monthly payments computed for each month for which coverage was not offered.
- **Failure to pay premium:** An employer will not be subject to the penalty for an employee whose coverage under the plan is terminated during the coverage period solely due to the employee's failure to make a timely payment of the employee portion of the premium.
- **Affordability safe harbor:** Employers may take advantage of one of three safe harbors to determine whether the plan they offer is "affordable."
  - An employer will not be subject to an assessable payment under section 4980H(b) with respect to a full-time employee if that employee's required contribution for the calendar year for the employer's lowest cost self-only coverage that provides minimum value during the entire calendar year (excluding COBRA or other continuation coverage) does not exceed 9.5 percent of that employee's Form W-2 wages from the employer for the calendar year. Application of this safe harbor is determined after the end of the calendar year and on an employee-by-employee basis, taking into account the Form W-2 wages and the required employee contribution for that year. For an employee who was not a full-time employee for the entire calendar year, the Form W-2 safe harbor is applied by adjusting the employee's Form 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.
  - Employers may instead choose to use a safe harbor based on the rate of pay if it does not exceed 9.5 percent of an amount equal to 130 hours multiplied by the employee's hourly rate of pay as of the first day of the coverage period (generally the first day of the plan year).
  - Alternatively, employers may use a safe harbor based on the federal poverty level.

Additional Transition Rules

- **Fiscal year plan years:** If an employer maintains a fiscal year plan as of December 27, 2012, and offers affordable, minimum value coverage to a full-time employee no later than the first day of the 2014 plan year, no section 4980H penalty will be due with respect to that employee for the period prior to the first day of the 2014 plan year. The relief applies with respect to employees of the applicable large employer member (whenever hired) 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.

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- **Multiemployer plans:** Employers participating in multiemployer plans face unique considerations that the proposed rule does not address. Although the IRS provides a transition rule intended to provide an administratively feasible means for employers that contribute to multiemployer plans to comply with section 4980H, a number of questions and challenges remain. Under this transition rule, an applicable large employer member will not be treated as failing to offer the opportunity to enroll in minimum essential coverage to a full-time employee (and the employee's dependents) and will not be subject to a penalty with respect to a full-time employee if: (1) the employer is required to make a contribution to a multiemployer plan with respect to the full-time employee pursuant to a collective bargaining agreement or an appropriate related participation agreement: (2) coverage under the multiemployer plan is offered to the full-time employee (and the employee's dependents); and (3) the coverage offered to the full-time employee is affordable and provides minimum value. Although this transition rule is stated as "relief," it literally may turn an affordability issue into a more serious failure to offer coverage. Further clarification is sorely needed.

Comments on the proposed rule must be received by March 18, 2013. Comments may be submitted electronically through the federal eRulemaking portal or sent by mail to: CC:PA:LPD:PR (REG-138006-12), Internal Revenue Service, room 5203, POB 7604, Ben Franklin Station, Washington, DC 20044. Written comments may also be hand-delivered to: CC:PA:LPD:PR (REG-138006-12), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C.

In addition, the IRS intends to hold a public hearing on the proposed rule on April 23, 2013, at 10:00 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, N.W., Washington, D.C. Suggested topics the IRS should address at this hearing must be submitted by April 3, 2013.

What This Means for Employers

The release of the long-awaited proposed rules provides a degree of much-needed clarity for employers facing the 2014 trigger of the play-or-pay penalty. However, the challenge to prepare for full implementation of ACA remains great. The proposed rules confirm the flexibility and safe harbors outlined in previous guidance. Yet, employers must contend with significant administrative burdens and make key strategic considerations in the months ahead.

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