

The First Pieces of Health Reform's Pay or Play Penalty Puzzle

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Early this week the Internal Revenue Service and Department of Treasury (the "IRS") issued the first piece of the Affordable Care Act ("ACA") penalty imposition jigsaw puzzle. It then followed up with 46 FAQs on the same subject. While much of the basic structure for the shared responsibility or pay or play penalty was previously issued in proposed regulations, the final regulations provide expanded guidance on many of the practical issues raised by the proposed regulations (e.g., employee terminations and rehires) and provide more transition rule relief. The most significant transition rule permits certain applicable large employers ("ALEs") with 50 to 99 employees to wait an additional year until 2016 before the pay or play penalty will be assessed with respect to their full-time employees. It is critical to understand the defined terms used in these regulations. The final regulations also add a number of qualifications that explain when certain rules may or may not be used, including transition rules and which transition rules may be used in conjunction with other transition rules. *This alert contains a high level summary of how the final pay or play penalty regulations calculate on whom a penalty might be assessable and it does not contain a full description of all of the requirements or transition rules. The nuances of all the various transition rules are not covered in this alert due to the fact specific inquiries involved. The application of the new regulations to any particular situation require careful analysis of the facts involved considering the details in the regulations for each rule and exception. The devil is always in the details.. No action should be taken based solely on the contents of this alert.*

*This is just one piece of the puzzle, but it is a key piece for employers because it establishes the meaning of some of the defined terms that will be used in the other pieces of guidance, such as the reporting requirements related to health plan coverage offered under the employer's plan to full-time employees and dependents and thus, it provides the definition of the parameters of the testing and the records an employer must maintain to defend against the assessment of the pay or play penalty. Employers must know who is a full-time employee and the dependents and spouses of such employee to know on whom they must report to the IRS regarding to whom coverage was offered and provided. The reporting requirements were proposed to only apply to those employees who were full-time employees as defined for the pay or play penalty. There are penalties for failing to file complete reports or reporting inaccurately on these reporting requirements are \$100 per form up to \$1,500,000 per year (there is a report sent to the IRS and a form for each FTE). This means that the employer must also know which employees are full-time employees (as defined by these regulations) for each month of the year beginning in 2014 for measurement periods starting in 2014, or for December 2014 if the employer uses the monthly facts and circumstances test, in order for the employer to know on whom it must report to the IRS regarding whether affordable coverage was offered for any particular month in a calendar year to such full-time employee, and how much such coverage cost and potentially also the dependents and spouses names and Social Security Numbers. *The determination of full-time status must be made for all employees including members of collective bargaining units that mandate coverage of all members because this is for penalty calculation and there is no exception to the penalty or to the reporting requirements for collective bargaining unit members even if all have coverage contractually.* It is not yet known whether the IRS will only accept reporting only on such full-time employees, their spouses and their dependents, or if it will accept over-reporting which would permit an employer to report on all employees regardless of whether they are full-time under this regulation. Over reporting will increase the burden on the IRS and on employers later to address which of the over reported employees is a full-time employee (as such term is defined by these rules) for which a pay or play penalty is assessable. This reporting will be used by the IRS to determine on which employees, spouses or dependents the IRS will assess a penalty on the employer and over reporting will cause the IRS to investigate additional employees that are not full-time employees. This reporting is also used by the IRS to determine which individuals might be entitled to a health care tax credit claimed by that individual on their income tax return or at the marketplace. Thus, these definitions and the related reporting will impact many persons.*

The definition and determination of who is a full-time employee in these regulations will have implications for (1) an employer's record capture and retention to enable an employer to defend against pay or play penalty assessments and (2) an the employer's ability to comply with the reporting requirements and avoid penalties for incomplete or inaccurate reporting. We anticipate that there will be additional guidance on the other aspects of the pay or play penalty administration scheme in the not too distant future to enable implementation of the penalty beginning in 2015. Employers should watch for the reporting requirements because those are likely to require many employers to gather information from both payroll and HRIS systems to complete the reports and may require reprogramming to identify on which individuals the employer must report, and to gather the right data for the monthly measurement periods.

A Simplified Reminder of When the Pay or Play Penalty is Assessed

The law imposes this penalty on an ALE for either (1) failure to offer coverage to all or at least 95% of its full-time employees and their dependents and at least one of the full time employees receives a premium tax credit to help pay for coverage on the marketplace or (2) offering coverage to full-time employees that is not affordable or does not provide minimum value and at least one such full-time employee purchases coverage on the marketplace/exchange and obtains either a premium tax credit on the marketplace to help pay for coverage. (This is a gross oversimplification to remind that the penalty can be imposed in two different situations.) There are also other restrictions and requirements beyond the scope of this alert.

The offer of coverage and the actual coverage in which an employee enrolls is proposed to be reported for the employee and any dependents including a spouse, while the final regulation on the pay or play penalty clarifies that the penalty can be assessed for failures with respect to "dependents" which is defined to only include children, but does not include a spouse. So the pay or play penalty may only be assessed for failure to offer coverage to a full-time employee or to his/her dependent(s), but not for failure to offer coverage to a spouse. Exclusion of spouses from the offer of coverage is likely to have other repercussions for employers, but not a tax penalty. However, the proposed reporting requirements include reporting on all persons who are covered, so there will be reporting on spouses which cannot trigger a pay or play penalty on the employer, but the plan can exclude spouses from coverage and the only ramification is in the individual's federal taxes under the individual mandate penalty.

Determination of Whether Your Entity is Subject to the Pay or Play Penalty

The penalty regulations do clarify a number of items. First, the penalty applies only to "applicable large employers" or an "ALE". Determining if an entity is an ALE requires counting the full-time employees and full-time equivalent employees of that employer and considering all such employees of the commonly controlled entities as members of the controlled group and as one employer of all of the respective entities' employees. Thus, all members of the controlled group must first be identified to identify which employees must be included in the count to determine if the number of full-time employees and full-time equivalent employees exceeds 50 or 99.

An employer must identify who are the *full time employees* ("FTEs"), and these are employees who are employed on the average at least 30 hours per week with that employer (using the controlled group or ALE definition of the employer and not just the common law employing entity). *This may present challenges in identifying who is full-time where an employee's services are allocated among more than one entity in a controlled group and may require employers to identify such shared employees as a separate group and test those considering services to all entities combined to determine if they are FTEs, if the controlled group is close on determining if it is an ALE.* The number of FTEs then must be added with the number of Full-time equivalent employees.

Calculating Hours Worked

Full time equivalent employees ("FTEEs") are determined by considering how many hours the other employees who are not regularly scheduled to work 30 hours per week actually work in total in a month (and disregarding hours in excess of 120 hours in a month by any individual) and dividing that total number of hours by 120 hours per month to determine how many worked more than 30 hours per week on the average in the particular month. Hours worked include hours paid or for which the employee is entitled to payment for services or entitled to payment for periods in which no duties are performed due to vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty or leave of absence. There is no clarification regarding whether the time while out and receiving short or long term disability benefits under a plan are treated as hours paid that must be counted or whether the way the disability benefit is funded changes

the answer (e.g., a disability benefit funded by an insurance policy paid for in part or in total by the employer, funded by an insurance policy paid for by the employee, or funded by a self-insured plan funded in part by the employee and employer). There is also no clarification as to whether hours that an individual is off due to a lay off or furlough during which the employee may receive payment from the union are counted since there is no payment from the employer.

Hours worked as a bona fide volunteer do not count and hours worked by students on certain work-study programs do not count. Hours worked outside the United States do not count if the compensation constitutes income from sources outside of the U.S. Hours worked by an individual whose work is done under a vow of poverty do not count toward treating the member of the order as a full-time employee. The Treasury is still considering difficult groups such as commission sales people and airline employees with layover hours and on-call hours, and adjunct faculty, and until guidance is issued on these categories, employers may use a reasonable method of crediting hours. The final regulations include methods for imputing hours when an employee is on certain unpaid leaves (FMLA, USERRA and jury duty) and for bridging breaks in service with rules regarding whether or not prior service must be counted.

*Once an employee is determined to be a FTE and the employer is determined to be an ALE based on employment in the prior calendar year, the effective date of the pay or play penalty is determined for the ALE. The next step is for the ALE to determine which employees are FTEs (under the rules for the pay or play penalty) and to which the penalty might apply. These are not eligibility rules. These are rules regarding to whom a penalty may apply if either coverage is not offered or if the coverage offered is not affordable or does not provide minimum value and the individual obtains a tax credit in the marketplace. The employer must be able to prove why the penalty does not apply to each FTE and why each person is not an FTE and retain records reflecting how they determined each individual is not subject to the penalty. The key here is this is not a determination of eligibility, **it is a determination of for whom the ALE must maintain records that can be used to defend the employer against the assessment of a shared responsibility penalty and the first step in for whom the employer will have reporting obligations to the IRS and for whom there may be penalties for such reporting.***

Determination of Who is a Full-Time Employee or FTE

The method used to determine FTE status may vary by the entities within the ALE and may also vary within a particular entity by certain categories of employees. However if employees change between positions using different methods, there are also transition rules related to the change in the method of determining FTE status. Employees within the group being tested are then divided into two buckets. Any employee who is hired into a position in which the individual is expected to work 30 or more hours per week, and who is not a seasonal employee, variable hour employee or part-time employee (a "SVPTTE"), are automatically counted as FTEs. This is important clarification because it makes it clear that even a SVPTTE who may work 30 or more hours per week for a limited period is still subject to being tested to determine if the individual is an FTE. When one is determined to be a FTE interacts with the ACA requirement that waiting periods not exceed 90 days. The regulations on how the 90-day waiting period will work have been sent to the Office of Management and Budget for review and are one of the pieces to this complex puzzle for determining to whom coverage must be offered, when it must be offered, and how to defend the employer against an imposition of a pay or play penalty for those individuals. For the SVPTTEs, those individuals are not outside of the testing to determine if the individual is a FTE. Seasonal employees is someone hired into a position for which the customary annual employment is six months or less, e.g., lifeguards working at outdoor pools or beaches in Michigan. The SVPTTEs and their dependents are not automatically required to be offered health coverage, but it is for the SVPTTEs that an employer must maintain records as to when they meet the full-time status definition and could subject the employer to a shared responsibility penalty. There are two types of tests an employer may use to determine whether a SVPTTE would cause the employer to potentially be subject to the 4980H tax. Employer may select one of two different methods. The method chosen determines the records that must be maintained. *Even if the employer offers health plan coverage to more individuals than those working 30 or more hours per week, unless the reporting rules permit over-reporting of non FTEs, the employer must be able to identify the FTEs under this definition to be able to comply with the health coverage offer, enrollment and cost reporting requirements for each month in the calendar year for the FTEs and to have the records to defend against the assessment of the pay or play penalty.*

For both of the following testing options to determine FTE status, the hours worked are calculated using the hours for which payment is made or due for hourly employees. For employees paid on a non-hourly basis, a day's worked equivalency can be used with 8 hours per each day worked credited or a weeks worked method crediting 40 hours for each week in which any work was performed. The equivalencies can be used as long as the equivalency does not result in crediting the individual with fewer hours than those actually worked. An employer can use different equivalency methods for different categories of non-hourly employees as long as the categories are reasonable and consistently applied (and provided your IT department can program the classification codes for the categories and different equivalency rules). The regulations did not include any special rule with respect to certain industries in which the hours worked are regulated by federal safety laws or regulations.

The *first* option for testing SVPTes to determine if they meet full time status and must be offered coverage to avoid a penalty is using the *monthly facts and circumstances method* which requires the employer to retain records for each month of employment for each individual who is a SVPTE to document whether or not the individual worked thirty or more hours per week in that month. Once the individual works 30 or more hours per week in a month, the individual must then be offered coverage as a FTE and not be subject to any waiting period in excess of 90 days and records must be maintained of such individual's hours worked for each month to comply with the reporting requirements. For any individual who does not work 30 or more hours per week under the monthly facts and circumstances method, records must be maintained to demonstrate that such individual is not a FTE for that month in order for the employer to defend against any penalty assessed for such individual.

The *second* method of determining whether a SVPTE is a FTE for whom the employer may potentially be subject to the penalty is using the *measurement and stability period method*. Any person hired into a position to work 30 or more hours per week is a FTE and must be offered coverage that will be effective no later than the first day of the fourth full calendar month after their date of hire to avoid a penalty. For testing the SVPTes, the employer designates a period over which the individual will be measured from initial employment for the related initial eligibility, and then there is a related period during which the determination made based on hours worked in the measurement period must remain in effect, the stability period. The initial measurement period must be at least 3 months and not more than 12 months. The stability period for an individual following their initial measurement period must be at least as long as the stability period would be for ongoing employees; however if the SVPTE is not determined to be a FTE after the initial measurement period, such individual's stability period must not be more than one month longer than their initial measurement period and cannot extend beyond the first standard measurement period and any related administration period. The stability period is required to immediately follow the measurement and any administration period. Different administrative periods may also be used for different categories of employees.

There is also a measurement and stability period for ongoing employees for whom records must be kept and there are rules related to transitioning from the initial measurement/stability period to ongoing measurement/stability periods. *If the measurement/stability period method is chosen, the employer must maintain records of hours worked for each employee's initial measurement period and for the ongoing measurement period for ongoing SVPTes and SVPTes that qualify as FTE for one measurement/stability period. The employer may use different measurement periods for different categories of employees as long as the records can be procured for each employee's respective initial and ongoing measurement period (and IT is willing).*

The individual's health plan coverage and the penalty applies after the administration period following the measurement period, and there are limits on how long the administration period may be depending upon the duration of the measurement period. The administration period is the period during which an employer must determine that the employee is or is not a FTE, and then offer the FTE coverage. While an employer is not required to use an administration period, as a practical matter most will need time to make the determination and offer coverage to the FTE in a manner compliant with all applicable requirements and disclosures. The administration period may not increase or decrease the length of the measurement or stability periods and it cannot exceed 90 days. There are special rules applicable when the longer measurement periods are used. Health plan coverage must be maintained for the duration of each stability period with respect to a measurement period during which the individual was determined to be a FTE.

The stability period for an ongoing employee must be at least 6 months and it cannot exceed 12 months. The stability period may not be shorter than the measurement period. The measurement period for ongoing employees must be at least 3 months and no longer than 12 months. There are also rules regarding measurement and stability period and how they must relate to each other. The individual measurement periods can be from 3 to 12 months and the stability period can be from a period of 6 to 12 months. If the measurement period/stability period method of FTE determination is used, there may be different measurement and stability periods for certain classes of employees. The 4 classifications of employees by which the measurement/stability period may vary are: (1) salaried v. hourly, (2) collective bargaining unit member, (3) member of different collective bargaining units, and (4) employees whose primary place of employment is in different states. However, there are additional limits and rules which apply in designating the measurement and stability period and the employer needs to be sure that all of those are addressed.

For the 2015 plan year, an employer may adopt a transition measurement period as long as it is at least 6 months long and no longer than 12 months and it begins before July 1, 2014 and it must end no earlier than the first day of the 2015 plan year. So a transition period from April 15, 2014 to October 14, 2014 would be permissible for a January 1, 2015 plan year, with an administrative period from October 15, 2014 to December 31, 2014.

There are special rules for determining FTE status for employees who are rehired or who return after an absence. If an individual performs no hours for at least 13 weeks, the employer may calculate his full-time status as if he were a new hire, provided the employer is not an educational organization. *The penalties will be assessed on individuals who are FTEs in 2015 which is determined based upon their hours worked in 2014, so the rules for determining FTE status may impact an employer's staffing decisions in 2014.*

Special Situations and FTE determination

The special rules for employees of educational organizations continue. Rules for churches are to be provided at a later date. If an employee transfers to a position outside of the U.S. that is expected to continue for at least 12 months and if substantially all of the compensation for such position will constitute compensation from sources outside of the U.S., that employee is not considered to be a FTE, but an individual transferred into employment of the U.S. entity for at least 12 months and whose compensation will constitute U.S. source income is counted as an FTE for whom the pay or play penalty could be assessed. *This is slightly different than other tax rules related to inpats and expats, so employers need to be careful in counting these individuals.* There are also special rules for certain inpats and expats when they move into the U.S. to permit treating them as new hires for purposes of the pay or play penalty.

For each choice there are many restrictions that also apply and must be considered. There are also a number of conditions related to which rules apply. The documentation of who is an FTE will also determine for which employees the employer will be required to report based on the preliminary regulations on reporting. At this time it is not clear whether the IRS will permit employers to over report and report on all employees offered coverage as opposed to just the employees who satisfy the FTE requirements and to whom the penalty might apply. Thus, it will be important to watch and determine on which employees an employer must reporting and how the reporting will need to be prepared. The proposed reporting regulations on health care coverage under the ACA are critical because they require pulling information that is often housed in different systems such as information on to whom coverage is offered and the premiums at which it is offered for particular months may be contained in the HRIS system while the hours worked may be contained in a payroll system and also soliciting for the information most employers do not hold, the Social Security Numbers of dependents and spouses. Thus, reporting may require employers to solicit information, pull information from separate computer systems and combine the data into one report for the IRS and statements sent to the FTEs.

The regulations also require employers to offer coverage to those full time employees qualifying as full time by the first day of the fourth month after the end of the measurement period to avoid the 4980H penalty for the first three months after the measurement period ends. If an employer fails to offer coverage to a FTE on any day during the month, that employee is treated as not offered coverage for the entire month and thus the employer is subject to the failure to offer coverage penalty for that employee for that month. This contrasts with the individual penalty where an employee can avoid the individual mandate penalty if they have coverage for just one day in a calendar month. *The employer must also report one day of coverage as a month of coverage under the proposed regulations, even though the employer cannot treat such*

same day of coverage as a month of coverage to defend itself against the assessment of the pay or play penalty with respect to the same individual, this may require some very good system programming.

However for January 2015 only, if the employer offers the employee coverage by the first day of the first payroll period in January 2015, the employer will be treated as offering coverage for the entire month. The use of the one day of non-coverage exposing the employer to the penalty for the entire month may cause employers to rethink the plan provisions regarding when coverage terminates for an employee or dependent and when coverage is added for the employee or dependent for a change in status or special enrollment period; however, employers need to be careful to consider how the cafeteria plan rules regarding the effective date of changes due to changes in status and special enrollment rights mesh with the ACA rule regarding a day of missed coverage means no coverage for the month and consider the cost of extending coverage as compared to the penalty cost for not providing coverage for a month.

Determining if Your Coverage is Affordable

An employer can use one of three safe harbors to determine if its coverage is affordable and less than 9.5% of an amount deemed to be the employee's household income. The three safe harbors are to use the employee's Form W-2 wages at the end of the year, the rate of pay safe harbor which multiplies the employee's base pay rate by 130 hours, or the federal poverty level. Only the rate of pay and federal poverty level safe harbors permit the employer to determine prior to the end of the calendar year if the coverage provided to the employees meets the affordability requirement.

Transition Rule For Pay or Play Penalty Based on Number of FTEs and FTEEs

Employers who have 50 or more individuals who are treated as either FTEs or FTEEs and less than 100 will not have to pay the assessable penalty for any individual in 2014 or 2015 and the pay or play penalty will not apply to those ALEs until 2016. For employers with 100 or more employees who are either FTEs or FTEEs on more than 120 days in the prior calendar year will be required to comply in 2015 and pay the penalty in 2015 for anyone who does not meet the requirements.

Safe Harbor/Transition Rules

In the proposed regulations on the penalty, an employer with a non-calendar year plan could avoid the penalty for failure to offer coverage if the employer met the safe harbor of offering affordable coverage to all but 5% of its employees, or if greater to all but 5 employees. The final regulations retain this rule for non-calendar year plans and permit an expansion of this safe harbor for 2015 to permit employers to avoid the penalty under Code section 4980H(a) for failure to offer affordable coverage if the employer offers affordable coverage to all but 30% of its FTEs, or it offers affordable coverage to at least 70% of its employees as of the first day of the 2015 plan year, then no 4980H(a) penalty applies for the months in the plan year during calendar year 2015. This expansion of the transition rule only applies for 2015 and only if the plan year has not changed and certain other requirements are satisfied.

It is important to remember that even if the employer uses this safe harbor to avoid imposition of the 4980H(a) penalty for failure to offer coverage, it still may be subject to the penalty under 4980H(b) when an employee seeks coverage from the marketplace and obtains a tax credit if the employer's coverage is either not affordable or does not provide minimum value.

Special transitional rules exist for non-calendar year plans. The non-calendar year transition rule for cafeteria plans was not extended and does not extend to plan years beginning in 2014.

There are other transition rules that may apply if certain conditions are satisfied. The transition rules and many of the details that need to be considered as an employer plans for avoidance or minimization of the pay or play penalty and being able to document its compliance, as well as planning to comply with the reporting requirements will require careful review of all the details of the regulations. All of the details of the regulations are beyond the scope of an alert. This is intended to only provide you with as brief as possible of an overview of the regulations and some of the related concerns.

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