IRS Issues Proposed Regulations on Affordable Care Act's "Play or Pay" Requirements – What Employers Need to Know

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Starting in 2014, "large" employers (essentially, those with 50 or more "full-time" employees) must offer minimum health insurance coverage to full-time employees or face hefty penalties. These provisions (a.k.a "shared responsibility," "play-or-pay" or the "employer mandate") were added as new Internal Revenue Code section 4980H by the Patient Protection and Affordable Care Act ("PPACA") in March 2010. Though these penalties do not start until 2014, employers need to plan *now* because determining whether a company meets the 50-employee threshold – and, if so, which employees it must cover – is based on employee data for 2013.

The Internal Revenue Service provided interim guidance on the employer mandate following the PPACA's enactment (Notices 2011-36, 2011-73, 2012-17, and 2012-58), and followed up with proposed regulations in December 2012. The proposed regulations reflect the IRS' prior guidance with some changes, and employers may rely on the proposed regulations pending public comments (due March 18, 2013) and IRS publication of final regulations. For those who would rather not read the 144 double-spaced pages of proposed regulations and explanation, the IRS has summarized them in question-and-answer format on its Web site.

Guidance here is welcome because Congress was vague in wording the statute and left it to the IRS and other agencies to flesh out details through regulations. Essentially, the *statute* (Code section 4980H) provides that a "large employer" pays penalties if even *one single employee* has enrolled in tax-subsidized health insurance through a federal- or state-run exchange under the PPACA (not a hard test to trip, considering that at some point at least one out of 50-plus employees is likely to do so) and if *either* of the following circumstances applies:

1. **"No-coverage"** - If the employer does not offer its "full-time" employees (and their "dependents") the opportunity to enroll in "minimum essential coverage," the monthly penalty is $166.67 times the number of *all* full-time employees for such month above a floor of thirty (30) employees. The term "minimum essential coverage" cross-references to Code section 5000A which is the *individual* (as opposed to *employer*) mandate upheld by the Supreme Court, and has yet to be precisely defined by federal agencies in regulations (though the standard group health policy will typically meet the requirements as will a government-run plan like Medicare or Medicaid).
2. **"Minimum value"** - If the employer *does* offer "minimum essential coverage" but does so "on the cheap" – that is, the coverage does not provide "minimum value" by allowing sufficient benefits in relation to the medical costs incurred by the employee, or the coverage is "unaffordable" because the premiums gobble up an undue percentage of the employee's income, then the monthly penalty is $250.00 times the number of full-time employees actually enrolled in exchange-run health insurance. However, if the employer would have ended up paying a lower penalty had the employer offered no coverage at all, then the employer pays the lower penalty determined under the no-coverage provisions above.

Congress also left the IRS with the tasks of (1) defining the "employer" in the case of commonly-controlled entities, or new or predecessor entities; (2) defining the relevant period for determining whether an employee is "large"; (3) defining a "full-time" employee; (4) defining a "dependent" of a full-time employee; (5) defining how to meet the "minimum essential coverage" requirement; (6) defining when coverage fails to meet the "minimum value" or "affordable" tests; and (7) defining how the different penalties are to be applied. The proposed regulations address all these issues.

Defining the "employer"
Defining the "employer" is straightforward for a single corporation, partnership or limited liability company, but less clear if there are multiple entities where one owns others (as with parent-subsidiary corporations) or there is common ownership (as with brother-sister corporations). At what level of ownership and control do the companies get lumped as a single "employer"? Also, what happens if a company has succeeded to the business of another through a purchase or merger?

The proposed regulations answer these questions by adopting the same technical and highly complex tests used to aggregate companies as a single "employer" for purposes of testing compliance by pension, 401K and other qualified retirement and employee benefit plans. For example, a parent corporation generally is combined with its subsidiary if it owns at least 80% – but not less – of the subsidiary's stock; as another example, brother-sister corporations generally are combined if up to 6 individuals – but not more – own stock in each corporation in equal proportions. It is also important to note that these rules combine companies that may have little or no common ownership but nonetheless are affiliated in providing services to clients or other third parties (as in the case of a medical or law partnership on the one hand and a partner's personal service corporation on the other hand).

Although two or more companies can be grouped as a single "employer" in applying the "large employer" tests, the proposed regulations apply the penalty on a company-by-company within the group and not on an aggregate basis. This pro-taxpayer rule reflects the concerns of private equity firms, consolidated corporate groups and other related employers that the failure of a small company inside a combined "employer" to offer coverage not "infect" other companies in the "employer" group.

The proposed regulations also describe the circumstances under which a successor company "steps into the shoes" of a predecessor (as in the case of a purchase of the predecessor's business, or a merger).

Defining the period for determining "large"-ness
Having identified what company or group constitutes the "employer," the next step is to determine whether that "employer" meets the "large" threshold. The employer meets that threshold if it employed, on a monthly average, at least 50 "full-time" or "full-time equivalent" employees in the prior calendar year. Thus, the relevant measuring period may depart from the employer's fiscal year used for other tax reporting or financial purposes. Further, even though the penalties are not effective until 2014, each employer must use employee data for 2013 to determine whether it is a "large" employer potentially so subject. Fortunately, the proposed regulations include a one-time transition rule allowing an employer to use any consecutive 6-month period it wants in 2013, instead of the full year, to calculate the average number of employees.

If an employer existed for only part of the preceding calendar year, the determination of whether such employer is "large" for the current year is based on the average number of employees that it is "reasonably expected" such employer will employ during the current year.

Defining "full-time" employee
Identifying "full-time" employees is crucial for two reasons: first, to determine whether the employer is "large" based on employee data for the prior calendar year; and second, to calculate penalties for a "large" employer that either fails to offer "minimum essential coverage" or offers coverage that flunks one or both of the "minimum value" or "affordable" tests.

A "full time" employee is one who was employed on average at least 30 hours of service per week. The proposed regulations use a 130-hour standard as a monthly equivalent of 30 hours per week, and further provide that an employee's hours of service include, not only each hour for which an employee actually performs duties, but also each hour for which an employee is paid (or entitled to payment) for periods during which no duties are performed (e.g., vacation, holiday, illness, disability, layoff, jury duty, military duty or leave of absence). Although IRS Notice 2011-36 had previously limited the period of leave that must be included to 160 hours, the proposed regulations do away with this limitation. An employer generally must take into account only work performed in the United States. The proposed regulations have hours-counting rules for educational institutions, employees on commission, and other special circumstances.

Part-time employees may also be deemed the equivalent of full-time, but only for purposes of determining whether an employee is "large" and not for purposes of calculating the penalties. The calculation works as follows: For a given month, add the number of hours for all part-time employees (counting no more than 120 hours for any one employee) and divide by 120. The result is the number of "full-time equivalent employees" ("FTEs") which are added to the number of actual full-time employees to determine if the employer meets the "large" threshold. Fractions are taken into account in determining the number of FTEs month-to-month, but not the number of FTEs plus actual full-time employees in computing the average for the year. For example, if for a calendar month employees who were not employed on average at least 30 hours of service per week have 1,260 hours of service in the aggregate, there would be 10.5 FTEs for that month (that is, 10 persons and one halfling (to borrow a term from The Hobbit)). However, if the employer gets 49.5 (that is, 49 persons and one Hobbit) after adding the monthly full-time employee and FTE totals and dividing by 12, the number is rounded down to 49 full-time employees (and thus the employer would not be a "large" employer for the following calendar year).

Defining "dependent"
After all that, the proposed regulations take a blessedly simple approach to defining a "dependent" of a full-time employee: The term includes a child up to age 26, but not a spouse. Thus, even though a spouse may be a "dependent" of a taxpayer for personal exemption and other income tax purposes, an employer need not cover a spouse under the PPACA's employer mandate. The proposed regulations offer transitional relief (again, only for 2014) for employers that do not currently provide dependent coverage, so long as the employer takes steps during its 2014 plan year to begin offering such coverage.

Defining how to meet "minimum essential coverage"
Code section 4980H literally provides that a "large employer" faces penalties if even a single gets tax-subsidized coverage through a PPACA exchange. The proposed regulations relax this draconian rule: For a given month beginning after 2013, the employer must offer minimum essential coverage to "substantially all" (not necessarily *all*) of its full-time employees and their dependents. "Substantially all" means all but 5% (or, if greater, 5 *per capita*) full-time employees. An employer is not subject to the penalty for failing to offer new employees coverage for up to the first 3 months of employment.

Defining "minimum value" and "affordable"
To avoid the penalties, it is necessary – but not *sufficient* – that a "large" employer offers "minimum essential coverage" to "substantially all" its "full-time" employees and their "dependents": That coverage must also "minimum value" and be "affordable."

"Minimum value." Coverage meets this test if it covers at least 60% of the total allowed cost of benefits that are expected to be incurred under the plan (considering deductibles, co-pays and the like). The IRS, along with the Department of Health and Human Services, is developing a calculator, which an employer can access online, to determine whether its coverage meets this test.

"Affordable." Coverage meets this test if the employee pays no more than 9.5% of his or her "household income" for self-only coverage. Because an employer typically will not know *each* employee's – let alone *any* employee's – household income, the IRS's prior guidance allowed employers to use an employee's W-2 reported wages as a safe harbor. The proposed regulations reaffirm and expand on this safe harbor, and add 2 more: coverage is deemed "affordable"

- if the employee's monthly cost for self-only coverage does not exceed 9.5% of his or her monthly rate of pay); or
- if the employee's cost for self-only coverage does not exceed 9.5% of the federal poverty line for a single individual).

Applying the penalties
Assuming that an employer faces penalties having gone through the foregoing analysis, how does the employer calculate those penalties considering that they are applied on a per-"full-time" employee, per-month basis? The IRS' prior guidance allowed an employer to use a "look-back" period of up to 12 months to determine whether a continuing employee (that is, one employed for at least the length of the look-back period selected) is "full-time" and the proposed regulations keep this safe harbor. employee. If an employer uses a look-back period for its continuing employees, it can use the same period for new and seasonal employees. The proposed regulations expand on the safe harbor by addressing the treatment for a new variable-hour employee or seasonal employee whose status changes during the look-back period, for rehired employees and employees returning from unpaid leaves of absence, and for employees of

temporary agencies.

The penalties are "assessable," meaning that – unlike the case with back taxes generally – the employer does not have the opportunity to protest them in the United States Tax Court before paying them. However, the proposed regulations provide that an employer will receive certification of an employee's receipt of subsidized exchange coverage, and be able to respond to the IRS before the IRS actually imposes a penalty in respect to that employee. The penalties also cannot be deducted in computing the employer's income taxes.

Important tips for employers
What should employers do now to get ready for the new penalty regime in 2014?

Get ownership records up-to-date. Now is the time for a company to gather stock ledgers, operating or partnership agreements, and other ownership records; update them; and review them with an attorney or benefits specialist to determine whether the company will be grouped with other companies into a single "employer."

Gather information on employees, hours, and W-2 income. The "employer" (however determined) must begin tracking employees and their hours and the W-2 income to determine, first, whether the "employer" will meet the 50-plus "large" threshold for 2014; second, which employees will be considered "full-time" for purposes of calculating any monthly penalties starting in 2014; and third, whether coverage is "affordable." If the employer is unable to institute the internal controls and tracking systems for such a task, an outside benefits or payroll firm can help.

Fine-tune hiring decisions and hours. If an employer wants to avoid being "large" in 2014, then the employer needs to fine-tune hiring decisions and hours worked in 2013 to avoid crossing the magic 50-plus threshold (keeping in mind that both actual full-time employees and "full-time equivalent" employees must be considered, and also the special and anti-abuse rules for seasonal, commissioned, leased, and other special-circumstance employees as well as employees going on or returning from leaves).

Incidentally, an employer should not try to wrestle an agreement from an employee that he or she will not go on a PPACA exchange in return for the employer's agreement not to cut the employee's hours. Such an agreement is almost certainly unenforceable.

Review and update group coverage. If the employer will meet the "large" threshold, then the employer should review available group health plans with a benefits specialist to ensure that they provide "minimum essential coverage" (as will usually be the case) and also provide "minimum value" while being "affordable" (not always the case and dependent on each employer's and its employees' unique circumstances).

Decide whether to obtain or keep group coverage. For an employer that does not currently offer health coverage, it may be that paying the penalty costs less than offering and maintaining the required coverage. However, such a decision must follow a careful analysis of the costs of coverage versus the costs of paying the penalty based on actual and projected hiring needs. Also remember that, while the employer can deduct the costs of group coverage, the employer cannot deduct the penalties.

Nothing prevents an employer that already offers coverage from discontinuing the same and paying the penalties instead. However, as a practical matter, such a scenario is far less likely than an employer's adjusting workforce and hours to stay below the "large" threshold, or a "large" employer deciding to pay penalties where the employer has not previously offered health coverage to employees and does not wish to start.

Revisit M&A agreements and due diligence. Companies interested in acquiring (through purchase or merger) or investing in other companies need to revisit their agreement templates to be sure that the standard representations and warranties "smoke out" the target company's compliance with the new employer mandate, and must also add this item to the standard due diligence list. Otherwise, a target's non-compliance may become the acquirer's or investor's headache.

How Nossaman Can Help

With expertise in healthcare, employment, benefits, corporate, M&A and tax, Nossaman is uniquely positioned to help clients navigate the confluence of issues created by the employer mandate as well as other provisions of the mammoth PPACA. (See here, here and here for prior e-alerts about the PPACA and its impacts, and here for the status of all the IRS's many regulatory projects under the PPACA.) Nossaman attorneys are available to assist with any questions you may have about the employer mandate and IRS's proposed regulations, and how to get ready for 2014 and beyond.