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IRS issues employer "shared responsibility" proposed regulations under the Affordable Care Act

On January 2, 2013, Treasury and the IRS published proposed regulations and new Q&A's providing guidance with respect to the employer "shared responsibility" excise tax under section 4980H of the Internal Revenue Code ("Code"), which was added by the Patient Protection and Affordable Care Act ("ACA") and is effective beginning in 2014. 78 Fed. Reg. 217 (January 2, 2013). The proposed regulations are broad in scope and contain several new rules and clarifications based on comments the IRS received in response to earlier notices. For example, the proposed regulations expand upon earlier IRS safe harbor guidance for determining whether an employee is full-time and for determining whether coverage is affordable. The proposed regulations also clarify that an employer will not be subject to tax for failure to offer coverage to spouses, and that an employer that offers coverage to all but 5% or less of its full-time employees (or, if greater, 5 employees) and their dependents will be considered to have offered coverage to "substantially all" of its full-time employees. In addition, each single employer within a controlled group of employers will be separately liable for the tax and employers will be notified that an employee has received premium tax credits or a cost-sharing reduction for coverage on an Exchange and will have an opportunity to respond before the IRS issues a notice and demand for payment.

Comments on the proposed regulations are due on March 18, 2013, and a public hearing is scheduled for April 23, 2013. Below, we provide background information on Code section 4980H and summarize key issues addressed in the proposed regulations and Q&A guidance.

I. Background

Effective beginning in 2014, Code section 4980H and implementing guidance generally provides that "large" employers (those with an average of at least 50 full-time employees) that do not offer "substantially all" full-time employees (and dependents) the opportunity to enroll in "minimum essential coverage" under an "eligible employer-sponsored plan" may be penalized. The penalty is triggered if at least one full-time employee receives premium tax credits or a cost-sharing reduction for health insurance coverage through an Exchange. The penalty, which is treated as an excise tax for certain purposes, is \$2,000 for each full-time employee (after subtracting 30) and is calculated on a monthly basis.

In addition, "large" employers that offer substantially all full-time employees (and dependents) the opportunity to enroll in "minimum essential coverage" under an "eligible employer-sponsored plan," but have at least one full-time employee receive premium tax credits or a cost-sharing reduction for Exchange coverage (because the employer coverage does not provide minimum value or is unaffordable as provided in ACA), are required to pay the lesser of a \$3,000 annual excise tax penalty for each full-time employee receiving the

credit (calculated on a monthly basis) or \$2,000 per employee for each full-time employee (after subtracting 30).

The ACA generally defines full-time employee for these purposes as an employee who works an average of 30 hours of service or more per week with respect to any month. The IRS has proposed a safe-harbor method for classifying employees as full-time for purposes of these rules.

II. Key Issues

The proposed regulations contain new definitions, safe harbor guidance, and details regarding the calculation and assessment of tax liability under Code section 4980H. Prop. Treas. Reg. § 54.4980H-0-54.4980H-6. Select issues covered by the proposed regulations are also addressed in Q&A guidance on the Employer Shared Responsibility provisions.¹ Below, we summarize key issues that employers should consider.

A. Determination of "Large" Employer

To determine whether an employer has an average of at least 50 full-time employees and is therefore subject to Code section 4980H, the employer must count the actual hours of service of employees in the prior year. "Employer" and "employee" are defined by the common law standard, so whether an employment relationship exists will depend on the facts and circumstances. Under the common law standard, an employment relationship exists if the person for whom the services are performed has the right to control and direct the individual performing the services not only as to the result to be accomplished but also as to the details and means by which the result is accomplished.

The specific rules for determining employer size are complex. For example, full-time equivalent employees must be calculated and included in the total number of full-time employees for purposes of the large employer determination. There are special rules for counting seasonal workers, for counting hours of service for hours worked outside of the U.S. and with respect to "new" employers. Further, all entities in a "controlled group" are included for purposes of determining whether the employer has at least 50 full-time employees.

If you have questions on whether an entity is a "large" employer and you are interested in working with Groom to answer these questions, please contact your regular Groom attorney or one of the attorneys in the health and welfare practice group.

B. Determination of "Full-Time" Employee Status

Generally, an employee who was employed on average at least 30 hours of service per week or 130 hours of service per month is considered full-time. In calculating hours of service, the following rules apply:

- The common law definition of employee is used.
- All hours of service an employee performs for members of the controlled group are counted.
- Each hour for which an employee is paid, or entitled to payment, for performance of duties for the employer is counted.

¹ Available at <http://www.irs.gov/uac/Newsroom/Questions-and-Answers-on-Employer-Shared-Responsibility-Provisions-Under-the-Affordable-Care-Act>

- Each hour for which an employee is paid, or entitled to payment, 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 is counted (in a change from Notice 2011-36, there now is no limit to the hours that may be credited for paid leave).
- Hourly employees: employers must use actual hours of service from records of hours worked and hours for which payment is made or due.
- Non-hourly employees: employers may calculate hours by (i) counting actual hours of service from records of hours worked and hours for which payment is made or due, (ii) using a days-worked equivalency (crediting 8 hours a day for each day with an hour of service), or (iii) using a weeks-worked equivalency (crediting 40 hours a week for each week with an hour of service). Employers may use different methods for non-hourly employees based on different classifications of employees if the classifications are reasonable and consistent and may change methods each calendar year. Employers may not use the days- or weeks-worked equivalency methods if those methods would substantially understate the hours worked.
- Services performed outside of the United States: hours of service do not include hours of service to the extent the compensation for those hours of service is "foreign source income." This means that hours of service generally will not include hours of service worked outside of the U.S. Residency or citizenship is not considered for these purposes.
- Commission Employees, Adjunct Faculty, Transportation Employees (e.g., Airline Pilots) and Similar Positions: until further guidance is issued, employers with employees in these types of positions must use a reasonable method of crediting hours of service consistent with the purpose of 4980H. Methods that result in counting only some of an employee's hours, or that would characterize a "full-time" employee as part-time would not be considered reasonable.

C. Optional Safe-Harbor For Determining Full-Time Employee Status

The statutory language of Code section 4980H suggests that the determination of full-time employee status-- and application of the excise tax penalties-- is required on a month-to-month basis. However, Treasury and the IRS recognize that applying these rules on a monthly basis could cause practical difficulties for employers, particularly with respect to employees with varying hours or employment schedules, and could result in employees moving in and out of employer coverage on a monthly basis. For that reason, the proposed regulations, consistent with Notice 2012-58 (see <http://www.groom.com/resources-716.html>) and Notice 2011-36 (see <http://www.groom.com/resources-597.html>) provide an optional "safe harbor" method as an alternative to a rigid "month-to-month" calculation of full-time employee status.

The safe harbor, which is complex, involves the use of a look-back "measurement period" for counting hours of service, a "stability period" during which coverage may have to be provided (depending on full-time employee status during measurement period), and an "administrative period" that allows time for enrollment or disenrollment. The employer chooses the length of time for such periods, within specified parameters (as described below), and may change the standard measurement or standard stability period from year to year, but cannot change either period once the standard measurement period has begun. The safe harbor requirements differ based on whether employees are "new" employees or "ongoing" employees, and, in the case of new employees, whether the employees are expected to work full-time or are "variable" or "seasonal" employees. The proposed regulations do not go into any

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detail concerning the steps that employers must take to use the safe harbor, other than referencing existing recordkeeping rules under Code section 6001 and Rev. Proc. 98-25. However, at a minimum, for plans subject to ERISA, employers should consider amending the eligibility provisions of plans and summary plan descriptions to reflect use of this safe harbor. Employers who choose to use the safe harbor will need to apply the following rules:

Ongoing Employees

An ongoing employee is an employee who has been employed for at least one standard measurement period (described below). An employer may look back over a standard measurement period to determine whether an employee was employed on average at least 30 hours of service per week. If so, then the employer must treat the employee as full-time for the subsequent standard stability period (described below). If not, then the employer may treat the employee as part-time for the subsequent stability period.

- **Standard measurement period:** The look-back period for calculating the hours of service of ongoing employees. The period cannot be less than 3 months, or more than 12 months. Employers may make certain adjustments at the beginning and end of the standard measurement period to accommodate weekly, bi-weekly or semi-monthly payroll periods.
- **Standard stability period:** The period during which the employee must be treated as full-time, if he/she averages at least 30 hours a week during the standard measurement period, regardless of the employee's number of hours of service during the stability period, so long as he or she remains an employee. The length of the standard stability period for an employee determined to work full-time during the standard measurement period must be the greater of 6 consecutive calendar months or the length of the standard measurement period. The standard stability period must begin immediately after the standard measurement period and any applicable administrative period (described below). If an employee is determined not to have worked full-time during the standard measurement period, the maximum length of the standard stability period during which the employee may be treated as part-time may not exceed the length of the standard measurement period.
- **Administrative period:** The optional period an employer may use after the end of the standard measurement period and immediately before the standard stability period. The administrative period cannot exceed 90 days and cannot reduce or lengthen the measurement or stability period. The administrative period must overlap with the prior stability period (i.e., an ongoing employee enrolled in coverage because of his full-time status in a prior measurement period must continue to receive coverage).

New Employees

The proposed regulations define "new employee" to mean an employee who has been employed for less than one complete standard measurement period. New employees are divided into two groups—new full-time employees and new variable hour or seasonal employees, with different rules that apply, as follows:

- **New Full-Time Employee:** A new full-time employee is an employee that, at his or her start date, is reasonably expected to be employed on average 30 hours of service or more per week (and is not a seasonal employee). In general, an employer must offer minimum essential coverage (that provides minimum value and satisfies the affordability requirements) at or before the end of the employee's first three months of employment in order to avoid excise tax penalties. Treasury and IRS are considering whether to include in

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future guidance the following factors to help determine if a new employee is reasonably expected to be employed 30 or more hours per week: whether an employee is replacing a full-time employee and whether the hours of service for ongoing employees in the same or comparable positions vary.

- **New Variable Hour/Seasonal Employee:** A variable hour employee is an employee for whom the employer is unable to determine, at his or her start date, whether he or she is reasonably expected to be employed on average at least 30 hours per week. Beginning 1/1/2015, employers must assume that variable hour employees will be employed for an entire measurement period. The term seasonal employee is not defined in the proposed regulations, and employers may use a reasonable, good faith interpretation of the term seasonal employee until further guidance. The preamble to the proposed regulations indicated that Treasury and IRS may adopt a specific time limit (e.g., up to 6 months) for "seasonal" in future guidance. Employees of educational organizations generally cannot be treated as seasonal. If an employer uses a look-back measurement period for ongoing employees, the employer may also use a look-back measurement period to determine whether variable or seasonal hour employees are full-time.

If a new variable hour or seasonal employee is full-time during the initial measurement period (described below), the employer must treat the employee as full-time for the subsequent stability period (described below) that must be at least 6 months but no shorter than the initial measurement period and must begin immediately after the measurement period (and any administrative period). If an employee is part-time during the initial measurement period, the employer may treat the employee as part-time during the subsequent stability period that must be not more than one month longer than the initial measurement period and must not exceed the remainder of the standard measurement period (plus any administrative period) in which the initial measurement period ends.

- **Initial measurement period:** employers may use an initial measurement period (between 3 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 to determine whether a new variable hour or seasonal employee was employed an average of 30 hours of service per week or more during the period. The initial measurement period and administrative period combined may not extend beyond 13 months and a fraction of a month (i.e., beyond the last day of the first calendar month beginning on or after the employee's first year anniversary).
- **Stability period:** the stability period for new employees must be the same length as the stability period for ongoing employees.
- **Administrative period:** An optional administrative period may be used before or after initial measurement period. The administrative period cannot exceed 90 days and cannot reduce or lengthen the measurement or stability period. The administrative period must overlap with the prior stability period (i.e., an ongoing employee enrolled in coverage because of his full-time status in a prior measurement period must continue to receive coverage).

Variation of Period Length

The measurement, stability, and administrative periods described above must generally be uniform lengths for all employees, but may vary for the following categories:

- Each group of collectively bargained employees covered by a separate collective bargaining agreement

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- Collectively-bargained and non-collectively bargained employees
- Salaried and hourly employees
- Employees whose primary places of employment are in different states

Change in Employment Status

If a new variable hour or seasonal employee experiences a change in employment status (i.e., a material change in the position of employment or other employment status) during the initial measurement period that, had the employee begun employment in such new status, would have resulted in the employee being reasonably expected to be employed on average at least 30 hours a week, the employee generally will be treated as a full-time employee on the first day of the fourth month following the change in employment status (or, if earlier and the employee averaged more than 30 hours of service during the initial measurement period, the first day of the first month following the end of the initial measurement period and any administrative period). Notably, this rule applies only to new employees, not ongoing employees.

Rehired Employees/Employees Who Resume Service After Absence

The proposed regulations contain rules regarding how the safe harbor requirements apply to employees who are rehired after termination of employment or who resume service after other absences, and, specifically, whether the employer is required to consider the employee's previous service in determining full-time status, as follows:

- **Treat as New Employee:** If the period of "no service" was at least 26 consecutive weeks, an employer may treat an employee who returns to work as a new employee for purposes of determining the employee's status as a full-time employee. For "no service" periods of less than 26 weeks, the employer may apply an optional rule of parity and treat the employee as a new employee if the "no service" period is at least 4 but less than 26 weeks long, and is longer than the period of employment. For example, if the employee works 3 weeks, terminates for 10 weeks, and is rehired, the employee may be treated as new.
- **Treat as Continuing Employee:** If neither of these tests is satisfied, the employer must treat the employee who returns to work as a continuing employee who retains the same measurement and stability period that would have applied if the employee had not had a period of "no service" (e.g., if an employee who was being treated as full-time for a stability period returns during that stability period, he or she must be treated as full-time for the balance of the stability period). For a continuing employee who resumes after a special unpaid leave (FMLA, USERRA, jury duty), the employer must determine the average hours of service per week for the employee excluding the special unpaid leave period and use that average as the average for the entire measurement period. Alternatively, the employer may credit the employee with hours of service for the special unpaid leave period at a rate equal to the average weekly rate at which the employee was credited with hours of service during the weeks in the measurement period that are not special unpaid leave.
- **Special Rule for Continuing Employee of Educational Organization.** Additional requirements apply to continuing employees of educational organizations for educational breaks. Specifically, for periods of at least 4 consecutive weeks (that are not unpaid special leave) the educational organization must either (1) determine average weekly hours excluding the break, or (2) credit employees with average hours for the

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break that equal the average during the weeks without the break. Crediting for any employment break period is capped at 501 hours a calendar year (not including special unpaid leave). Treasury and IRS are considering extending this rule to all employers (but not before 2015) and are requesting comments.

Comments Requested

In addition to the requested comments described above, Treasury IRS also requests comments on the following issues related to the safe harbor:

- How short-term employees should be treated;
- Whether special rules are needed for high turnover positions; and
- Whether temporary staffing agency employees (which only includes agencies that are the common law employers of the individual providing temporary services to a client) should be presumed to be variable employees and whether any other special rules are necessary for staffing agencies, including separation of service rules.

D. Avoiding Liability under Code section 4980H

As described in Section I, in order to avoid the imposition of penalties under Code section 4980H completely, an employer must offer minimum essential coverage to "substantially all" of its full-time employees (and their dependents) that is affordable and provides minimum value. In contrast, an employer that offers minimum essential coverage to substantially all of its full-time employees (and their dependents) but does not satisfy the minimum value and affordability requirements also will be at risk for paying penalties, but these penalties generally will be at a lower level than if minimum essential coverage was not offered at all. The proposed regulations clarify the meaning of "substantially all," "dependents," and what it means to "offer coverage" for purposes of these rules. In addition, the proposed regulations broaden the safe harbor for determining affordability described in earlier guidance, as described below.

Substantially All

An employer will satisfy the requirement to offer minimum essential coverage to "substantially all" of its full-time employees (and their dependents) if it offers such coverage to 95% of its full-time employees and their dependents (or, if greater, to 5 employees). The failure to offer coverage to the 5% of an employer's full-time employees (or, if greater, to 5 full-time employees) need not be inadvertent. Note that if any of the 5% of full-time employees who are not offered coverage receive premium tax credits or cost-sharing assistance for coverage purchased on an Exchange, the employer will be required to pay an annual penalty of \$3,000 per employee who receives such premium tax credit or cost-sharing assistance.

Dependents

The proposed regulations define "dependents" for purposes of this rule narrowly to include only an employee's child as defined in Code section 152(f)(1)—i.e., son, daughter, stepson, stepdaughter, adopted child, child placed for adoption and foster child-- up to age 26 (measured on the day he/she attains age 26). Employers may rely on employee representations regarding the identity and ages of their children. Surprisingly, "dependent" for purposes of these rules does not include an employee's spouse, which may incent employers to drop spousal coverage

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completely to enhance the ability of a spouse to obtain premium tax credits and/or cost-sharing assistance for coverage purchased on an Exchange.

Offer of Coverage

The proposed regulations state that if the employee does not have an effective opportunity to accept coverage at least once during the plan year, the employee will not be treated as having been offered coverage. Employers may offer coverage electronically, and can follow the IRS safe harbor method for use of electronic media. See Treas. Reg. § 1.401(a)-21; See also Notice 99-1. Whether an employee has an effective opportunity is determined based on all of the relevant facts and circumstances, including adequacy of notice of the availability of the offer of coverage, the period of time during which acceptance of the offer of coverage may be made, and any other conditions on the offer. If the coverage is not affordable or does not provide minimum value, the employee also must be permitted to decline coverage.

The proposed regulations also provide that in order for an employer to satisfy the requirement to "offer" coverage for a particular month, the employer must offer coverage that, if accepted, would be applicable for that month (or that day). If there is a day during a month in which the coverage would not be effective, the employee is treated as not having been offered coverage for the entire month, unless the employee is terminated. General recordkeeping requirements (Code section 6001) apply to demonstrate that an employer has "offered" coverage.

Late or nonpayment of premiums

If an employee enrolls in coverage but fails to pay the employee's share of the premium on a timely basis, the proposed regulations helpfully provide that the employer is not required to provide coverage for the period for which the premium is not timely paid, and the employer is treated as having offered that employee coverage for the remainder of the coverage period (typically the remainder of the plan year) for purposes of Code section 4980H. COBRA rules will generally apply for purposes of determining whether premiums are not timely paid (those rules generally allow a 30-day grace period and include rules regarding when a failure to pay the full premium is "insignificant").

Affordability

An employer that offers minimum essential coverage must ensure that it provides affordable coverage to avoid liability for penalties under Code section 4980H. Generally, if the employee's required contribution toward the cost of self-only coverage does not exceed 9.5% of the employee's household income, the coverage is considered "affordable." Because employers generally will not know an employee's household income, a safe harbor is needed so that employers may design compliant plans. Treasury and the IRS previously described a Form W-2 safe harbor in Notice 2011-73. The proposed regulations adopt this Form W-2 safe harbor and expand the affordability safe harbor to include two alternative methods. Employers may use different safe harbors for different categories of employees, provided the categories are reasonable.

- **Form W-2 Safe Harbor:** The employer must offer minimum essential coverage to full-time employees (and their dependents) under an eligible employer-sponsored plan, and the required employee contribution for self-only coverage for the lowest cost option that provides minimum value must not exceed 9.5% of the employee's Form W-2 wages for that calendar year. If an employee that was not a full-time employee for the entire calendar year, the Form W-2 wages are adjusted to reflect the period when the employee was offered coverage and the employee's share of premium for that period. Note that this means that the safe

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harbor will apply on an employee-by-employee basis and that the employer will not know for certain if it has satisfied the requirements of the safe harbor until the end of the calendar year, unless the contribution toward coverage is set as a percentage of wages.

- **Rate of pay Safe Harbor:** The employer may take the hourly rate of pay for each hourly employee who is eligible, multiply that by 130 and determine affordability based on the monthly wage. Affordable coverage must require a contribution of no more than 9.5% percent of the monthly wage. This safe harbor will not apply if the employer reduces wages during the year.
- **Federal Poverty Level ("FPL") Safe Harbor:** The employer may also rely on a design-based safe harbor that will be satisfied if the self-only cost of coverage does not exceed 9.5% of the most recently published federal poverty level for a single individual.

E. Assessment and Payment of Excise Tax

If the excise tax is triggered, the proposed regulations and IRS Q&As provide that liability for the tax is calculated and assessed based on each member of the controlled group – not on a controlled group basis. However, the 30 person reduction that applies to the annual \$2,000/full-time employee tax is applied on a pro-rata basis across the controlled group. The proposed regulations also provide that HHS and IRS will inform employers that a full-time employee has received subsidized Exchange coverage and give employers an opportunity to respond before the IRS issues a notice and demand for payment. That notice will instruct the employer on how to make the payment. Employers will not be required to include the Employer Shared Responsibility payment on any tax return that they file. The excise tax, if imposed, is nondeductible.

F. Transition Rules

The proposed regulations include several transition rules, as follows:

All Plans

- **Solely for purposes of stability periods beginning in 2014,** employers may adopt a transition measurement period that is shorter than 12 months, but not less than 6 months and begins not 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.
- **Applicable Large Employer Determination for 2014:** for the 2014 year, employers may use six consecutive months (or more) in 2013 to determine whether the employer employed an average of at least 50 full-time employees on business days during any consecutive six-month period in 2013.
- **Dependent Coverage:** if an employer does not offer dependent coverage currently, it will not be liable for failure to offer dependent coverage in 2014 if it takes steps during the 2014 plan year to begin offering dependent coverage.
- **Variable Hour Employee Definition:** Beginning January 2015, employers must assume that variable hour employees will remain employed during the entire initial measurement period. In 2014, the status of an individual employee as a variable hour employee can be based on objective facts and circumstances specific to the newly hired employee at the start date demonstrating that the individual employee's employment is

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reasonably expected to be of limited duration within the initial measurement period. However, even in 2014, the status of an individual employee as a variable hour employee cannot be based on employer expectations regarding aggregate turnover.

Fiscal Year Plans

- **Delayed Effective Date:** If, as of December 27, 2012, an applicable large employer maintained a fiscal year plan, transition relief is provided with respect to employees of the employer who would be eligible for coverage as of the first day of the 2014 plan year under the eligibility terms of the plan in effect on December 27, 2012, provided that the employee is offered affordable, minimum value coverage no later than the first day of the 2014 plan year. Further relief is provided for employers that have a significant percentage of their employees already eligible for or covered under a fiscal year plan as of December 27, 2012.
- **Salary Reduction Elections:** An employer that maintains a fiscal year plan may permit an employee to prospectively revoke or change his or her election once (without regard to whether the employee experienced a change in status event) and an employer may permit an employee to begin cafeteria plan salary reductions after open enrollment (without regard to whether the employee experiences a change in status event). These changes must be reflected in the plan document to be effective.

Multiemployer Plans

Under a transition rule that applies through 2014 with respect to employers that make contributions to a multiemployer plan, the employer will be treated as having satisfied Code section 4980H if: (i) employers make a contribution to a multiemployer plan pursuant to a collective bargaining or participation agreement, (ii) coverage under the plan is offered to the full-time employee (and the employee's dependents), and (iii) the coverage is affordable and provides minimum value.

III. Conclusion

The proposed regulations and Q&A guidance represent a significant step forward with respect to assisting employers in understanding and complying with their shared responsibility requirements in 2014. The rules are largely helpful, in that they balance the employer's need for flexibility with the need for certainty. However, the timing of the rules leaves little opportunity for employers to make plan design decisions for 2014, particularly since guidance pertaining to minimum essential coverage and minimum value, although expected, has not yet been issued. In addition, the safe harbor for determining full-time employee status is complicated, and many employers may therefore be reluctant to take advantage of it. Please contact your regular Groom attorney or one of the attorneys in the health and welfare practice group to determine how the proposed rules may apply to your business.