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Pay or Play Penalty—Affordability Safe Harbors

The Affordable Care Act (ACA) requires applicable large employers (ALEs) to offer affordable, minimum value health coverage to their full-time employees or pay a penalty. This employer mandate provision is also known as the "employer shared responsibility" or "pay or play" rules. An ALE is only liable for a pay or play penalty if one or more of its full-time employees receive a subsidy for coverage under an insurance Exchange.

> The employer mandate provisions were set to take effect on Jan. 1, 2014. However, on July 2, 2013, the Treasury **delayed the employer mandate penalties and related reporting requirements for one year, until 2015**. Therefore, these payments did not apply for 2014. On July 9, 2013, the IRS issued Notice 2013-45 to provide more formal guidance on the delay. No other provisions of the ACA are affected by the delay.

On Feb. 12, 2014, the IRS published **final regulations** on the ACA's employer shared responsibility rules. Under the final regulations, **ALEs that have fewer than 100 full-time employees generally will have an additional year, until 2016, to comply with the pay or play rules**. ALEs with 100 or more full-time employees must comply with the pay or play rules starting in 2015.

The final regulations also provide guidance on determining affordability of an employer-sponsored plan, including **three optional safe harbors** that employers may use. In addition, on July 24, 2014, the IRS released Revenue Procedure 2014-37 to index the ACA's affordability contribution percentage for 2015. The IRS further increased the affordability contribution percentage for 2016 on Nov. 21, 2014, in Rev. Proc. 2014-62. Employer-sponsored coverage will generally be considered affordable under the pay or play rules if the employee's required contribution for self-only coverage does not exceed:

- **9.56 percent** of the employee's household income for the year, for plan years beginning in 2015; and
- **9.66 percent** of the employee's household income for the year, for plan years beginning in 2016.

However, ALEs using an affordability safe harbor **may have to continue using a contribution percentage of 9.5 percent** to measure their plan's affordability.

AFFORDABILITY DETERMINATION

The affordability of health coverage offered by an ALE is a key point in determining whether the employer will be subject to an employer shared responsibility penalty. In general, an ALE that offers health coverage to substantially all of its full-time employees (and dependents) may be subject to an employer shared responsibility penalty if the health coverage does not provide minimum value or is unaffordable.

Under the ACA, an ALE's health coverage is considered affordable if the employee's required contribution to the plan does not exceed **9.5 percent** of the employee's household income for the taxable year (**adjusted to 9.56 percent for plan years beginning in 2015**, or **9.66 percent for plan years beginning in 2016**). "Household income" means the modified adjusted gross income of the employee and any members of the employee's family, including a spouse and dependents.

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The affordability test applies only to the portion of **the annual premiums for self-only coverage**, and does not include any additional cost for family coverage. Also, if an employer offers multiple health coverage options, the affordability test applies to the lowest-cost option that also satisfies the minimum value requirement.

CAFETERIA PLAN CONTRIBUTIONS, HRA CONTRIBUTIONS AND WELLNESS PROGRAM INCENTIVES

Some questions remain as to how employer contributions to a cafeteria plan (flex contributions), health reimbursement arrangements (HRAs) and wellness program incentives are counted in determining the affordability of employer-sponsored coverage. (Employer contributions to health savings accounts (HSAs) do not affect the affordability of employer-sponsored coverage because HSA amounts may generally not be used to pay for health insurance premiums.)

There is no direct guidance that addresses these issues for purposes of determining affordability under the employer shared responsibility rules. Therefore, it is largely unclear as to how these types of employer contributions would be treated for purposes of determining affordability under the employer shared responsibility rules. However, on May 3, 2013, the IRS released a proposed rule on the premium tax credit that included guidance on how flex contributions, HRAs and wellness program incentives are counted in determining the affordability of employer-sponsored coverage. Also, a separate final rule on the individual mandate was issued on Nov. 26, 2014, that addresses similar issues.

The IRS has not addressed whether the same treatment in the premium tax credit proposed rule and individual mandate final rule would apply for purposes of determining affordability under the employer shared responsibility rules. More guidance on this issue would be helpful.

Flex Contributions

For purposes of determining the affordability of coverage, the November 2014 individual mandate final regulations provide that the required contribution is reduced by any contributions made by an employer under a Section 125 cafeteria plan that:

- May not be taken as a taxable benefit;
- May be used to pay for minimum essential coverage; and
- May be used only to pay for medical care.

According to the IRS, if an employee may use nontaxable employer contributions to a cafeteria plan to pay for minimum essential coverage and only to pay for medical expenses, then that represents a real reduction in the cost to the employee of purchasing minimum essential coverage. In this case, it is appropriate to treat the amounts as a reduction in the employee's required contribution. However, if an employee's use of nontaxable employer contributions to a cafeteria plan is not limited to medical expenses, then it cannot be assumed that the employee will use the contribution for purchasing minimum essential coverage.

Accordingly, the final regulations provide that health flex contributions made available for the current plan year are taken into account for purposes of determining an individual's required contribution. As a result, health flex contributions reduce an employee's (or related individual's) required contribution for employer-sponsored coverage.

HRA Contributions

Under special rules in the November 2014 individual mandate final regulations, amounts made newly available under an HRA that is integrated with an employer-sponsored plan for the current plan year are taken into account only in determining affordability if the employee may either:

- Use the amounts only for premiums; or

- Choose to use the amounts for either premiums or cost-sharing.

Treating amounts that may be used either for premiums or cost-sharing only toward affordability prevents double counting the HRA amounts when assessing minimum value and affordability of employer-sponsored coverage.

On Sept. 13, 2013, the Department of Labor (DOL) issued Technical Release 2013-03, which provides detailed guidance on when an HRA will be considered integrated with other group health coverage. This guidance is generally effective for plan years beginning on or after Jan. 1, 2014, although it may be applied for all prior periods. It is not required that the HRA and the coverage with which it is integrated:

- Share the same plan sponsor or the same plan document or governing instruments; or
- File a single Form 5500, if applicable.

The Technical Release contains the following guidance on including HRA contributions in determining affordability for purposes of the premium tax credit:

- Even if an HRA is integrated with a plan offered by another employer for purposes of the ACA's annual dollar limit prohibition and the preventive services requirements, the HRA does not count toward the affordability or minimum value requirement of the plan offered by the other employer.
- Additionally, if an employer offers an HRA on the condition that the employee does not enroll in non-HRA coverage offered by the employer and instead enrolls in non-HRA coverage from a different source, the HRA does not count in determining whether the employer's non-HRA coverage satisfies either the affordability or minimum value requirement.

Wellness Program Incentives

Also, according to the November 2014 individual mandate final regulations, affordability of an employer-sponsored plan is determined by **assuming that each employee fails to satisfy the wellness program's requirements**, unless the wellness program is related to **tobacco use**. This means the affordability of a plan that charges a higher initial premium for tobacco users will be determined based on the premium charged to non-tobacco users, or tobacco users who complete the related wellness program, such as attending smoking cessation classes.

The proposed regulations provided transition relief for plan years beginning before Jan. 1, 2015. Under this relief, if an employee receives a premium tax credit because an employer-sponsored health plan is unaffordable or does not provide minimum value, but the employer coverage would have been affordable or provided minimum value had the employee satisfied the requirements of a nondiscriminatory wellness program that was in effect on May 3, 2013, the ALE will not be subject to the employer mandate penalty.

However, this transition relief **has not been specifically finalized in any final regulations**. Generally, proposed transition relief provisions may not be relied upon unless they are adopted in final regulations. **Because it has not been specifically finalized, it is unclear whether this transition relief remains available.**

If the transition relief is still available, the proposed regulations provide that the transition relief applies only:

- To the extent of the reward as of May 3, 2013, expressed as either a dollar amount or a fraction of the total required employee contribution to the premium (or the employee cost-sharing, as applicable);
- Under the terms of a wellness program as in effect on May 3, 2013; and
- With respect to an employee who is in a category of employees eligible under the terms of the wellness program as in effect on May 3, 2013 (regardless of whether the employee was hired before or after that date).

Any required employee contribution to premium determined based upon assumed satisfaction of the requirements of a wellness program under this transition relief could be applied to the use of an affordability safe harbor.

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OVERVIEW OF THE AFFORDABILITY SAFE HARBORS

Because an employer generally will not know an employee's household income, the IRS has provided three optional affordability safe harbors that ALEs may use to determine affordability based on information that is available to them—the Form W-2 safe harbor, the rate of pay safe harbor and the federal poverty level safe harbor.

Note that these affordability safe harbors specifically refer to 9.5 percent as the required contribution, and do not include an adjustment mechanism. Thus, ALEs using any of the affordability safe harbors will generally measure their plan's affordability using a required contribution of 9.5 percent (instead of the adjusted percentage). The IRS may issue guidance in the future to address this disconnect.

An employer may use one or more of the affordability safe harbors if it offers its full-time employees (and dependents) the opportunity to enroll in minimum essential coverage under a health plan that provides minimum value with respect to the self-only coverage offered to the employees.

Safe Harbor Application

The three affordability safe harbors are all **optional**. An employer may choose to use one or more of the affordability safe harbors for all its employees or for any reasonable category of employees, provided it does so on a uniform and consistent basis for all employees in a category. Reasonable categories of employees generally include:

- Specified job categories;
- Nature of compensation (for example, salaried or hourly);
- Geographic location; and
- Similar bona fide business criteria.

A listing of employees by name (or other specific criteria having substantially the same effect) is not considered a reasonable category.

The affordability safe harbors are only used to determine whether an ALE's coverage satisfies the affordability test for purposes of the employer shared responsibility penalty. **These safe harbors do not affect an employee's eligibility for an Exchange subsidy, which is based on the affordability of employer-sponsored coverage relative to an employee's household income**.

This means that, in some instances, an ALE's offer of coverage to an employee could be considered:

- Affordable (for example, based on W-2 wages) for purposes of determining whether the employer is subject to a penalty; and, at the same time,
- Unaffordable (based on household income) for purposes of determining whether the employee is eligible for an Exchange subsidy.

Changes to the Affordability Percentage

Rev. Proc. 2014-37 adjusted the ACA's affordability contribution percentage for 2015, and Rev. Proc. 2014-62 further adjusted the affordability percentage for 2016. Employer-sponsored coverage will generally be considered affordable under the pay or play rules if the employee's required contribution for self-only coverage does not exceed:

- **9.56 percent** of the employee's household income for the year, for plan years beginning in 2015; and
- **9.66 percent** of the employee's household income for the year, for plan years beginning in 2016.

However, ALEs using an affordability safe harbor **may have to continue using a contribution percentage of 9.5 percent** to measure their plan's affordability in 2015.

Under the statute, for purposes of the employer shared responsibility provision, affordability is determined by reference to the rules for determining premium tax credit eligibility. However, the affordability safe harbors do not reference the premium tax credit eligibility rules. Instead**, the safe harbor rules specifically use 9.5 percent** as the required contribution, and do not include an adjustment mechanism.

Thus, based on a literal reading of the affordability safe harbor rules, ALEs using an affordability safe harbor will measure their plan's affordability using a required contribution of 9.5 percent (instead of the adjusted percentage). ALEs who are not using any of the affordability safe harbors will apply the required contribution percentage under the premium tax credit eligibility rules. As a result, these ALEs can measure their health plan's affordability using the adjusted required contribution percentage (**9.56 percent in 2015**, or **9.66 percent in 2016**).

The 2015 draft instructions for Forms 1094-C and 1095-C (for purposes of reporting for ALEs under Section 6056) address this disconnect. According to these instructions, references to 9.5 percent in the affordability safe harbors may be subject to change if future IRS guidance provides that the percentage is indexed in the same manner as it is indexed for purposes of the premium tax credit.

FORM W-2 SAFE HARBOR

Under the Form W-2 safe harbor, an ALE may determine the affordability of its health coverage by reference **only to an employee's wages from that ALE**, instead of by reference to the employee's household income. For this purpose, "wages" is the amount that is required to be reported in Box 1 of the employee's Form W-2.

An ALE satisfies the Form W-2 safe harbor with respect to an employee if the employee's required contribution for the calendar year for the ALE's lowest cost self-only coverage that provides minimum value during the entire calendar year (excluding COBRA or other continuation coverage except with respect to an active employee eligible for continuation coverage) **does not exceed 9.5 percent of that employee's Form W–2 wages** from the employer for the calendar year.

Eligibility for the Form W-2 Safe Harbor

To be eligible for the Form W-2 safe harbor, the employee's required contribution must remain a consistent amount or percentage of all Form W–2 wages during the calendar year (or during the plan year for plans with non-calendar year plan years). Thus, an ALE may not make discretionary adjustments to the required employee contribution for a pay period.

A periodic contribution that is based on a consistent percentage of all Form W–2 wages may be subject to a dollar limit specified by the employer.

Timing of the Form W-2 Safe Harbor

ALEs determine whether the Form W-2 safe harbor applies after the end of the calendar year and on an employee-by-employee basis, taking into account W-2 wages and employee contributions.

Partial-year Offers of Coverage

For an employee who was not offered coverage for an 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
- Comparing the adjusted wage amount to the employee's share of the premium for the employer's lowest cost self-only coverage that provides minimum value for the periods when coverage was offered.

Specifically, the amount of the employee's compensation for purposes of the Form W-2 safe harbor is determined by multiplying the wages for the calendar year by a fraction equal to the number of calendar months for which coverage was offered over the number of calendar months in the employee's period of employment with the ALE during the calendar year. For this purpose, if coverage is offered during at least one day during the calendar month, or the employee is employed for at least one day during the calendar month, the entire calendar month is counted in determining the applicable fraction.

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RATE OF PAY SAFE HARBOR

The rate of pay safe harbor was designed to allow ALEs to prospectively satisfy affordability without the need to analyze every employee's wages and hours. **For hourly employees**, the rate of pay safe harbor allows an ALE to:

- Take the lower of the hourly employee's rate of pay as of the first day of the coverage period (generally, the first day of the plan year) or the employee's lowest hourly rate of pay during the calendar month;
- Multiply that rate by 130 hours per month (the benchmark for full-time status for a month); and
- Determine affordability for the calendar month based on the resulting monthly wage amount.

Specifically, the employee's monthly contribution amount (for the self-only premium of the employer's lowest cost coverage that provides minimum value) is affordable for a calendar month if it is equal to or lower than 9.5 percent of the computed monthly wages (that is, the employee's applicable hourly rate of pay multiplied by 130 hours).

The final regulations, unlike the proposed regulations, allow an ALE to use the rate of pay safe harbor even if an hourly employee's rate of pay is reduced during the year.

For salaried employees, monthly salary as of the first day of the coverage period would be used, instead of hourly salary multiplied by 130 hours. However, if the monthly salary is reduced, including due to a reduction in work hours, the rate of pay safe harbor may not be used.

FEDERAL POVERTY LINE SAFE HARBOR

An ALE may also rely on a design-based safe harbor using the federal poverty line (FPL) for a single individual. Employer-provided coverage is considered affordable under the FPL safe harbor if the employee's required contribution for the calendar month for the lowest cost self-only coverage that provides minimum value does not exceed 9.5 percent of the FPL for a single individual for the applicable calendar year, divided by 12. The final regulations allow ALEs to use any of the poverty guidelines in effect within six months before the first day of the plan year for purposes of this safe harbor.

The FPL safe harbor allows ALEs to disregard certain employees in determining the affordability of health coverage (that is, employees who cannot receive an Exchange subsidy because of their income level or eligibility for Medicare, and therefore cannot trigger an ALE's liability for an employer shared responsibility penalty). The FPL safe harbor also provides ALEs with a predetermined maximum amount of employee contribution that in all cases will result in the coverage being deemed affordable.

Source: Internal Revenue Service

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