
Guidance on employer penalties under the Affordable Care Act

January 10, 2013

In brief

Under the Affordable Care Act (ACA), employers face significant penalties (sometimes called the 'pay or play' provisions) if they fail to offer healthcare coverage to their full-time employees or if the coverage offered is not affordable. The IRS recently issued proposed regulations on the employer shared responsibility penalties and followed this by posting FAQs on their website. The proposed regulations incorporate and expand upon some of the guidance previously provided in IRS Notices.

The IRS provides guidance on:

- determining whether the employer is an applicable large employer (employs at least 50 full-time plus full-time equivalent employees) that may be subject to the penalties
 - determining full-time employees, including measuring hours of service and safe harbors for measurement periods followed by stability periods, elaborating on those proposed last year in Notices 2012-58 and 59
 - determining whether the employer provides affordable coverage
 - calculating the penalty amount and assessment of penalties.
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In detail

What penalties are imposed on employers who don't provide health coverage?

Under the ACA, an employer with at least 50 full-time employees (an applicable large employer) is assessed a 'shared responsibility' penalty if:

1. the employer fails to offer health coverage to at least 95% of its full-time employees (and their

dependents), if any employee obtains subsidized coverage on an exchange, or

2. the employer does offer coverage to at least 95% of its full-time employees and their dependents, but nonetheless, any full-time employee obtains subsidized coverage on an exchange.

The penalty for failure to offer coverage (described in 1 above) is calculated as 1/12 of \$2,000 multiplied by the number of the

employer's full-time employees (less 30) for any month in which any full-time employee obtains subsidized coverage on an exchange.

Note that this penalty amount does not depend on the number of employees receiving subsidized coverage, but is calculated by reference to the total number of full-time employees (less 30), including those who are offered coverage by the employer.

The penalty for an employer offering coverage that has an employee who obtains subsidized exchange coverage (described in 2 above) is 1/12 of \$3,000 for each employee who obtains subsidized coverage for that month (but not more than the penalty for failure to offer coverage). This may occur if the coverage offered by the employer does not provide minimum value or is not affordable for that employee, or if that employee was not offered coverage by the employer.

How does an employee qualify to obtain subsidized coverage on an exchange?

Employees can qualify to obtain subsidized coverage on an exchange starting in 2014 only if:

- their household income is between 100 and 400% of the federal poverty level
- they are not eligible for coverage through a government-sponsored program like Medicaid, CHIP or Medicare, and
- they either are not eligible for employer-sponsored coverage or are eligible only for employer-sponsored coverage that is unaffordable to them (i.e., cost of self-only coverage exceeds 9.5% of household income) or does not provide minimum value (i.e., covers less than 60% of the value of benefits covered under the plan).

What employers are potentially liable for penalties?

The pay or play provisions apply to employers that employ at least 50 full-time employees, or a combination of full- and part-time employees that equals at least 50, on average during the year. For example, 40 full-time employees employed 30 or more hours per week on average plus 20 half-time employees employed 15

hours per week on average are equivalent to 50 full-time employees. Employees working abroad are not taken into account.

The determination of whether or not an employer is potentially liable for penalties is made on a controlled group basis. Each year employers must determine whether they will be considered a large employer for the next calendar year using their current headcount. Under a transition rule for 2014 only, employers will be permitted to make this determination based on any period of at least six consecutive months during 2013, rather than the entire calendar year.

These requirements are imposed on all employers meeting the 50-employee threshold, including for-profit, not-for-profit and governmental employers.

Must employers offer family coverage?

The penalties apply if the employer fails to offer coverage to its full-time employees and their dependents, defined as children (including biological, adopted, foster and stepchildren) up to age 26, but not spouses. In order to give employers time to redesign plans where they currently offer self-only coverage to their employees, no penalty will be assessed during the 2014 plan year solely on account of a failure to offer coverage to dependents for that plan year.

There is no requirement under the ACA for family health coverage to be 'affordable'; affordability is measured by reference to the cost to an employee for self-only coverage. Accordingly, employers may require employees to pay up to the full cost of coverage for their dependent children.

What is a full-time employee? How is full-time status determined?

A full-time employee is a common law employee who works on average at least 30 hours a week. The proposed regulations include optional administrative safe-harbors for identifying full-time employees. These permit the employer to choose a measurement period of three to 12 months during which to measure their employees' hours of service, followed by a stability period during which those employees who worked on average 30 hours a week during the measurement period will be offered coverage. If the employer utilizes such a safe harbor, no penalties will be assessed during the stability period even if an employee who would otherwise be considered to be full-time obtains a subsidy on an exchange.

Safe harbors may be used both for ongoing employees and for new variable hour employees or seasonal employees. For these purposes, an employee's hours of service are those hours for which the employee is paid or entitled to payment for performing duties for the employer or due to vacation, holiday, illness, etc. For employees paid on an hourly basis, all hours must be counted. For other employees, employers may calculate actual hours worked, or credit 8 hours for each day worked, or 40 hours for each week worked, as long as this doesn't understate an employee's actual hours of service for the week. Hours worked outside the United States are generally not counted.

Special rules are proposed for teachers and other employees of educational organizations. The regulations do not specifically address independent contractors, or the consequences of a reclassification of workers by the IRS, but comments are requested on

whether special rules should be applied for those employed through temporary staffing agencies.

How is it determined whether the coverage is affordable?

If an employer offers coverage but it is not affordable for an employee, the employer will pay a \$3,000 penalty for each employee who obtains subsidized coverage on an exchange (but no more than \$2,000 multiplied by all full-time employees less 30). Under ACA, coverage is affordable if the cost of self-only coverage is less than 9.5% of the employee's family income.

Employers may use any of three optional safe-harbors solely for purposes of determining the employer's liability for penalties. These include the W-2 safe harbor previously proposed (coverage is deemed to be affordable if it costs no employee more than 9.5% of the employee's W-2 wages) and two new safe harbors — a rate of pay safe harbor and a federal poverty line safe harbor, which may be met by plan design. If the plan is 'affordable' utilizing one of these safe-harbors, the employer would not be subject to penalties even if an employee were able to obtain subsidized coverage on the exchange because the coverage costs more than 9.5% of that employee's family income.

How are these penalties applied?

The \$2,000 times all full-time employees (less 30) penalty does not apply if the entity offers coverage to at least 95% of its full-time employees, and, after 2014, their dependents. This allows for some margin of error for employers inadvertently failing to offer coverage to a small portion of their workforce, and may accommodate limited plan design flexibility.

Importantly, the guidance provides that the penalties are separately

applied to separate members of a controlled group. Thus, if a parent company has five subsidiaries, liability for, and the amount of, the penalty will be determined separately for each of the six members of the controlled group. The 30-employee exclusion, which applies when calculating the first penalty or the cap on the second penalty (\$2,000 multiplied by all full-time employees less 30), is apportioned pro rata among the members of the controlled group based on the percent of employees of the controlled group employed by each member. This new rule means that a company will not face enormous penalties simply because a small entity within its controlled group fails to offer coverage to its full-time employees. The penalty will be calculated solely based on the employees of that entity, and not the total employee population of the controlled group, as had been feared.

How are the penalties assessed?

IRS will assess a penalty by notifying the employer (no self-reporting is required). According to FAQs posted by the IRS, the notice will be provided after employees' individual tax returns are due for that year claiming premium tax credits, and after the due date for large employers to file information returns identifying their full-time employees and describing the coverage that was offered (if any). Guidance has not yet been provided regarding the timing and content of any of these upcoming reporting requirements, which will begin in 2015 with respect to coverage provided in 2014. The penalties are not deductible.

When are these rules effective? Is there any transition relief?

The penalties apply beginning January 1, 2014, with some transition rules for the first year, including:

- Employers that are close to the 50-employee threshold may use any

six consecutive months of 2013 to determine whether they have at least 50 full-time and full-time equivalent employees.

- Employers that operate a health plan on a fiscal year basis rather than a calendar year may be able to take advantage of safe harbors under which the employer will not be subject to penalties until the first day of the fiscal plan year starting in 2014.
- Employers can amend their plan documents to allow fiscal year plan participants to make mid-year plan election changes during the fiscal plan year starting in 2013 without regard to the change in status rules. This transition rule will allow employees to newly elect or change their coverage in response to employer plan changes made in connection with the new rules, such as offering coverage to a new group of employees, or offering dependent coverage.
- Employers won't be subject to penalties for 2014 solely due to the failure to offer coverage to employees' children.

The takeaway

Dependent coverage

Employers will want to consider how they offer coverage to employees' dependents. If they currently do not offer any family coverage, employers must take steps to offer coverage to employees' children beginning no later than the first day of the 2015 plan year. Where family coverage is currently offered, but step-children and foster children are not eligible, eligibility must be broadened to include these children. Employers must determine how much employees should pay for the cost of covering dependents, and whether or not to subsidize those costs.

Retail and similar industries

Retailers and other businesses with large low-wage workforces and part-time or seasonal employees should begin now to determine the identity of their full-time employees. They should consider adopting the safe harbor methods for determining full-time employees and an appropriate method for counting hours of service for each employee, and should begin to count their actual hours of service. In addition, these employers should analyze the 'pay or play' choice for 2014 and beyond — whether to begin to provide health insurance coverage to those groups of employees and, if so, what type and level of coverage, or to pay the penalties once the health insurance exchanges open.

This new guidance provides some helpful provisions, including the application of the penalty on an entity-by-entity basis within a

controlled group, that may make the exchange alternative more palatable for certain groups of employees, provided that the coverage offered to other employees is nondiscriminatory.

Independent contractors

Employers with independent contractors should analyze their workforces to assess whether these workers have been properly classified.

The guidance does not address the consequences of an IRS reclassification of independent contractors as employees. In the absence of any relief for such a situation, the penalties could be significant. Under a temporary IRS program, employers may reclassify independent contractors as employees on a prospective basis for employment tax and benefits purposes, with reduced penalties. This program may be of interest to employers concerned

about potential liability for such workers if they have been incorrectly classified as independent contractors.

Mergers and acquisitions

Companies involved in mergers and acquisitions should be certain to have health coverage on their list of issues to highlight in the transaction. Fortunately, the penalties will be imposed entity by entity rather than on the entire controlled group, easing some of the concerns that had been raised about inadvertently triggering enormous penalties as a result of acquiring a non-compliant entity.

Prepare now for new reporting requirements

Future guidance will provide rules for reporting to the IRS on the coverage offered by an employer, and the employees to whom it is offered. It will be important to be prepared to provide this information when it is requested.

Let's talk

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