The IRS has proposed regulations requiring employers to treat the value of certain health insurance opt-out incentives as part of employees' cost of coverage when calculating and reporting the affordability of that coverage under the Affordable Care Act (ACA). The rules will be of interest to the growing minority of employers who provide “cash-or-coverage” or similar incentives to employees who opt out of the employer’s health plan. The IRS expects to quickly finalize the proposed rules and make them effective Jan. 1, 2017.

The regulations are a bit irksome, but happily the IRS has provided an easy work-around to their wrinkles. And ironically, many employers offering opt-out incentives would risk very little even if they ignore the work-around.

Unfortunately, while the IRS’s rules may prove to be a largely inconsequential hurdle for most employers, a recent court case threatens to upend the opt-out cart by requiring employers to include opt-out incentives in non-exempt employees’ base rate of compensation, for overtime purposes.

**Opt-Out Incentives: How They Work, and How the IRS Views Them**

The typical opt-out incentive is a cash payment made by an employer to an employee who declines the employer’s offer of medical coverage. These incentives are different from employer-supplied “flexible benefit credits” an employee can use to pay down the cost of the employer’s medical plan or, alternatively, take as cash. The opt-out incentives addressed in this Alert are paid where the employee declines the employer’s coverage, and cannot be used to purchase that coverage.

Unfortunately, the IRS views the opt-out incentive as *increasing the cost of the employer’s coverage offer to the employee*, because the employee who enrolls in the medical plan not
only pays the prescribed employee contribution but also loses out on the opt-out incentive. Thus, if the employer offers self-only coverage at an employee cost of $75 per month, but offers a $200 opt-out incentive, the IRS views the employee’s cost as $275 per month, whether the employee takes the coverage or takes the cash.

The IRS also wants the incentive added to the cost of the employee’s coverage as reported on line 15 of the employee’s Form 1095-C, if the incentive is available for waiving the employer’s least expensive, self-only minimum value medical coverage offer.

Nevertheless, the IRS’s proposed rules offer employers an easy work-around. Employers can avoid taking the opt-out incentive into account (and avoid the related reporting hassle) if the employer obtains “reasonable evidence” that the employee and his or her tax family have or will have group-type health insurance elsewhere. (e.g., employer group coverage, Medicare, TRICARE, etc; essentially, the other coverage can be any minimum essential coverage other than individual market coverage).

Lockton comment: The “tax family” includes all individuals for whom the employee reasonably expects to claim a personal exemption deduction on his or her federal income taxes for the taxable year(s) that begin or end in or with the plan year to which the opt-out incentive applies.

The reasonable evidence:

- Can be a mere attestation by the employee. (This is very good news.)
- Doesn’t have to identify the other coverage.
- Should be obtained not earlier than a reasonable time prior to the beginning of the period to which the opt-out incentive applies (typically the plan year of the employer’s medical plan).
- Can be obtained after the plan year begins; an employer might want to wait if it intends to condition payment of the opt-out incentive on proof that the employee and tax family are actually enrolled in other group coverage.
- Must be obtained annually, for every year to which the opt-out incentive applies. (This threatens to be a hassle for employers that use evergreen coverage elections, that is, elections, including a waiver of coverage, that remain in force year after year until the employee changes them.)

We suspect most employers with opt-out incentives will go the attestation route, and merely include it as part of the enrollment process, such as an additional box to check on the enrollment form.

The IRS’s proposed rules also require that the opt-out arrangement “provide” that the incentive will not be paid if the employer knows or has reason to know the employee or any member of his or her tax family doesn’t have and won’t have the alternate coverage. It probably makes sense for the employer to simply include this caveat as part of any employee communication about the incentive, or as part of the attestation language.

The Work-Around Isn’t Necessary for Many Employees
If an employer wants to offer an opt-out incentive, but not mess with the reasonable evidence requirement, it risks transforming an affordable coverage offer into an unaffordable one. But that risk might create little or no ACA penalty drama for the employer, with respect to most of its employees.

That’s because employer mandate penalties under the ACA, for offering unaffordable coverage, arise only if an online health insurance marketplace qualifies full-time employees for subsidies to help them buy individual health insurance. But employees can’t qualify for subsidies if they are enrolled in an employer’s medical plan, or a public program like Medicaid or Medicare.

So even if the employer offers an opt-out incentive and ignores the reasonable evidence requirement (and as a result the employee’s coverage offer becomes unaffordable), the employer can’t be penalized in any of the following cases:

- The employee is not a full-time employee for ACA purposes.
- The employee turns down the opt-out incentive and actually enrolls in the employer's plan (this will be the most typical case).
- The employee takes the opt-out incentive, and actually enrolls in another group plan, such as a plan offered by the employer of the employee's spouse or parent.
- The employee takes the opt-out incentive, but is enrolled in a public program like Medicaid or Medicare.
- The employee takes the opt-out incentive, and enrolls in no other coverage.
- The employee takes the opt-out incentive and buys an individual policy outside of a marketplace (our assumption here is that the employer doesn't condition the incentive on the employee buying individual coverage, as that would violate IRS rules).
- The employee takes the opt-out incentive and buys an individual policy in a marketplace (the same assumption as in the previous bullet applies), but doesn't qualify for subsidies because his or her household income is too high.

What does this leave? It leaves an ACA penalty risk with respect to a full-time employee who takes the incentive, doesn’t enroll in other group coverage, and qualifies for subsidies to buy an individual policy in an online public health insurance marketplace.

**Lockton comment:** So should an employer simply ignore the reasonable evidence requirement? We don’t think so, mostly because the work-around is fairly easy to meet, and satisfying it not only moots the potential for an affordability-related penalty. It also eliminates the need – and this is no small point – for the employer to coordinate with its ACA reporting vendor to ensure the employee's Form 1095-C reflects, on line 15, a cost that includes the opt-out incentive.

**Davis-Bacon/Service Contract Act Employees and Bargaining Unit Employees**

Some employers providing goods or services to the federal government via contracts under the Davis-Bacon or Service Contract Act, or a related act, offer employees, per the government contract, cash wages plus fringe benefits that can be taken as cash at the employee’s choice. The IRS’s proposed regulations don’t specifically address the implications of these arrangements. Previous IRS guidance gave these employers a free pass on the issue.
for 2016. See our recent summary of Davis-Bacon/Service Contract Act issues related to flexible benefit credits.

Other employers provide cash-in-lieu-of-benefits options to collectively bargained employees. These arrangements should be reviewed to assess the proposed rules’ implications. The IRS’s proposed rules indicate employers offering these options under a bargaining agreement in effect in mid-December 2015 will enjoy a bit of a grace period. See the Effective Date section immediately below.

**Effective Date**

The IRS expects to finalize its proposed opt-out incentive rules fairly quickly, and anticipates an effective date of Jan. 1, 2017, for the final regulations. Taking into account these anticipated effective dates and previous IRS guidance on opt-out incentives, there are four key timing rules related to opt-out incentives:

1. Opt-out incentives in place or adopted before Dec. 16, 2015, do not affect affordability calculations for 2016, even if they don’t require evidence of other coverage.
3. Opt-out incentives provided under a collective bargaining agreement in effect before Dec. 16, 2015, do not affect affordability calculations for 2016, and are not required to comply with the IRS’s new rules until the later of their effective date and the first day of the employer’s plan year occurring after expiration of the bargaining agreement.
4. All other opt-out incentives are subject to the new rules (once finalized) beginning in 2017.

**Other Opt-Out Wrinkles**

*Section 125 Requirements*

Because cash-or-coverage incentives offer employees a choice between a nontaxable benefit (health insurance) and a taxable benefit (e.g., cash), they must be offered under the employer’s Tax Code section 125 cafeteria plan to avoid an adverse tax result to the employees who take the health insurance. Many cafeteria plans’ terms regarding benefit elections are expressed broadly enough that they won’t require an amendment when the employer adds an opt-out feature. But the terms should be reviewed to determine whether an amendment would be appropriate or not.

*Medicare and TRICARE Considerations*

Medicare and TRICARE rules prohibit an employer from singling out Medicare- or TRICARE-eligible employees, and offering incentives just to them, to waive employer coverage. But federal authorities are willing to allow broader-based opt-out incentives to operate, even if some of the employees offered the incentives are Medicare- or TRICARE-eligible.

*Overtime Calculations*
Under the federal Fair Labor Standards Act (FLSA), employers must compensate non-exempt employees for overtime at one-and-one-half times the employees’ regular rate of pay. Generally, all forms of compensation (with certain exceptions) are taken into account when determining the regular rate of pay.

The federal Ninth U.S. Circuit Court of Appeals\(^1\) recently decided that an employer must include in non-exempt employees’ regular rate of pay, for purposes of calculating their overtime rate, cash paid to employees in lieu of benefits.

The case involved a flexible benefits plan to which the employer contributed flex credits that employees could apply to purchase benefits. The employer allowed employees to convert some of the credits to cash.

This is a troubling decision, one that even the court acknowledged could drive employers away from offering cash in lieu of benefits. The employer argued that the cash-in-lieu-of-benefits payments shouldn’t be included in the regular rate of pay because the payments were not compensation for hours worked, but the court rejected the argument.

**Lockton comment:** Would the court reach the same conclusion with respect to an opt-out incentive payable only where the employee declines coverage, as opposed to a flex credit that could be used to purchase benefits or taken as cash? The answer is unclear. An employer typically awards flex credits as a component of compensation, sometimes even adjusting the credits based on position, tenure or wages. But an opt-out incentive payable only upon a waiver of coverage might be viewed differently.

In light of the recent court decision, any employer considering installing or continuing an opt-out incentive will want to discuss that matter with employment law counsel, which should be able to supply a legal opinion of the incentive’s effect – if any – under the FLSA.

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