

January 4, 2013

At Last: Proposed "Play or Pay" Regulations...Part I

Executive Summary

- The IRS has released its first set of formal, proposed regulations, and a parallel set of questions and answers, on the health reform law's "play or pay" mandate on employers. Generally, the proposed regulations -- when finalized -- will likely apply for 2014 except where they deal with matters already addressed in earlier guidance upon which employers are permitted to rely for 2014 (such as the IRS's important Notice in late August, addressing how to determine "full-time employees"). However, employers *may* rely on the proposed regulations before they are finalized, if employers find it helpful to do so.
- *Big news!* Health reform's "play or pay" mandate on employers applies January 1, 2014, but after pressure from many employer groups, the IRS proposes to permit some employers with *non-calendar* year plans to delay coverage offers to their full-time employees until the first day of their plan year beginning in 2014. But many retail, hospitality, staffing and similar employers will not be able to take advantage of this special accommodation unless they currently offer at least *some* coverage to their full-time employees.
- *Bigger news!* For controlled groups of employers subject to the play or pay mandate, the mandate's obligations and penalties would be applied *not on a controlled group basis*, but on an employer-by-employer (EIN-by-EIN) basis. This means that if one employer in a controlled group decides not to offer coverage to its full-time employees, only *that* employer -- not *every* employer in the controlled group -- would be penalized.
- The health reform law requires an employer subject to the play or pay mandate to offer minimum essential coverage to its full-time employees and dependents, or pay a penalty. The proposed regulations would deem an employer in compliance if it offered coverage to at least 95 percent of its full-time employees, and the employees' children under age 26. The proposed rules would not require the employer to offer coverage to spouses.
- When determining whether an offer of coverage to a full-time employee is "affordable" under the PPACA, an employer would be permitted to use one of *three* "affordability safe harbors," one based on W-2 pay, one based on the employee's rate of pay as of the beginning of the plan year, or one based on the federal poverty level.
- The proposed regulations' guidance regarding how to determine "full-time employees" will be addressed in a second Alert, to follow shortly after this one.

Late Friday, December 28, the IRS released its first set of proposed regulations on the employer "play or pay" mandate under the Patient Protection and Affordable Care Act (PPACA). The proposed regulations largely track earlier non-regulatory guidance on the mandate, but add several important twists.

Employers may continue to rely for 2014 on the *earlier* guidance regarding how to determine full-time employees using measurement periods (see our [Alert](#) of September 10, 2012) but if they choose, employers may rely on the newly proposed regulations. When the proposed regulations are finalized later in 2013, the final rules -- if more restrictive than the proposed rules -- will apply only for future periods.

The proposed regulations are a mixed bag. On one hand, they provide some welcome accommodations for employers, to ease implementation and administration of many health reform-related requirements. But the regulations add other layers of complexity to increasingly byzantine issues.

Background

The PPACA's signature provisions come online January 1, 2014, and relate like the legs on a three-legged stool. First, Americans become subject to the "individual mandate," which requires them to have at least "minimum essential coverage" by January 1 or risk modest tax penalties.

Where are Americans to get this minimum essential coverage? The second leg on the health reform stool is supplied by employers: Employers with at least 50 full-time equivalent employees in their controlled group must offer minimum essential coverage to their full-time employees and dependents, or risk penalties.

The third leg on the stool is supplied by the states. Each state is required to establish a health insurance exchange to facilitate the purchase of health insurance by individuals who don't receive an offer of adequate and affordable coverage from an employer. See our [Alert](#), dated March 22, 2012, regarding health insurance exchanges.

The proposed regulations deal exclusively with the second leg on the stool, the employer mandate, which the PPACA refers to as the employer "shared responsibility" requirement.

This Alert is Part I of a two-Alert package on last week's proposed regulations. This Alert deals with several aspects of the "play or pay" mandate, including the topics listed in the Executive Summary above, but not the process for determining an employer's full-time employees through the use of look-back measurement periods. Part II will address the proposed regulations' guidance concerning measurement periods and related issues, such as counting hours of service, use of payroll periods, rehires, etc.

In the Boat, or Out?

Only employers with an average of at least 50 full-time equivalent employees for the prior calendar year are subject to the play or pay mandate. When counting employees for this purpose, *all employees -- full-time and part-time -- in the employer's controlled group are considered*. Controlled group determinations are easiest when dealing with corporations and other businesses because the controlled group rules are based on stock ownership, for the most part. The IRS expects governmental entities and churches to make good faith controlled group determinations.¹

When counting employees, individuals who are not common law employees are disregarded, such as leased employees, partners, sole proprietors, more than two percent shareholders in subchapter S corporations, and bona fide independent contractors. When counting hours, the proposed rules would permit employers to disregard hours worked overseas, or hours for which an employee does not receive U.S.-source income.

Here's how the determination is made:

- First, determine the number of common law *full-time employees* -- those working at least 30 hours per week -- employed by the employers in the controlled group for each month in the preceding calendar year, and add those monthly totals together.
- Second, for each month, add the hours worked by *part-time* employees in the month (don't count more than 120 hours for any one part-time employee), and divide by 120 to determine the number of "full-time *equivalent* employees" for the month. Then add those monthly totals together.
- Third, add the monthly totals of full-time and full-time equivalent employees from steps one and two together, and divide by 12. Round any fraction *down*.

If the result is less than 50, the employers in the controlled group are not subject to the play or pay mandate. If the result is 50 or more, *all* employers in the controlled group are subject to the play or pay mandate, even the ones who employ fewer than 50.

Lockton Comment: If the sum of a controlled group's full-time and full-time equivalent employees exceeds 50 for only 120 days (or four months) or less during the preceding calendar year, and it was seasonal employees who caused the controlled group's employees to exceed the 50 threshold, the controlled group is *not* subject to the play or pay mandate. A "seasonal employee" is an employee who performs labor on a seasonal basis, as determined by the employer in good faith, including retail employees employed solely during the holiday season.

For employers hovering near the 50 full-time/full-time equivalent threshold, the proposed regulations would permit the employer to determine the number of its employees over a six-consecutive-month period in 2013, rather than the entire 2013 calendar year. This modest transition rule will permit small employers to select a six-month period in 2013 over which to count their full-time/full-time equivalent employees, and leave the employers time after that period, but prior to 2014, to implement the results of that determination, if implementation is necessary.

Play or Pay Wrinkles: Good News All Around...but Complexity Too

For employers subject to the play or pay mandate, the mandate takes effect on January 1, 2014. By that January 1, the PPACA requires employers to have identified their full-time employees (as defined by the PPACA) and offered them and their dependents health insurance, or the employers risk penalties. The employer obligation has two tiers:

- First, the employer must offer at least *some* coverage -- specifically, "minimum essential coverage" -- to its full-time employees and their dependents, or pay a nondeductible penalty of \$2,000 per year (1/12th of that amount per month) times all the employer's full-time employees, less the first 30 full-time employees (we call this the "free 30" rule). At least for now, minimum essential coverage appears to be any coverage more robust than a health flexible spending account or a dental or vision plan.
- Second, if the minimum essential coverage does not also meet a "minimum value" standard -- we've long called this "qualifying coverage" -- *and* is not "affordable" to a full-time employee, *and* the employee instead obtains subsidized health insurance in a public health insurance exchange, the employer pays a \$3,000 annual nondeductible penalty (1/12th of that amount per month) with respect to that employee.

The proposed regulations offer some welcome accommodations and interpretations regarding this two-

tiered obligation.

Play or Pay Penalties Apply on an EIN-by-EIN Basis

Most welcome, where the play or pay mandate applies to a controlled group of companies, the penalties don't apply on a controlled group basis, *but on an employer-by-employer basis*. So if one corporation in a controlled group doesn't offer its full-time employees health insurance, only that corporation pays the \$2,000 annual penalty for each of its full-time employees; the other employers in the controlled group do not.

Lockton Comment: Thus, the proposed regulations defuse the much feared "nuclear penalty" under which one employer's failure to offer coverage to some full-time employees would have sent penalties rippling through the entire controlled group, even with respect to other group members who offer coverage to their employees.

Under the proposed regulations, if one member of a controlled group triggers the first-tier penalty described above, that member's penalty calculation would be made not by ignoring the first 30 full-time employees of *that* member. Rather, the "free 30" rule would be applied by prorating the "free 30" between the members of the controlled group, based on the portion of the group's full-time employees employed by each member.

Lockton Comment: This accommodation, if retained in the final regulations, sets up nice planning opportunities for some employers who would prefer not to offer coverage to a portion of the full-time workforce. Take, for example, an employer that employs 1,030 full-time employees in two divisions (single EIN), one with 800 full-time employees who receive an offer of coverage and one with 230 full-time employees who don't. The employer would pay a \$2 million nondeductible annual penalty under the play or pay mandate ($\$2,000 \times (1030-30)$).

But if the employer broke the 230 employees out into a separately incorporated subsidiary, the employer would pay a \$2,000 annual penalty with respect to only 223 employees, that is, 230 employees minus that subsidiary's pro rata share (7, or 22.3 percent of 30) under the "free 30" rule.

Offer Coverage to All Full-Time Employees...or Mostly All?

Although the PPACA provides that the employer's first-tier obligation is to offer minimum essential coverage to its full-time employees and their dependents, the regulations propose that offering coverage to *95 percent* of an employer's full-time employees and to their dependents is adequate to satisfy this mandate.

Lockton Comment: It doesn't matter whether the failure to offer coverage to the other five percent is inadvertent or deliberate. In short, employers have a five percent margin of error, with respect to offering coverage to full-time employees and dependents.

"Dependents" Means "Children," But Not Spouses

Speaking of those dependents, the proposed regulations surprisingly say that "dependents" include only children up to age 26, and don't include spouses. Thus, employers would have no obligation whatsoever to offer coverage to the spouse of a full-time employee. "Children" include biological, step, adopted and foster children.

Lockton Comment: Note the distinction between health reform's rule requiring coverage of children to continue to age 26, and this requirement under the play or pay mandate. The "age 26 rule," as we've come to call it, doesn't require a plan to cover any specific children. It's just that, if the plan covers biological, step, adopted and/or foster children, it must cover them to age 26 without further condition. Most plans that cover children cover these categories, as a practical matter. Under the PPACA, coverage for these children is nontaxable to the end of the year in which the child attains age 26, regardless of the child's tax dependency.

Tier 1 of the "play or pay" mandate, however, says the employer must offer minimum essential coverage to at least 95% of FTEs under the same EIN, and their biological, step, adopted and foster children to age 26, or risk penalties. This will require employers who don't currently cover all four categories of children, to broaden their plans' eligibility rules to cover them, or risk penalties.

Lockton Comment: Because there is no obligation to offer coverage to the employee's spouse, employers may continue to use spousal carve-out programs that deny enrollment to the employee's spouse if the spouse has access to other employment-based coverage.

The proposed regulations would also offer a transition rule for plans that currently cover only employees. These plans are insulated from penalties for not offering coverage to dependent children of full-time employees for the plan year beginning in 2014, as long as the employer "takes steps during [that plan year] toward satisfying" the obligation to offer dependent coverage.

"Minimum Essential Coverage"... Still No Guidance

Recall that the first-tier employer obligation is to offer minimum essential coverage, or "MEC," to at least 95 percent of the employer's full-time employees, and to their children under age 26.² How modest may an offer of MEC be? The PPACA essentially says that any employer-based coverage other than an "excepted benefit" is MEC. Excepted benefits include typical dental and vision plans, and most health flexible spending accounts.

Unfortunately, the proposed regulations don't supply a more precise definition of MEC.

Ditto for "Minimum Value"

The employer's second-tier obligation, under the play or pay mandate, is to ensure that its offer of MEC is affordable and satisfies a "minimum value" standard, which means it must have at least a 60 percent actuarial value. We have often referred to this level of coverage as "qualifying coverage." The preamble to the proposed regulations indicates federal authorities will shortly issue a calculator that will allow employers to determine the actuarial value of their coverage offerings.

Lockton Comment: The proposed regulations do make clear, however, that the minimum value requirement, like its companion "affordability" requirement, applies just to employee-only coverage. Thus, while employers subject to the play or pay mandate must offer MEC to full-time employees and their children under age 26 in order to satisfy the first-tier obligation, it is merely the employee-only coverage that must be qualifying and affordable to satisfy the second tier. The coverage offered to children may be unsubsidized and (apparently) skimpy.

"Affordable" Coverage: A Look-Back Calculation, But Three Safe Harbors

The PPACA says coverage is affordable if the employee is not asked to pay more than 9.5 percent of household income -- basically, adjusted gross income -- for employee-only coverage under the employer's least expensive coverage offering. The determination is a look-back determination, made after the close of the calendar year.

Employers are in no position to know an employee's household income, so the IRS has said for several months that if an employer charges no more than 9.5 percent of an employee's W-2 wages (wages reflected in Box 1 of the Form W-2) for employee-only coverage, the employer will be deemed to have made an affordable coverage offer.

The proposed regulations reiterate the W-2 safe harbor, and would add two other safe harbors.

The proposed safe harbors include:

- **W-2 safe harbor:** The W-2 safe harbor is available where the employee-only premium is described as a flat dollar amount or percentage of W-2 wages that does not exceed 9.5 percent of the employee's Box 1 wages. *The employee-only premium may not be adjusted in the middle of a plan year.* Where an employer sets the employee-only premium as a percentage of W-2 wages, it may also impose a dollar limit (e.g., "9.5 percent of W-2 wages, up to \$200 per month").

Lockton Comment: W-2 wages -- that is, wages shown in Box 1 of the Form W-2 -- do not include pre-tax contributions to 401(k) or cafeteria plans. Employers need to keep that in mind, although with regard to cafeteria plan contributions, this fact is not particularly distressing. In many cases, an employee making pre-tax contributions to a cafeteria plan will be paying for the employer's health insurance coverage. If he or she is actually *enrolled* in an employer plan, it's irrelevant that the coverage might be "unaffordable" within the meaning of the PPACA. The employer can't be penalized for offering unaffordable coverage if the employee enrolls in it.

If an employee is employed for only a portion of a year, the W-2 safe harbor is applied by multiplying the employee's wages from the employer by a fraction: the months coverage was offered to the employee over the months the employee was employed (count a month even if the employee was employed or offered coverage for only part of the month). Compare the adjusted wage amount to the employee's premium for the months the employer offered coverage.

- **Rate of Pay Safe Harbor:** An offer of coverage would be considered affordable for a given month if the employee-only premium for the month does not exceed 9.5 percent of an amount equal to 130 hours multiplied by the employee's hourly rate of pay *as of the first day of the plan year.* For salaried employees, the employer would use monthly salary as of the first day of the plan year. *To use the safe harbor, the employer may not decrease the employee's rate of pay during the calendar year.*

Lockton Comment: Using this "rate of pay" safe harbor avoids challenges an employer may have in attempting to comply with the W-2 safe harbor, due to the fact that W-2 wages don't include pre-tax benefit deductions. It also seems to avoid an affordability issue that would otherwise be created where an employee's monthly pay decreases mid-year due to reduced hours.

- **Poverty Line Safe Harbor:** An offer of coverage would be considered "affordable" for a given

month if the employee-only premium for the month does not exceed 9.5 percent of 1/12th of the federal poverty level for a single individual for the state in which the employee is employed.³

Failure to Offer Qualifying and Affordable Coverage: What Happens Next?

An employer subject to the play or pay mandate who fails to offer qualifying (i.e., minimum value) and affordable coverage to full-time employees risks a \$3,000 nondeductible annual penalty for each full-time employee who instead obtains subsidized health insurance in a public health insurance exchange.

But here's the catch: An employee doesn't qualify for subsidies -- and therefore cannot trigger a penalty against the employer -- if he or she is actually *enrolled* in minimum essential coverage through an employer. The proposed regulations, however, would prohibit employers from unilaterally enrolling employees in coverage without giving them the right to opt out.

A Play or Pay Delay...Hooray! But Only for Some Employers

The play or pay mandate applies January 1, 2014, but some employers sponsor health plans that operate on a non-calendar year fiscal year. Many employers and trade associations pushed the IRS to delay the mandate for these employers, to allow them to avoid modifying their plans or onboarding a new crop of enrollees in the middle of a plan year.

In the proposed regulations the IRS offers a deferred effective date in two situations, *but only for some plans*, and *only for some purposes*.

Eligibility by First Day of 2014-15 Plan Year, Under the Plan's Current Eligibility Rule

The IRS proposes to not penalize the employer for failing to offer coverage to full-time employees prior to the first day of the 2014-15 plan year, as long as the employees receive an offer of qualifying and affordable coverage by the first day of that plan year...*under the plan's eligibility rules as in effect today*.⁴

Lockton Comment: This accommodation won't help fiscal year plan sponsors such as some retail, restaurant, hospitality, staffing and similar employers, who today don't offer any coverage to some full-time employees. The accommodation won't help because the employees will not become eligible for coverage by the first day of the plan's 2014-15 year, under the plan's *current* eligibility rules.

The accommodation might, however, help sponsors who today offer full-time, rank-and-file employees at least some coverage, if only a limited medical plan. If the plan were amended by the first day of the plan's 2014-15 year to provide qualifying and affordable coverage, it appears the employer would receive a free pass under the play or pay penalties for the portion of 2014 preceding the first day of the plan year, at least with respect to any full-time employee who is or would be eligible for that coverage by the first day of the 2014-15 plan year *under the plan's eligibility rules in effect on December 27, 2012*.

Accommodation for a New Class of Eligible Full-Time Employees

A second accommodation might help retail, restaurant, staffing and similar employers, or at least some of them, who don't offer any coverage today to a class of full-time employees.

This accommodation applies to employers who, as of the end of the open enrollment period that

immediately preceded December 27, 2012, *covered* at least one-fourth of their employees under a non-calendar year plan (or multiple non-calendar plans with the same plan year), or *offered coverage* to at least one-third of their employees under such plan(s).

In that event, the employer won't have to worry about offering coverage to other full-time employees, such as employees in a class not eligible for coverage today, by January 1, 2014. The employer won't be penalized as long as these full-time employees are offered qualifying and affordable coverage by the first day of the 2014-15 plan year.

Lockton Comment: This accommodation does not apply with respect to full-time employees who would have been eligible for coverage under a *calendar year plan* in effect on December 27, 2012.

Unfortunately, employers who today offer coverage to only a minor fraction of employees would not be able to take advantage of this accommodation. They would remain obligated to make mid-year coverage offers to a great number of full-time employees, for a January 1, 2014, effective date, or risk penalties.

No Delay from Reporting Obligations

Even if an employer with a non-calendar year plan may take advantage of the short-term reprieve from play or pay penalties until the first day of the 2014-15 plan year, the employer will still have an obligation to make any applicable, and as yet undefined, reports to federal authorities for periods beginning January 1, 2014.

Partial Reprieve for Employers Contributing to Multiemployer (Taft-Hartley) Plans

The play or pay mandate has befuddled employers with full-time employees on whose behalf the employer makes contributions to a multiemployer health plan. Does the employer receive credit for that contribution and coverage, or must the employer offer coverage of its own to the employee?

In the proposed regulations, the IRS asks for additional comments on how the play or pay mandate should apply to employers participating in multiemployer plans. Through 2014, however, the employer won't be subjected to play or pay penalties with respect to full-time employees on whose behalf the employer is bound to make contributions to a multiemployer plan, if:

- The plan offers coverage to the employee and his or her children to age 26, and
- The plan's coverage is qualifying and affordable, at least with respect to the employee. The employer may use any of the affordability safe harbors, or may consider the employee's wages reported by the employer to the multiemployer fund (the employer may use actual wages or the wage rate dictated by the bargaining agreement).

Lockton Comment: Multiemployer plan coverage tends to be relatively robust and therefore should satisfy the minimum value standard (although it behooves the employer to confirm this). The employee usually pays nothing or a modest premium for the coverage, which means the coverage will likely also be considered affordable.

The employer's issue, then, is most likely to arise with respect to bargaining unit employees who are also "full-time" under the play or pay rules, but might not be eligible for coverage under the multiemployer plan. Identifying employees in this gap might be a headache.

Up Next: Determining Full-Time Employees under the Proposed Regulations

Part II of our two-part Alert package will address how, after 2014, the proposed regulations would require employers to determine full-time employees for purposes of the play or pay mandate. Our September 10 [Alert](#) summarizes guidance that applies for 2014, although the IRS will permit employers to rely on last week's proposed regulations, even for 2014, if the employer so chooses.

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¹A not-for-profit entity, including a government or church, will typically determine the members of its "controlled group" by considering the extent to which the entity has the right to appoint and remove at least 80 percent of trustees, directors or other leaders of the other organizations.

²Not to be confused with "essential health benefits," which is an entirely different concept and not addressed here, or "minimum value," which means 60 percent actuarial value.

³There are three federal poverty levels, one for the 48 contiguous states and Washington D.C., and one each for Alaska and Hawaii.

⁴Employers are not permitted to amend their plan years simply to take advantage of this deferred effective date.

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