WELLS FARGO INSURANCE

Legislative Alert

January 4, 2013

IRS and Treasury Department issue proposed regulations on health care pay or play mandate

On December 28, 2012, the Treasury Department and the Internal Revenue Service (the "Departments") issued proposed regulations on the "Shared Responsibility for Employers regarding Health Coverage," commonly referred to as the employer "pay or play mandate" of the Patient Protection and Affordable Care Act (ACA). In the proposed regulations, the Departments reaffirmed some of the provisions discussed in previously issued IRS Notices 2011-36, 2011-73, 2012-17, and 2012-58. However, they also provided new and additional guidance on some provisions of the pay or play mandate.

Employers subject to the pay or play mandate

The proposed regulations reaffirm that a large employer subject to the pay or play mandate is defined as an employer who employs more than 50 employees (including full-time-equivalent employees [FTEs]) during the preceding calendar year. To determine the number of FTEs of the employer (those employees not working at least 30 hours per week or 130 hours per month), the employer must aggregate the number of hours of service per month (capped at 120 hours per employee) of all non-full-time employees, including seasonal employees, and divide the service hours by 120. The resulting number of FTEs is then added to the number of actual full-time employees of the employer.

Employers that form a controlled group as defined in IRC 414(b), (c), (m), or (o) must aggregate the number of employees in each company to determine if the members of that controlled group constitute a large employer.

For the 2014 calendar year, employers that are close to the 50-employee threshold are provided transitional relief. The relief allows employers to select a period of at least six consecutive calendar months in the 2013 calendar year to determine if the employer employed an average of 50 full-time employees or more. For example, an employer can use January and February to establish its counting method, March through August (six months) to determine if the employer employed 50 employees or more during 2013, and September through December to make arrangements to offer coverage to employees if the employer employed 50 or more employees during the six month period.

Foreign employers and foreign employees

The service performed by foreign employees of a foreign company and services rendered by U.S. employees or foreign nationals for companies outside of the U.S. that constitute foreign source income, will not be counted for the purpose of determining if an employer is a large employer or if the employee is a full time employee.

Assessing pay or play penalties on controlled groups

Although the number of employees of a member company of a controlled group are aggregated for the purpose of determining if the member company is a large employer, when assessing penalties under the pay or play mandate, each participating employer of a controlled or affiliated group of companies will be treated as a separate large employer. Therefore, each member company will have to assess separately whether the member company offers minimum essential coverage to full time employees and whether the coverage the member company offers is affordable (employee-only coverage cost is less than 9.5% of the employees household income) and offers minimum essential value (60% actuarial value).

- **Assessing the penalty for not offering minimum essential coverage (MEC).** The penalty assessable against an employer who fails to offer MEC to full-time employees is $2,000 times the number of actual full-time employees of the employer minus the first 30 employees. Controlled groups will be allowed to claim a 30-employee reduction in calculating the pay or play mandate penalty for failure to offer MEC. The reduction is allocated ratably among the members of the controlled group based on the number of full-time employees of each member company during the calendar year. For example, if Company A owns 100% of the shares of Company B, Company A and B are members of a controlled group. Company A employs 40 employees and Company B employs 35 employees for each month of 2015. Company A does not offer MEC to its employees while Company B does offer MEC to employees. For purposes of the pay or play mandate, Company A and Company B are deemed to be a large employer for 2015 because together they employ 75 employees. If one of the full-time employees of Company A purchases coverage from an Insurance Exchange and receives a tax subsidy for the coverage for the 2015 calendar year, then the tax penalty for Company A for failure to offer MEC is triggered. The tax penalty on Company A would be calculated to be $48,000: 40 employees, minus 16 (40 employees of Company A divided by 75 total employees of Company A and B, multiplied by 30), times $2,000.
- **Assessing the penalty for offering coverage that does not meet affordability and minimum value requirements.** The penalty for failure to offer coverage that is both affordable and meets the minimum value is $3,000 per year per employee that receives subsidized coverage from an Exchange. The penalty would be assessed only on member companies that did not offer employees coverage meeting the affordability and minimum value thresholds.

Minimum essential coverage (MEC)

Any employer sponsored coverage other an excepted benefit plan is deemed to be MEC for purposes of the ACA. Future guidance is anticipated on this topic and will include self-funded medical plans in the definition of MEC.

Failure to offer MEC to full-time employees (95% rule)

The proposed regulations establish a new threshold for large employers required to offer MEC to full-time employees and their dependents, which is primarily designed to ease concerns of inadvertently failing to offer MEC to all such individuals. Specifically, the proposed regulations provide that a large employer is deemed to offer MEC to its full time employees and dependents if the employer offers MEC to all but 5%, or if greater, all but five of its full-time employees. Thus, the $2,000 pay or play mandate penalty will not be imposed on employers who fail to offer MEC to all full-time employees as long as the employer offers coverage to at least 95% of its full-time employees. However, it should be noted that failure to offer coverage to any full-time employees could result in a $3,000 pay or play mandate penalty for each employee who receives subsidized coverage from an Exchange.

Hours of service definition and calculations

The proposed regulations confirmed that the definition of hours of service and the calculation of hours of service as initially suggested in Notice 2011-36 will apply. Hours of service will be defined as 1) each hour for which an employee is paid, or is entitled to payment for the performance of duties to the employer; and 2) each hour for which an employee is paid, or is entitled to payment by the employer on account of a period of time during which duties are not performed due to vacation, holiday, illness, incapacity (including disability), layoff, jury duty, and military leave of absence. However, the proposed regulations remove the 160-hour limit on paid leave, so that all periods of paid leave, as defined above, must be treated as an hour of service and taken into account in determining if an employee is a full-time employee and in assessing if an employer is a large employer under the pay or play mandate. In addition, the guidance imposes a 501-hour limit on the number of hours an educational organization is required to take into account for absences in a calendar year for purposes of determining the average hours of service under a measurement period. The guidance also provides that:

- **Calculating the hours of service of non-hourly employees.** Hours of service for employees not paid on an hourly basis must be calculated using either the actual-hours method (actual hours worked by the employee), days-worked

equivalency method (eight hours per day), or weeks-worked equivalency method (40 hours per week). Employers will have the option of selecting one of these three methods to calculate the number of hours worked by non-hourly employees in different job classifications, as long as the classifications are reasonable and are consistently applied. An employer can modify the method of calculating the hours of non-hourly employees on a calendar-year basis. Employers are prohibited from using the days-worked or the weeks-worked equivalence methods in calculating the number of hours worked by non-hourly employees if the results would understate the number of hours worked by an employee.

- **Calculating the hours worked for employees of educational institution and other employees.** There will be special rules for educational organizations to determine the number of hours worked by employees, due to the fact that the hours worked by employees in educational institutions are closely related to an academic year, not a 12-month period. The adoption of a 12-month measurement period would exclude employees of educational institutions from satisfying the definition of a full-time employee due to scheduled closures or breaks in service. The guidance also states that employers of educational institutions should use an averaging method for breaks in employment caused due to breaks in the academic or school year. If there is an unpaid employment break period of at least four consecutive weeks for a continuing employee, the educational organization must either determine the average hours of service per week (excluding the period of unpaid leave) during the measurement period and use that average as the average for the entire measurement period, or credit employees during the employment break period at the rate equal to the average hours of service during the measurement period that are not part of the employment break period.

Although no official guidance or methodologies are discussed in calculating the number of hours worked by adjunct faculty employees, the notice states that educational institutions should use a reasonable method for crediting hours of service that is consistent with the anti-abuse rules. This means that educational institutions could not take into account only the hours that an adjunct faculty member teaches in a classroom or other instruction time without taking into account "the hours that are necessary to perform the employee's duties, such as class preparation time." Further guidance is anticipated on the treatment of adjunct faculty members as well as employees compensated on a commission basis, transportation employees, and analogous employment positions whose compensation is not primarily based on hours.

- **Measurement periods and stability periods.** The guidance retains the measurement and stability periods addressed in Notice 2012-58 by stating that an employer has the option of using standard and initial measurement periods (look-back periods) of not less than three months but not greater than 12 months to determine if an employee is a full-time employee. Measurement periods may be used by employers who are unable to determine at the time the employee is hired if the employee is anticipated to work on average 30 hours per week or 130 hours per month. Measurement periods may be used to assess the full-time employee status of employees with variable hours of employment or seasonal employees. A stability period is the period of time subsequent to a standard or initial measurement period (and applicable administrative period) that is the greater of six consecutive months or the duration as the measurement period. An employee who was deemed to be a full-time employee during the measurement period must be offered benefit coverage and, if elected, such coverage must remain in place throughout the term of the stability period regardless of the number of hours worked by the employee during the stability period. Benefit coverage under the stability period can only be terminated if the employee ceases to be employed by the employer, assuming that the employee is not rehired during the term of the stability period (as described below) and for as long as the employee makes timely premium payments. Premium payments are deemed to be timely if made within 30 days of their due date.
  - **Standard measurement periods (SMPs) for ongoing employees.** An SMP applies only to ongoing employees. An ongoing employee is defined as an employee who has been employed by the employer for at least one standard measurement period. Different SMPs may be used for the following categories of employees: each group of collectively bargained employees subject to separate collectively bargained agreements, collectively bargained and non-collectively bargained employees, salaried and hourly employees, and employees who are in different states. However, new guidance eliminates the classification for employees in controlled groups, as each member company will be treated as a separate employer for purpose of assessing penalties under the pay or play mandate.
  - **Ability to change standard measurement period and stability period.** Applicable large employers will be able to change the SMP and associated stability period for

subsequent years, and there is a special transition rule for stability periods beginning in 2014 for employers who want to use a 12-month SMP in subsequent years. Employers may adopt a transition measurement period that is shorter than 12 months but that at least six months long and that begins no 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.

- **New employees.** The new guidance retains the provisions pertaining to new employees under Notice 2012-58 by requiring that benefit coverage be offered to non-seasonal employees who at their start date are scheduled to work 30 or more hours per week, following 90 continuous days of employment counted from the employee's hire date. For new variable-hour and seasonal employees, an employer can use an initial measurement period (IMP) of at least three months but not more than 12 months to assess whether an employee is a full-time employee, and an administrative period of up to 90 days; however, the IMP and administrative period combined may not extend past 13 months and a fraction counted from the employee's hire date. The IMP and administrative period are followed by a stability period, which is the greater of six months or the IMP.
- **Seasonal employees.** Through 2014, employers must use reasonable good faith efforts in assessing whether a seasonal employee is a full-time employee. The Departments anticipate issuing guidance on the definition of a seasonal employee for the 2015 calendar year, which will establish a limit of six months of continuous employment for seasonal employees.
- **Paid or unpaid leave before or during a stability period.** A full-time employee that goes on leave, paid or unpaid, prior to the beginning of the stability period, retains his or her full-time employee status upon returning to work and coverage must be made available on the first day the employee is credited with an hour of service, or as soon as administratively possible. If the employee goes on leave during the stability period during which the employee was deemed to be a full-time employee, the employee is treated as a full-time employee for the duration of the stability period.
- **Measurement periods and unpaid leave.** In determining an employee's full-time status during a measurement period when the employee is on a special unpaid leave (such as unpaid leave under the Family and Medical Leave Act (FMLA), the Uniformed Services Employment and Reemployment Rights Act (USERRA), and jury duty), and the employee is deemed to be a continuing employee (employee resumes his or her position upon expiration of the leave), an employer is allowed to use one of two methods in determining if the employee satisfied the definition of a full-time employee: the averaging method and the crediting-hours method. The averaging method requires the employer to determine the average number of hours of service per week during the measurement period excluding the period of special unpaid leave, and to use that average for the entire measurement period. The crediting-hours method requires the employer to credit the number of hours of special unpaid leave at a rate equal to the average weekly rate the employee earned during the period that was not special unpaid leave.
- **Change in employment status rules.** Change in employment status rules only apply to new variable hour or seasonal employees during their IMP, with a change in employment status defined as a material change in the position of employment that, had the employee begun employment in the new position, would have resulted in the employee being reasonably expected to be a full-time employee. The proposed regulations provide that an employee who has such an event is treated as a full-time employee as of the first day of the fourth month following the change or, if earlier and the employee averages more than 30 hours per week during the IMP, the first day of the first month following the end of the IMP.
- **Termination of employment and resumption of service rules.** Employees rehired after termination of employment will be treated as new employees if the employee incurs a period of at least 26 consecutive weeks for which no hours of service are credited, or if the period with no credited hours is at least four weeks long and is greater than the employee's period of employment immediately preceding the period with no credited hours of service. For example, an employee works for an employer for three consecutive weeks, terminates employment, and is rehired eight weeks later. In this case, the employee would be treated as a new employee, as the employee experienced an eight-week gap of employment prior to being rehired and the three-week period that the employee worked for the employer is less than the eight-week period the employee was not employed.
- **No relief for high-turnover employees.** The proposed regulations do not contain any special rules for high-turnover positions, and essentially prevents employers from applying the variable hour employee rules in a manner that precludes or improperly delays high-turnover employees' eligibility for coverage. In particular,

effective January 1, 2015 (and except for seasonal employees), employers will be required to assume that a new variable hour employee will continue to be employed by the employer for the entire IMP (that is, the employer cannot take into account the likelihood that the employee's employment will terminate before the end of the IMP). Even in 2014, the status of any individual new variable hour employee cannot be based on the employer's expectations regarding aggregate turnover; rather, there must be objective facts and circumstances specific to the newly hired employee at the start date demonstrating that the individual employee's employment is reasonably expected to be of limited duration. This could be problematic for restaurants and other clients with similar workforces. Note, however, that the Departments are soliciting comments on special relief for temporary staffing agencies, so further guidance is expected.

- **Temporary staffing agencies.** Temporary staffing agencies must exercise caution in classifying all of their temporary employees as variable-hour employees. Staffing agencies should conduct an analysis of the facts and circumstances surrounding the employee's placement prior to determining whether the employee's is a variable hour employee. The Departments consider that employees who are assigned to long-term projects with defined work schedules, such as those performed by highly-skilled technical or professional workers, would most likely not satisfy the definition of a variable-hour employee. In the Departments' view, a variable-hour employee working for a staffing agency would be an employee whose periods of employment at 30 hours per week or more are of limited duration, who experiences gaps between assignments, and where there is often and considerable uncertainty as to the likelihood or duration of assignments. In its discussion of the applicability of the pay or play mandate rules to staffing agencies, the Departments concluded that future guidance will address potential areas of abuse to require that, if an employee provides services to an employer and also performs the same or similar services for that employer as an employee of a staffing agency of which the employer is a client, all hours worked by the employee (including the hours worked for the staffing agency) will be attributed to the employer for purposes of determining if the employee is a full-time employee. It also states that if a client of a staffing agency is the common-law employer of an employee placed through a staffing agency, or if the employee provides the same or similar services under two or more staffing agencies for that employer, the hours worked by the employee will be aggregated for purposes of determining the employer/client's responsibilities under the pay or play mandate. If the staffing agency client is not the common-law employer, then one of the staffing agencies that employs the employee will be responsible for determining if the employee is a full-time employee.

Multiple safe harbors on premium "affordability"

With respect to the employee premium affordability standard, the proposed regulations establish three safe harbors.

1. **Box 1 of Form W-2.** The employer uses the wages reported in Box 1 (annual wages reduced by cafeteria plan contributions and 401(k) and 403(b) contributions) of an employee's Form W-2 to determine if the annual cost of medical coverage is less than or equal to 9.5% of the employee's income. The determination is made after the end of the calendar year and on an employee-by-employee basis. Thus, the determination of whether an employer actually satisfied this safe harbor is made after the end of the applicable calendar year. However, the employer may also use the safe harbor prospectively, by setting the employee contribution for the year at 9.5% of the employee's W-2 wages for that year and automatically deducting 9.5% (or less) from each employee's W-2 wages each pay period.
2. **Rate of pay.** Under the rate of pay safe harbor, the employer determines affordability by multiplying the hourly rate of pay for each hourly employee by 130 hours per month (or uses the monthly rate of pay for salaried employees) and then multiplies that amount by 9.5%. The resulting amount represents the "affordable" employee contribution for employee-only coverage under the employer's lowest cost plan that provides minimum value (has 60% actuarial value). Employers may use this method provided the employer does not reduce the rate of pay for employees during the year. Note that this option may be more beneficial for employers than the W-2 safe harbor in assessing the affordability of their plans, as it takes into account the employees' full rate of pay or monthly wages (salaried employees) prior to any cafeteria plan or retirement plan deductions.
3. **Federal poverty level.** Under this option, an employer's coverage is affordable if the employee's cost for self-only coverage does not exceed 9.5% of the federal poverty level for a single individual. For 2012 the federal poverty level is $11,170, so the cost of affordable coverage would be $88.43 per month ((9.5% x $11,170) / 12).

These safe harbors are all optional, and an employer may choose to use one or more of the safe harbors for all of its employees or for any reasonable category of employees.

Extension of coverage to dependents but not spouses

Coverage must be extended to all full-time employees and dependents, with a dependent defined as the employee's child who is under age 26 but not the employee's spouse. This provision would potentially allow an employer to exclude coverage for spouses under the employer's plan in all cases, assuming the exclusion is applied on a uniform basis to all employees eligible for employer-sponsored coverage. Practically speaking, it will allow employers to continue a current trend that would make an employee's spouse ineligible for coverage when that spouse has access to major medical coverage through that spouse's own employer.

Fiscal plan year relief

The proposed regulations also provide transition relief for fiscal year plans. For an employer that, as of December 27, 2012, already offers health insurance coverage through a plan that operates on a fiscal year (a fiscal year plan), transition relief is available. First, for any employees who are eligible to participate in the plan under its terms as of December 27, 2012 (whether or not they take the coverage), the employer will not be subject to a potential payment until the first day of the fiscal plan year starting in 2014. Second, if the fiscal year plan (including any other fiscal year plans that have the same plan year) was offered to at least one third of the employer's employees (full-time and part-time) at the most recent open season or the fiscal year plan covered at least one fourth of the employer's employees, then the employer also will not be subject to the Employer Shared Responsibility payment for any of its full-time employees (including employees who were not eligible for the plan as of December 27, 2012) until the first day of the fiscal plan year starting in 2014, provided that those full-time employees are offered affordable coverage that provides minimum value no later than that first day.

Large employers participating in multiemployer plans

Employers participating in large multiemployer plans (plans established as part of collectively bargained agreements) are granted a transitional period through 2014 until final guidance is issued by the Departments. The transitional rule applies to contributions made by large employers to a multiemployer plan. The rule provides that a large employer member of a multiemployer plan would not be subject to a penalty under the pay or play mandate if, with respect to a full-time employee of the employer (full-time status is determined based on the number of hours worked by an employee for that employer):

1. The employer is required to make a contribution pursuant to a collectively bargained agreement or participation agreement
2. Coverage is offered to the full-time employee and dependents under the multiemployer plan
3. The coverage offered under the multiemployer plan is affordable and meets the minimum essential value

Coverage offered under a cafeteria plan and Exchange coverage

The Departments have provided transition relief for 2014 for employers sponsoring fiscal year cafeteria plans. The relief allows employees participating in their employer's cafeteria plan to revoke their election and enroll in Insurance Exchange coverage or elect to enroll in their employer-sponsored accidental and health coverage, if previously waived. According to the Departments, an employee's eligibility to enroll in a health insurance plan offered through an Exchange does not constitute a status change under cafeteria plan rules, therefore an employee who made an election during 2013 (to participate or waive participation in the employer's accident and health plan) is ineligible to revoke an election under the cafeteria plan until the end of the cafeteria's plan year. However, with the transition relief, an employer sponsoring a fiscal year cafeteria plan is allowed to amend its plan documents to allow the following changes in employee's elections:

- Prospectively revoke or change an election with respect to the accident and health plan (medical plan) election once during that plan year, without regard to whether the employee experienced a status change
- If the employee waived participation in the employer's cafeteria plan, the employee may elect to make a salary reduction election to participate in the employer's medical plan, as long as the prospective election to participate is made on or after the first day of the 2013 cafeteria plan year

Employers interested in allowing employees to modify their elections to terminate enrollment in the employer's medical plan or enroll in the plan will be required to amend their cafeteria plan document no later than December 31, 2014. This cafeteria plan amendment would be effective retroactively as of the first day of the 2013 cafeteria plan year.

Although the guidance sheds light on many unanswered questions on the pay or play mandate, additional guidance is awaited on employee classifications that are not commonly compensated on an hourly basis, the definition of seasonal employees, how to properly identify variable-hour employees, and the responsibilities of employers participating in multiemployer plans. Employers should carefully review the new

guidance to identify provisions that may affect their existing employee benefits strategy to comply with the pay or play mandate and contact their Wells Fargo Insurance representative if they have any questions. To view some of the key elements of this new guidance in a FAQ format please visit http://www.irs.gov/uac/Newsroom/Questions-and-Answers-on-Employer-Shared-Responsibility-Provisions-Under-the-Affordable-Care-Act.