Patterson Belknap Webb & Tyler LLP

Employee Benefits & Executive Compensation Alert March 2013

New Employer Shared Responsibility Penalty Guidance: Timely Employer Action Needed

The Affordable Care Act, the federal health care reform law enacted in 2010, added a provision to the Internal Revenue Code ("Code") (Code Section 4980H) that, beginning on January 1, 2014, may subject employers to an excise tax penalty if a covered employer fails to offer health plan coverage to a sufficient number of its employees and their dependents or if it offers coverage that is deemed unaffordable or fails to provide a certain prescribed minimum level of benefit value. This new penalty provision, formally known as the "employer shared responsibility penalty," is often referred to as the "employer pay or play" provision. In this Alert, these new rules are referred to as the "Health Care Penalty" or "Health Care Penalties."

The Internal Revenue Service and U.S. Treasury Department recently issued proposed regulations and related frequently asked questions concerning the Health Care Penalty (collectively, the "Proposed Regulations"). The rules are very complex and can require detailed consideration of the nature of an employer's workforce, including the hours of service worked by employees. This Alert is intended to provide an overview of the Proposed Regulations, including some helpful transition rules, to assist employers in understanding the Health Care Penalty requirements that apply beginning in 2014.

A. WHAT IS THE EMPLOYER SHARED RESPONSIBILITY PENALTY?

A Health Care Penalty can apply if:

(i) at least one full-time employee ("FT employee") of an "applicable large employer" is certified as having received a financial subsidy (in the form of a premium tax credit or cost-sharing reduction payment) to help pay the premium for health plan coverage under the newly established health insurance exchanges ("Exchanges");[1] and

(ii) either:

(a) the employer fails to offer its FT employees (and their dependents) the opportunity to enroll in an

[1] Under the Affordable Care Act, federal government-provided subsidies are available to assist employees in paying for health coverage they obtain through the Exchanges. To be eligible for an Exchange-based premium subsidy, an employee must:

(i) have annual "household income" (*i.e.*, annual "adjusted gross income" of the employee, employee's spouse and the employee's dependents who are required to file a federal income tax return with certain modifications (*e.g.*, adding back tax-exempt interest)) of at least 100% and no more than 400% of the federal poverty level ("FPL") for the employee's family size. For instance, in 2013, the FPL for all states (except Hawaii and Alaska where the FPL is slightly higher) for a single individual is $11,490, and $23,550 for a family of four;

(ii) not be eligible for employer health plan coverage that is "affordable" (*i.e.*, for purposes of determining eligibility for the Exchange-based subsidies, based on the employee's cost of the least expensive employee-only employer-provided coverage being no more than 9.5% of the employee's household income) and that meets the minimum value requirements;

(iii) not be actually enrolled in employer health plan coverage, even if that coverage is "unaffordable" or fails the minimum value test;

(iv) not be eligible for health coverage under a government-sponsored program, such as Medicare or Medicaid; and

(v) if married at the end of the relevant calendar year, file a joint income tax return for such year.

Although the Exchange-based subsidies are provided by the federal government, employers will be interested as to which, if any, of its employees may be eligible for the premium subsidies because, as described in this Alert, the imposition of Health Care Penalties is dependent in the first instance on at least one FT employee obtaining subsidized Exchange-based coverage, and in the case of the "unaffordable coverage penalty," such penalty amount is based directly on the number of FT employees receiving subsidized Exchange-based coverage.

eligible employer-sponsored plan[2] (referred to here as the **"failure to offer coverage penalty"**), or

(b) the employer offers its FT employees (and their dependents) the opportunity to enroll in an eligible employer-sponsored plan but coverage under such plan is considered "unaffordable" or fails to provide "minimum value" (herein referred to as the **"unaffordable coverage penalty"**).

What Is the "Failure To Offer Coverage Penalty"?

As noted, if a covered employer fails to offer its FT employees (and their dependents) eligible employer-sponsored health plan coverage and one or more of its FT employees receives subsidized health coverage through the insurance Exchanges, the employer will be subject to an excise tax penalty. For purposes of determining whether such penalty applies, an employer will be treated as "offering" coverage to its FT employees (and their dependents) for a given calendar month only if for that month it offers qualifying coverage to at least 95% of its FT employees (or, if greater, all but 5 of its FT employees) and such employees' dependents. The permitted exclusion of up to 5% of an employer's FT employees (or, if greater, 5 FT employees) applies regardless of whether the failure to offer coverage to FT employees was intentional or inadvertent.

The requirement to provide "dependent coverage" means qualifying coverage also needs to be provided for an FT employee's children, as defined under the Code (including step-children, adopted and foster children), who are under age 26. Employers are permitted to rely on the representations of employees as to the identity and ages of their children. Significantly, the Proposed Regulations provide that an employee's "dependents" do not include the employee's spouse. Moreover, in calculating the failure to offer penalty and the unaffordable coverage penalty (described below) only FT employees are taken into account; part-time employees are disregarded for purposes of such penalty.

How Is The "Failure To Offer Coverage Penalty" Calculated?

The "failure to offer coverage penalty" tax is, on an annual basis, calculated as follows: annual penalty = total number of FT employees (reduced by 30 FT employees)[3] x $2,000.[4]

Example. Company A does not offer eligible health plan coverage to its FT employees and their dependents (*i.e.*, fails to offer coverage to at least 95% of its FT employees (or, where applicable, fails to offer coverage to more than five FT employees). Company A for 2014 has 100 FT employees, 25 of whom receive subsidized health coverage through the insurance Exchanges, and 20 part-time employees. The annual failure to offer coverage penalty is 70 (100 FT employees (part-time employees are disregarded) less 30) x $2,000 = $140,000 penalty tax. The penalty amount is not dependent on how many FT employees receive subsidized health coverage through the Exchanges - so long as at least one FT employee receives subsidized Exchange-based coverage the penalty will apply.

What Is The "Unaffordable Coverage Penalty"?

The "unaffordable coverage penalty" applies if the employer offers its FT employees (and their dependents)

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[2] The Proposed Regulations require, under the Health Care Penalty rules, the opportunity to enroll in "minimum essential coverage," which, under separate recently proposed regulations governing the tax penalty imposed on individuals for failing to obtain minimum essential health coverage, includes generally coverage under an employer-sponsored group health plan (that meets certain health care market reforms under the Affordable Care Act), but excludes certain specialized coverage, such as coverage only for vision or dental care. Future guidance is expected to elaborate on the definition of "minimum essential coverage" as it applies in the context of the Health Care Penalty rules. For purposes of this Alert, we have assumed that employer-sponsored group health plan coverage would qualify as "minimum essential coverage" for purposes of the Health Care Penalty rules.

[3] In applying the 30 FT employees exclusion when calculating the "failure to offer coverage penalty," in the case of employers that are part of a controlled group or affiliated service group, the 30 FT employees exclusion is allocated pro rata (on the basis of the number of FT employees employed by each employer) among the members of such group, with fractions less than one rounded up to one.

[4] Both the "failure to offer" and "unaffordable coverage" penalties are actually determined on a monthly basis, and therefore, the per FT employee penalty amount is $166.67 per month in the case of the "failure to offer" penalty and $250 per month in the case of the unaffordable coverage penalty. Further, each such dollar penalty amount will be adjusted for inflation in accordance with the health care reform law.

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the opportunity to enroll in coverage under an eligible employer-sponsored health plan but such coverage is unaffordable or fails to provide minimum value, and at least one FT employee receives subsidized health coverage through the insurance Exchanges. In addition, if an employer offers qualifying coverage meeting the affordability and minimum value requirements but such coverage is provided to less than 100% of its FT employees and their dependents (but coverage is offered to a sufficient number of FT employees and their dependents to avoid the "failure to offer coverage penalty" (described above)), the employer will still be subject to the unaffordable coverage penalty with respect to the excluded FT employees to the extent such employees receive subsidized Exchange-based coverage. A health plan will be considered to provide the required "minimum value" if the plan pays at least 60% of the total cost of allowed benefits. Recently released final regulations provide that a plan's "minimum value" may be determined pursuant to:

(i) a minimum value calculator developed by the IRS and the U.S. Department of Health and Human Services;

(ii) certain regulatory-prescribed safe harbor plan designs; or

(iii) certification by an actuary.

Future IRS guidance will likely offer more details as to how to determine if an employer's health plan provides "minimum value."

When Is Coverage "Unaffordable"?

Under the Health Care Penalty rules, coverage is "unaffordable" if the employee's share of the premium for the lowest cost **employee-only** coverage under the employer's health plan exceeds 9.5% of the employee's household income. Significantly, the employee's share of the premium cost for other coverage types (*e.g.*, family or dependent coverage) is not relevant in determining whether coverage is "affordable" for purposes of the Health Care Penalty rules.

Recognizing the difficulty employers would have in determining an employee's household income, the Proposed Regulations offer three "affordability" safe harbors that an employer may use in complying with the affordable coverage requirement. An employer may elect to use the same safe harbor for all its employees or different safe harbors with respect to reasonable categories of employees provided such safe harbors are applied on a uniform and consistent basis for all such employees within a category.

The three affordability safe harbors are as follows:

(i) Form W-2 Safe Harbor. Coverage will be treated as affordable if the employee's contribution toward the premium for the lowest cost, employee-only coverage option does not exceed 9.5% of the employee's Form W-2 wages (*i.e.*, the wages reported in box 1 of Form W-2) for the calendar year. Under the W-2 safe harbor, applicable wages are not determined after adding back pre-tax salary deferrals under a Code section 401(k) or 403(b) retirement plan or Code section 125 cafeteria plan or transportation fringe benefits arrangement (such as transit check and parking benefits). Thus, unless this rule is changed, the W-2 compensation being considered in this safe harbor will need to be determined after the deduction for pre-tax contributions under those Code arrangements.[5] Special rules apply under the Proposed Regulations for determining the W-2 wages of employees who are offered coverage for less than the full calendar year.

(ii) Rate of Pay Safe Harbor. Coverage is affordable if an employee's monthly contribution for the lowest cost, employee-only coverage option does not exceed 9.5% of the employee's monthly wages determined as follows: (a) for hourly employees, multiply the employee's hourly rate of pay as of the beginning of the plan year by 130 hours, and (b) for salaried employees, the employee's monthly salary rate would be used. The rate of pay safe harbor may not be used, however, if the employer reduces the hourly

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[5] This W-2 safe harbor compensation calculation is different than the rule that applies regarding pre-tax salary deferrals when determining compensation for most qualified pension, 401(k) and 403(b) plans.

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wage rate or monthly wages, as applicable, of the employee during the year.

(iii) Federal Poverty Line Safe Harbor. Coverage is affordable if the employee's contribution for the lowest cost, employee-only coverage option does not exceed 9.5% of the "federal poverty line" for a single individual in the state where the employee is employed. For purpose of this safe harbor, employers may use the most recently published federal poverty guidelines as of the beginning of the plan year. For instance, based on the federal poverty guidelines for 2013, the income threshold for a single individual in all states, except Hawaii and Alaska (separate slightly higher income thresholds apply in Hawaii and Alaska), is $11,490. Thus, the federal poverty line affordability safe harbor for 2013 would require an annual employee self-only coverage contribution that does not exceed $1,091.55 ($11,490 x 9.5%), or $90.96 per month.

How Is The "Unaffordable Coverage Penalty" Calculated?

The unaffordable coverage penalty tax is, on an annual basis, calculated as follows: annual penalty = total number of FT employees who received subsidized coverage through the insurance Exchanges x $3,000.[6] Such penalty, however, is capped at the penalty amount that would otherwise apply if the employer was subject to the failure to offer coverage penalty.

Example. Employer A offers in 2014 coverage to all of its FT employees and their dependents (and thus avoids the failure to offer coverage penalty), but such coverage does not satisfy the affordability and minimum value tests. Employer A for such year has 100 FT employees, 25 of whom receive subsidized coverage through the insurance Exchanges, and 20 part-time employees. Thus, the unaffordable coverage penalty is calculated as follows: 25 (number of FT employees who receive subsidized Exchange coverage) x $3,000 = $75,000. The failure to offer coverage penalty cap (70 x $2,000 = $140,000) would not apply in this example.

Example. Company Z, for 2014, has 200 FT employees and offers health plan coverage that meets the affordability and minimum value requirements to 190 of its FT employees (*i.e.*, 95% of its FT employees). Accordingly, such offer of coverage is sufficient to avoid the failure to offer coverage penalty, but leaves 10 FT employees who are not offered affordable/minimum value employer health plan coverage. Thus, if any of these 10 FT employees obtains subsidized health coverage through the Exchanges, Company Z will be subject to an annual Health Care Penalty of $3,000 for each such employee who receives subsidized Exchange coverage.

B. WHAT IS AN "APPLICABLE LARGE EMPLOYER"?

An "applicable large employer" is, with respect to a calendar year, an employer that employed an average of at least 50 FT employees (including "full-time equivalent employees" ("FTE employees")), described below, on business days during the ***preceding*** calendar year. An applicable large employer can include for-profit, non-profit and governmental entities.

In calculating whether the 50 FT and FTE employees threshold is met for a calendar year, the Proposed Regulations provide that the number of FT and FTE employees are determined for each calendar month in the preceding calendar year and then the sum of such monthly amounts is divided by 12. If the result of such calculation is less than 50, the employer is not an applicable large employer for the current calendar year. However, if the result is 50 or more, the employer is an applicable large employer and therefore subject to the Health Care Penalty rules for the calendar year, unless a special seasonal worker exception applies.[7]

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[6] As noted above, the unaffordable coverage penalty applies and is calculated on a monthly basis, and thus the penalty per FT employee who receives subsidized Exchange-based health coverage is $250 per month.

[7] Under the seasonal worker exception, if the sum of the employer's FT and FTE employees during the preceding calendar year exceeds 50 for 120 days or less (or, alternatively, for four calendar months or less during the preceding calendar year), in each case whether or not consecutive, and the employees in excess of 50 who were employed during that 120-day (or four calendar month) period are all seasonal workers, the employer will not be treated as an applicable large employer for the current calendar year. (Footnote continued on following page.)

For purposes of determining whether an employer is an applicable large employer (based on employing at least 50 FT employees and FTE employees in the preceding calendar year), all entities that are part of a controlled group (which may include corporate and unincorporated entities) or an affiliated service group (reflecting entities that are service-based organizations that have certain ownership and service interrelationships) are treated as an aggregated single employer. The Proposed Regulations do not address the application of the controlled group and affiliated service group rules under the Health Care Penalty rules to churches, conventions or associations of churches or governmental entities, and until further guidance is issued, such entities may apply a reasonable, good faith interpretation of the employer aggregation rules.

The employer aggregation rules can have a significant impact in that a small employer (*i.e.*, with less than 50 FT and FTE employees) could nonetheless be treated as an applicable large employer, and therefore, subject to the Health Care Penalty. For example, if a controlled group of entities consists of three employers having 25, 20 and 15 FT and FTE employees, respectively, because such employers are aggregated as members of the same controlled group and treated as a single employer having at least 50 FT and FTE employees, then each such employer would be considered an applicable large employer subject to the Health Care Penalty rules, notwithstanding that, if analyzed on an individual employer basis, none of these employers would be subject to the Health Care Penalty rules. If a new employer was not in existence for the entire preceding calendar year, such entity would be treated as an applicable large employer for the initial calendar year if it is reasonably expected to employ an average of at least 50 FT and FTE employees on business days during the calendar year.

C. WHO IS A FT EMPLOYEE AND FTE EMPLOYEE?

A FT employee is an employee who is employed on average at least 30 hours of service per week or at least 130 hours of service per calendar month. For these purposes, an employee means a common law employee, and thus, would not include a leased employee (*i.e.*, who is not otherwise a common law employee of the employer receiving such leased employee's services) or an independent contractor, or a partner in a partnership.

Solely for purposes of determining whether an employer is an applicable large employer, FTE employees of an employee count in the calculation of whether the employer meets the "at least 50 FT and FTE employees" threshold. A FTE employee is a combination of employees, each of whom individually is not treated as a FT employee (*i.e.*, because such employee does not work at least 30 hours of service per week or 130 hours of service per calendar month). The number of FTE employees is determined for each calendar month as follows: aggregate the number of hours of service (but not more than 120 hours of service) for all employees who are not otherwise FT employees for that month and divide the total by 120, with such result constituting the number of FTE employees for such month. Fractions are taken into account in making each monthly calculation, but are disregarded in calculating the final annual FT and FTE employee amount.

Example. Company Z has 35 FT employees (*i.e.*, employees who work on average at least 30 hours of service per week or 130 hours of service per month) and a number of part-time employees whose aggregate hours of service for the month equals 1,800 hours of service (taking into account no more than 120 hours for any such part-time employee). Thus, Company Z would have 15 FTE employees (1,800 ÷ 120 = 15 FTE employees), that when added to the 35 FT employees would result in Company Z having at least 50 FT and FTE employees for such month. Therefore, if the same FT and FTE employee calculation applied for the other months in the same calendar year, then Company Z would be an applicable large employer for the following calendar year, even though it had only 35 FT employees.

(Footnote continued from preceding page.)
As to whether an employee is a "seasonal worker," the Proposed Regulations provide that until further guidance is issued employers may apply a reasonable, good faith interpretation of the statutory definition and certain U.S. Department of Labor regulations which provide generally that a seasonal worker is an individual who performs labor on a seasonal basis, which is of a kind exclusively performed at certain seasons or periods of the year, and that, from its nature, may not be continuous or carried on throughout the year.

D. HOW ARE HOURS OF SERVICE COUNTED?

As discussed above, FT and FTE employee status is determined based on credited "hours of service." Under the Proposed Regulations, an employee's hours of service include (i) each hour for which the employee is paid or entitled to payment for the performance of duties for the employer, and (ii) each hour for which an employee is paid or entitled to payment by the employer for periods for which no duties are performed due to vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty or paid leave of absence (collectively, "paid non-work activities"). This hour of service definition is the same as the one applicable in the context of a qualified retirement plan.

In the case of employees paid on an hourly basis, employers must calculate actual hours of service worked and hours attributable to paid non-work activities. For other employees (*i.e.*, salaried employees), an employer may determine hours of service using any of the following three methods: (i) counting actual hours of service (in a manner similar to hourly employees); (ii) using a days-worked equivalency method whereby an employee is credited with 8 hours of service for each day the employee would otherwise be credited with at least one hour of service; and (iii) using a weeks-worked equivalency method whereby an employee is credited with 40 hours of service for each week in which the employee would otherwise be credited with at least one hour of service. In determining an employee's FT employee status, all hours of service performed for all entities that are part of the same controlled group or affiliated service group are taken into account.

While an employer must use one of the three hours of service counting methods for its salaried employees, it need not use the same method every year or with respect to different employee classifications so long as the classifications are reasonable and consistently applied. However, notwithstanding the availability of the days-worked or weeks-worked equivalency methods to calculate hours of service, if the use of an equivalency method would result in a substantial understatement of an employee's actual hours of service, such that the employee would not be treated as a FT employee, then such method may not be used. For instance, if an employee worked three 10-hour days per week, the use of the days-worked equivalency method would be prohibited because it would substantially understate the employee's hours of service per week and treat the employee as not a FT employee (30 hours actually worked v. 24 hours of service credited under the days-worked equivalency (8 hours/day x 3 days worked for which one hour of service would be credited)).

In the case of employees working outside the United States, hours of service for purposes of the Health Care Penalty do not include services performed outside the U.S. to the extent the compensation for such services constitutes foreign source income under the Code. Moreover, such treatment of services performed outside the U.S. applies without regard to the employee's citizenship or residency. Thus, employees working in other countries, even if they are U.S. citizens, generally would not have hours of services, and therefore would not be FT employees for purposes of determining an employer's status as an applicable large employer or potential shared responsibility penalties. However, all hours of service for which an employee receives income from U.S. sources will be taken into account for purposes of the Health Care Penalty rules. Finally, the Proposed Regulations provide special hours counting rules for teachers and other employees of educational organizations due to the unique consequences of working during an academic year that involves periods in which the organization is not in session, and also provide, until further guidance is issued, for the use of any reasonable method of crediting hours of service for those employees whose compensation is not based primarily on hours worked (*e.g.*, commissioned-based employees) or whose work hours are subject to safety-related regulatory limits (*e.g.*, airline pilots).

E. WHAT METHODS MAY BE USED TO DETERMINE FT EMPLOYEE STATUS?

As noted above, in determining whether an employer is an applicable large employer (and, therefore, subject to the Health Care Penalty rules), the employer's FT employees (and FTE employees) are determined in the calendar year preceding the calendar year for which the applicable large employer determination is being made. In

addition to the determination of FT employee status for applicable large employer purposes, employers will need to identify their FT employees for purposes of applying the Health Care Penalty rules and determining whether any penalties apply for a given month and, as applicable, the amount of such penalties. It is this latter FT employee determination that can be difficult for many employers.

For employers whose workforces are relatively stable and consist solely or substantially of employees who clearly meet the FT employee hours of service threshold, making a FT employee determination in "real time" on a monthly basis may not pose significant administrative problems. However, for many employers that employ employees who work a variable schedule or whose hours of service fluctuate week to week or month to month, such employers may encounter difficulties in being able to timely identify which of its employees are FT employees and thus should be offered coverage under the employer's health plan. This uncertainty and unpredictability in assessing who is a FT employee for given month can lead to a failure to timely offer eligible FT employees affordable/minimum value health plan coverage with the consequence that the employer could become subject to the Health Care Penalty despite actions taken to avoid such penalties.

To assist employers in this regard, the Proposed Regulations, reflecting earlier IRS administrative pronouncements, offer employers the option to use a look-back measurement period and make its FT employee determinations during such measurement period that will then apply to a subsequent period, known as a "stability period." This optional measurement/stability period method is applied separately to an employer's "ongoing employees" and newly hired "variable hour employees." Further, employers may designate measurement and stability periods that differ in length or their starting and ending dates for the following different categories of employees: (i) collectively bargained vs. non-collectively bargained employees, (ii) each group of collectively bargained employees covered by a separate collective bargaining agreement, (iii) salaried vs. hourly employees, and (iv) employees whose primary places of employment are in different states.

Ongoing Employees

In applying the measurement/stability period method to ongoing employees, an employer will need to establish a look-back measurement period, which is a period of at least three but not more than 12 consecutive months. This measurement period for ongoing employees is referred to as the "standard measurement period." (A special transition rule, described below in the paragraph titled "**TRANSITION RULES**," is available for determining the standard measurement period with respect to the stability period beginning in 2014.) The related stability period is a period that immediately follows the standard measurement period (or, as applicable, any "administrative period," described below) that is equal to the greater of six consecutive calendar months or the length of the standard measurement period. It can be expected that most employers will choose to apply a 12-month stability period in order to facilitate plan administration and conform to the annual negotiation of their health insurance contracts and open enrollment periods. An ongoing employee is an employee who is employed by an employer for at least one full standard measurement period.

To further assist employers in making determinations of their employees' FT employee status and timely offering coverage to those FT employees, the Proposed Regulations also permit employers to establish an "administrative period" immediately following the end of a standard measurement period and prior to the beginning of the related stability period. The purpose of an administrative period is to afford employers time to finalize their FT employee determinations with respect to a related measurement period, provide notices and other information to FT employees regarding the availability of coverage, and enable eligible FT employees to make health plan coverage elections for the upcoming stability period. The administrative period may be up to 90 days but it may neither reduce nor lengthen the related standard measurement period or stability period. If an ongoing employee is determined to be a FT employee under a standard measurement period, then such employee is treated as a FT employee during the entire related stability period, regardless of the number of hours of service the employee performs during the stability period, or, if applicable, the related administrative period. Similarly, an employee who is determined to not be a FT employee during the standard

measurement period will not be treated as a FT employee during the entire related stability period, regardless of the number of hours of service the employee performs during the stability period or, if applicable, the related administrative period.

As an example, a standard measurement period, stability period and administrative period could be implemented as follows:[8]

Standard Measurement Period-	12-month period measured from November 1, 2012 – October 31, 2013
Administrative Period-	60-day period beginning November 1, 2013 – December 31, 2013
Stability Period-	12-month period beginning January 1, 2014 – December 31, 2014

New Employees

Because new employees may not work during the entire standard measurement period in which they first perform an hour of service, special rules apply in determining such new employees' status as FT employees. For a newly hired employee who is reasonably expected as of his or her start date to work on average at least 30 hours of service per week, and who is not otherwise a "seasonal employee," the employer will not be subject to a Health Care Penalty with respect to such employee for the period ending with the third full calendar month of employment if the employee is offered health plan coverage under the employer's group health plan by the end of such three calendar month period. If coverage is not so offered to such a new FT employee, the employer may be subject to Health Care Penalties with respect to such employee for the initial three calendar months of employment as well as future months for which health plan coverage is not offered to the employee. The Proposed Regulations do not define a "seasonal employee" and instead provide that, through 2014, a reasonable, good faith interpretation of the term seasonal employee will be permitted.

In the case of a newly hired employee who is a "variable hour" employee, the employer may, if it uses the standard measurement period/stability period measurement method for its ongoing employees, also use a similar methodology involving an initial measurement period and related stability period to determine the FT employee status of its new variable hour employees. A separate initial measurement period and related stability period would apply for each new variable hour employee. A new employee is a variable hour employee if, based on the facts and circumstances at the employee's start date, it cannot be determined that the employee is reasonably expected to work on average at least 30 hours of service per week.

The initial measurement period for a new variable hour employee is a period of 3 to 12 consecutive months. An administrative period of up to 90 days may be added at the end of the initial measurement period. However, the initial measurement period and administrative period combined may not extend beyond the last day of the first calendar month beginning on or after the one-year anniversary of the employee's start date. Therefore, the total of the initial measurement period and administrative period for a new variable hour employee may not exceed 13 months and a fraction of a month. Thus, if the initial measurement period is a 12-month period beginning on the variable employee's start date, the related administrative period could begin following the initial measurement period and continue through the end of the first calendar month that begins on or immediately following the one-year anniversary of the initial measurement period start date. The initial measurement period may also begin on the first day of the calendar month immediately following the employee's start date, in which case any applicable post-initial measurement period will be slightly shorter than would be the case if the initial measurement period begins on the employee's start date. The stability period for a new variable hour employee must be the same length as the stability period for ongoing employees.

[8] See the discussion below under the heading **"TRANSITION RULES"** for alternative rules available for establishing the standard measurement period for the stability period commencing in 2014.

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If a new variable hour or new seasonal employee is determined not to be a FT employee during the initial measurement period, the employer may treat the employee as not a FT employee during the related stability period. After the FT employee status of the new variable hour employee is made for the initial measurement period, the employer will next determine the employee's FT employee status in the same manner as is applicable in the case of its other ongoing employees (*i.e.*, applying the relevant standard measurement period and related stability period). Thus, after a new variable hour employee's FT employee status is determined under the employee's initial measurement period, such employee will be treated as an ongoing employee whose FT employee status is determined beginning with the standard measurement period that commences during the employee's initial measurement period.

The following example illustrates the use of an initial measurement period and related administrative period for a new variable hour employee and then such employee's transition to an ongoing employee and the use of a standard measurement period to determine the employee's FT employee status during those respective measurement periods.

Example. Assume an Employer uses a 12-month initial measurement period beginning on the variable hour employee's employment start date, applies an administrative period that begins after the initial measurement period and continues through the end of the first calendar month beginning on or after the end of the initial measurement period, and uses a 12-month stability period. John Smith, a new variable hour employee, commences employment on February 20, 2014. Accordingly, he would be tested for FT employee status during the initial measurement period beginning February 20, 2014 and ending February 19, 2015, and then, if determined to be a FT employee during such initial measurement period, would be treated as a FT employee for the stability period commencing April 1, 2015 through March 31, 2016 (reflecting an administrative period beginning February 20, 2015 through March 31, 2015).

Assume further, the Employer uses a standard measurement period beginning November 1 through October 31, an administrative period from November 1 through December 31, and a 12-month stability period based on the calendar year. Thus, John Smith would, after being tested for FT employee status during his initial measurement period, next be tested with the ongoing employees for the standard measurement period that begins after Smith's start date. Therefore, Smith would be tested for FT employee status during the standard measurement period beginning on November 1, 2014 and ending on October 31, 2015, and if determined to be an FT employee during such standard measurement period he would be treated as a FT employee for the entire stability period associated with that standard measurement period (*i.e.*, calendar year 2016). Thus, Smith would be treated as a FT employee for purposes of the Health Care Penalty rules for the two overlapping stability periods, *i.e.*, the initial stability period (April 1, 2015 - March 31, 2016) and the stability period associated with Smith's first standard measurement period (January 1, 2016 - December 31, 2016).

Changes In Employment Status or Termination/Rehire Situations

If a new variable or seasonal employee has a change in employment status during the initial measurement period so that after the change, the employee is in a job that, had he or she been in that job at the start of the employee's employment, the employee would have reasonably been expected to work on average at least 30 hours of service per week and classified as a FT employee, then such employee's FT employee status will change. An employee who has such a change in employment status will be treated as a FT employee for purposes of the Health Care Penalty as of the first day of the fourth calendar month following the change in employment status or, if earlier and the employee averages more than 30 hours of services per week during the initial measurement period, the first day of the first month after the end of the initial measurement period and, as applicable any administrative period associated with the initial measurement period.

This change in employment status rule applies only for new variable hour and seasonal employees and **not** to changes in employment status for ongoing employees. Thus, if an ongoing employee is determined to be a FT employee during a standard measurement period, such employee will continue to be a FT employee during the related stability period even if the employee has a change in employment status during the stability period (*e.g.*, a reduction

in hours of service to less than 30 hours of service per week) that would otherwise cause the employee to no longer be a FT employee.

In the case of an employee who has a period for which no hours of service are credited (*e.g.*, due to a termination of employment or period of unpaid leave of absence) (a "no-service period"), if such period is at least 26 consecutive weeks, the employer may treat the employee who has an hour of service after a no-service period as having terminated employment and then been rehired as a new employee when applying the measurement period rules upon the employee's rehire. If the no-service period is less than 26 consecutive weeks, an employer may apply a rule of parity whereby an employee may be treated as having terminated employment and rehired as a new employee if the no-service period is at least four weeks long and is longer than the employee's period of employment immediately preceding the no-service period. For example, if an employee works five weeks, terminates employment and then is rehired 12 weeks later, because the no-service period (*i.e.*, 12 weeks) is at least four weeks long and exceeds the prior period of employment, the employer may treat the rehired employee as a new employee for purposes of determining his or her FT employee status under the applicable look-back measurement period rules.[9]

The Proposed Regulations provide a method for crediting hours of service for periods that include "special unpaid leave" in the case of an employee who is treated as a continuing employee (and not as a terminated/new employee) upon the employee's return to employment. Special unpaid leave means a period of unpaid leave under the Family and Medical Leave Act or the Uniform Services Employment and Reemployment Rights Act, or on account of jury duty. Special rules also apply under the Proposed Regulations to employment break periods for employees of an educational organization.[10] The IRS is seeking comments regarding the FT employee determination applicable to employees of temporary staffing agencies.

TRANSITION RULES

Under the Proposed Regulations, the IRS offers the following special transition rules to facilitate employer compliance with the Health Care Penalty requirements.[11]

Measurement Period for Stability Period Beginning in 2014

As described above, where an employer wishes to use a 12-month stability period (which we anticipate most employers will want to do), the employer would need to also establish a 12-month measurement period. Due to the limited time in 2013 to develop a measurement/stability period strategy for complying with the Health Care Penalty requirements for 2014, the Proposed Regulations provide, solely for purposes of establishing a stability period beginning in 2014, that an employer may use a measurement period that is shorter than 12 months but no less than six months, and that begins no later than July 1, 2013 and ends no earlier than 90 days (reflecting an optional administrative period) before the start of the plan year of the employer's health plan that begins in 2014. This transition relief is available only for purposes of applying the stability period that begins in 2014 (which stability period may carry over

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[9] If an employee who had a no-service period later returns to service and is not treated as a new employee for Health Care Penalty purposes, then upon the resumption of services the employee will pick up the status (*e.g.*, FT employee) he or she had with respect to an applicable stability period (*i.e.,* if the employee returns during a stability period for which the employee is treated as a FT employee, the employee would retain that status for the balance of that stability period for Health Care Penalty purposes).

[10] In the case of an employment break period (*i.e.*, a period of at least four consecutive weeks, but disregarding any special unpaid leave periods) during the non-working period under an educational organization's academic calendar when the employee has no hours of service, the educational organization must either (i) determine an employee's average hours of service per week during the measurement period by excluding the employment break period and apply such average for the entire measurement period or (ii) treat the employee as credited with hours of service for the employment break period at a rate equal to the average weekly rate at which the employee was credited with hours of service during the weeks in the measurement period that are not part of the employment break period. The educational organization is not required to credit an employee in any calendar year with more than 501 hours of service for any employment break period (disregarding for this 501-hour limit, hours of service credited for special unpaid leave). Further, these educational organization employment break period rules apply only to an employee treated as a continuing employee upon his or her return to service, and not to an employee otherwise treated as terminated and then rehired as a new employee.

[11] In addition to the transition relief described herein, a special transition rule applies through 2014 for employers contributing to and participating in a multiemployer health plan.

into 2015 if a non-calendar year stability period beginning in 2014 and extending to 2015 is used).

Example. Assume an employer maintains a calendar year health plan and desires to establish the calendar year as the stability period for 2014. Under the transition relief, the employer could elect to use a six-month measurement period beginning on May 1, 2013 and ending on October 31, 2013, and then apply an administrative period from November 1, 2013 through December 31, 2013. The ability to use a less than 12-month measurement period may prove beneficial to employers, both administratively and substantively in determining their FT employees for purposes of applying the Health Care Penalty requirements in 2014.

Applicable Large Employer Determination for 2014

While the status of many employers as applicable large employers (*i.e.*, employers with at least 50 FT and FTE employees during the prior calendar year) will be self-evident due to the size of the employer's workforce, for some smaller employers the determination of applicable large employer status (and thus whether they are subject to the Health Care Penalty requirements) will require greater analysis in calculating whether they meet the "at least 50 FT and FTE employees" threshold. To assist employers in making an applicable large employer calculation in 2013 for purposes of determining whether an employer is subject to the Health Care Penalty rules for the 2014 calendar year, the transition relief gives an employer the option to determine its status as an applicable large employer by reference to a period of at least six consecutive calendar months, as selected by the employer, in the 2013 calendar year (rather than using the entire 2013 calendar year to make such determination). For instance, an employer may choose to determine whether it employs an average of at least 50 FT and FTE employees during the period April 1, 2013 through September 30, 2013 for purposes of determining whether it is an applicable large employer and thus subject to the Health Care Penalty rules for 2014.

Dependent Coverage

As noted, in order to avoid Health Care Penalty, an employer must offer qualifying health plan coverage to its employees and their dependents (*i.e.*, an employee's children under age 26). To assist those employers whose health plans do not presently offer dependent coverage, the transition relief provides that if an employer "takes steps" during the 2014 plan year to implement the offering of coverage to FT employees' dependents, such employer will not be liable for the Health Care Penalty solely due to the failure to offer dependent coverage for the 2014 plan year.

Variable Hour Employee Determination

In assessing whether a new employee is a FT employee for Health Care Penalty purposes, the Proposed Regulations distinguish between employees who as of their start date are reasonably expected to work on average at least 30 hours of service per week (*i.e.*, a FT employee) and those who are not reasonably expected to meet such 30 hour threshold (*i.e.*, a variable hour employee). Prior to January 1, 2015, the transition relief allows an employer, in determining whether a new employee is initially a FT employee or variable hour employee, to take into account at the employee's start date that the employee's period of employment is reasonably expected to be of limited duration such that the employee would not be reasonably expected to work at least 30 hours per week over the employee's entire initial measurement period. Thus, for 2014, an employer could treat a new hire as a variable hour employee if the employee's employment period is reasonably expected to be of limited duration during the initial measurement period, and therefore, such employee would not be reasonably expected to satisfy the 30 hours of service per week requirement over the full initial measurement period. Such treatment could apply even though the employee is reasonably expected to work at least 30 hours per week during the anticipated limited initial employment period. However, even for 2014, an employer's determination that an employee's expected employment period will be of limited duration must be based on objective facts specific to the particular employee involved and cannot be based on expectations of aggregate employee turnover. Beginning in 2015 and thereafter, except in the case of a seasonal employee, an employer will be required to assume that, although an employee's hours of service may be expected to vary, the employee will continue to be employed by the employer for the entire initial measurement period.

Fiscal Year Plan Years

If an employer maintained a group health plan with a non-calendar plan year (a "fiscal year plan") as of December 27, 2012 (*i.e.*, the day preceding the date the Proposed Regulations were issued), then, with respect to an employee who would be eligible for coverage as of the first day of the first fiscal plan year that begins in 2014 under the plan's eligibility provisions in effect on December 27, 2012, if such employee is offered affordable, minimum value coverage no later than the first day of that 2014 plan year, no Health Care Penalty will apply with regard to that employee for the period beginning January 1, 2014 until the start of the plan year commencing in 2014. Additional transition relief may be available to employers with fiscal year plans that covered or offered coverage to a certain minimum percentage of their employees as of December 27, 2012.

Fiscal Year Cafeteria Plans

Under applicable IRS regulations, salary deferral contribution elections under an employer's cafeteria or "flex" plan (*i.e.*, an Internal Revenue Code Section 125 plan) to purchase, on a pre-tax basis, health plan coverage must generally be made prior to the beginning of the plan year. Such elections, once made, are irrevocable for a plan year unless the employee has a "change in status" under IRS rules (*e.g*., employee's marriage or divorce, commencement or termination of employee's spouse's employment, or birth of a child). Enrollment, in 2014, in health plan coverage through an Exchange or under an employer's health plan does not constitute a "change in status" under a cafeteria plan. Such change in health plan coverage, with the attendant desired change in salary deferral elections under a cafeteria plan (*i.e*., to revoke such election if opting for Exchange-based coverage or to make a new salary deferral election to commence participation in the employer's health plan), may be motivated by the employee's interest in avoiding the individual coverage mandate penalty imposed if an individual fails to obtain qualifying coverage or an individual's desire to obtain applicable subsidies to reduce the cost of Exchange-based coverage.

Accordingly, the Proposed Regulations offer transition relief for a cafeteria plan's fiscal year beginning in 2013 by permitting an employer maintaining such a plan to amend the plan to permit either or both of the following mid-plan year changes in salary deferral elections for such plan year.

(i) An employee who elected a salary deferral contribution to the cafeteria plan for health plan coverage with respect to the fiscal plan year starting in 2013 is permitted, on a one-time basis, to prospectively revoke or change the election for that plan year without regard to whether the employee has had a change in status event.

(ii) An employee who failed to make a salary deferral contribution election for health plan coverage under his or her employer's cafeteria plan for the fiscal year beginning in 2013 is permitted to make a prospective salary deferral contribution election for health plan coverage under the cafeteria plan during such 2013 plan year without regard to whether the employee has had a change in status event.

If the employer chooses to provide the transition election relief, the cafeteria plan must be amended retroactively to reflect such relief effective as of the first day of the 2013 plan year and such amendment must be adopted by December 31, 2014.

ASSESSMENT OF HEALTH CARE PENALTIES AND REPORTING REQUIREMENTS

Health Care Penalty Assessments

Health Care Penalties will be imposed on an individual employer basis. Thus, according to the Proposed Regulations, if an employer is part of a controlled group, such employer will be liable only for its own Health Care Penalties and will not be liable for the penalties assessed against the other members of its controlled group. If an employer is liable for Health Care Penalties, the IRS will send the employer a notice and demand for payment. The notice will prescribe the manner in which the penalty is to be paid. Employers are not required to include the Health Care Penalty on any employer tax return and the penalty amount is not deductible by the employer.

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The assessment of Health Care Penalties will involve Exchanges verifying an employee's representations concerning eligibility for Exchange-based subsidies. Thus, information regarding whether an employee is eligible for employer-provided health coverage, and if so, whether such coverage is affordable and provides minimum value will need to be made available to the Exchanges so that they can make proper subsidy-eligible determinations. While further guidance will elaborate on the subsidy eligibility process, interim rules provide that employers will be afforded an opportunity to review and appeal Exchange determinations regarding an employee's eligibility for a subsidy. It can be expected that employers may want to aggressively contest certain improper subsidy-eligible determinations because the Health Care Penalties can be impacted significantly by the number of FT employees who receive subsidized Exchange-based coverage.

Accordingly, employers should be developing procedures to determine which of its employees are FT employees (as described above) and whether affordable/minimum value employer health coverage is offered to those FT employees, and maintaining adequate records to support such determinations. In addition, the provision of substantial and accurate communications to an employer's FT employees will be essential to minimize the likelihood that employees will inappropriately be determined to be eligible for Exchange-based subsidies and the employer incorrectly assessed Health Care Penalties. The correct determination of the eligibility of FT employees for Exchange-based subsidies is not only in the employer's financial interests, but also in their employees' interest because any improperly paid subsidies will need to be reconciled and repaid to the government by the affected employee.

Health Care Reporting

To facilitate the implementation of the Health Care Penalty rules and the determination of the availability of Exchange-based premium subsidies, the Affordable Care Act added certain reporting requirements under the Code. Accordingly, employers subject to the Health Care Penalty rules (*i.e.*, applicable large employers) will be required to file a return with the IRS that reports the terms and conditions of the health care coverage provided to the employer's FT employees for the calendar year. Such information will include (i) a certification whether the employer offers its FT employees and their dependents the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan, (ii) the monthly premium for the lowest cost coverage under the plan, (iii) the share of the total allowed costs of benefits provided under the plan, (iv) the number of FT employees for each month in the calendar year, and (v) for each FT employee, the months (if any) during which the FT employee or any dependents were covered under the employer's health plan. Unless these requirements are delayed, such information returns are to first be filed with the IRS in 2015 for the initial 2014 reporting year. Further, no later than January 31 of the calendar year following the reporting year (*i.e.*, January 31, 2015 for the 2014 reporting calendar year), the employer will need to furnish to each FT employee a written statement that includes the information relating to coverage provided to the employee and his or her dependents that is otherwise required to be reported to the IRS.

In addition, health insurance insurers (*i.e.*, with respect to insured employer-provided group health plans), sponsors of self-insured health plans, government agencies that administer government-sponsored health insurance programs, and other entities that provide minimum essential coverage will be required to file annual information returns with the IRS reporting for each individual for whom such coverage is provided the period during which the individual was so covered during the calendar year, and for insured coverage through an employer's group health plan, the portion of the premium paid by the employer. A written statement will also be needed to be furnished to each individual listed on the return that provides the information furnished to the IRS for that individual. Unless these requirements are delayed, the information return is to be filed initially in 2015 for the 2014 reporting calendar year. The IRS has requested comments concerning these reporting requirements and intends to issue formal regulations regarding the reporting requirements in the near future.

EFFECTIVE DATE

The Health Care Penalty provisions are effective beginning January 1, 2014. Although the IRS regulations issued so far are in proposed form, employers may rely on the Proposed Regulations until final regulations or other applicable guidance is issued. If future IRS guidance, including final IRS regulations under the Health Care Penalty, is more restrictive than the Proposed Regulations, such future guidance will be applied without retroactive effect and employers will be afforded sufficient time to comply with the future guidance.

EMPLOYER CONSIDERATIONS/ACTION STEPS

The Health Care Penalty rules will soon become effective and employers are wise to take action now to understand how the rules work and how they may impact their decision whether to continue offering health plan coverage, and what, if any, changes may be needed to their plans in order to avoid tax penalties from being imposed. In light of the Health Care Penalty requirements, the Proposed Regulations, and the January 1, 2014 implementation date, all employers should consider the following questions and administrative issues:

Questions Regarding Continuance of Employer Health Plan Coverage and Possible Plan or Workforce Changes

- Should the employer continue offering qualifying health plan coverage to its FT employees and their dependents or cease providing coverage and pay the applicable failure to offer coverage penalties?
- If the employer continues to offer health plan coverage, does such coverage meet the affordability and minimum value requirements under the Health Care Penalty rules? If not, what changes are needed to the employer's health plan to meet such requirements (*e.g.*, revise the employee's share of the premium for the lowest cost self-only coverage option to incorporate one of the "affordability" safe harbor formulas)?
- Does the employer need to modify its plan's eligibility requirements to conform to the FT employee definition under the Proposed Regulations?
- Should the employer consider restructuring its workforce to reduce the number of FT employees it has by lowering their employees' hours worked per week?
- If the employer ceases offering health plan coverage to any employees, does the employer wish to increase employee pay to help subsidize the employees' cost of obtaining coverage through the Exchanges?

Compliance Steps

- If the measurement/stability period method is to be used, establishing applicable standard and initial measurement periods and related stability and, as applicable, administrative periods.
- Develop internal recordkeeping systems to calculate hours of service. For salaried employees, will hours of service be credited using an equivalency method? If so, will it be the days-worked or weeks-worked equivalency formula?
- Make appropriate determinations of FT (and, as applicable, FTE) employee status.

- Is the employer part of a controlled group or an affiliated service group? If so, consider the impact on (i) the determination of applicable large employer status for each group member, (ii) the allocation of 30 FT employees exclusion in calculating the failure to offer coverage penalty, and (iii) the crediting of hours of service to employees working within the group.

- For new hires, document the initial determination as to whether the new employees are reasonably expected to work on average at least 30 hours of service per week.

- Develop procedures for tracking employees who perform no hours of service (*i.e.*, due to a termination of employment or unpaid leave of absence) and then return to service so as to properly determine the impact on their FT employee status when they return.

- Consider establishing a procedure to review, and, if desired, to proactively address, any improper determination of employee eligibility for Exchange-based subsidies. Maintain documentation showing the employer health coverage, if any, made available to FT employees.

- Develop procedures to obtain the health plan coverage information necessary to file and furnish applicable information returns with the IRS and written statements to FT employees, and coordinate with outside vendors (*e.g.*, health insurers) with respect to the required information filings.

These are just some of the issues employers may wish to consider in deciding how to proceed with respect to the Health Care Penalty requirements. However, all employers should take action as promptly as practicable to develop a strategy to address the Health Care Penalty rules and the potential employer shared responsibility tax penalties thereunder. Contact any of the attorneys listed below if you would like assistance with respect to the impact of these new tax rules.

This alert is for general informational purposes only and should not be construed as specific legal advice. If you would like more information about this alert, please contact one of the following attorneys or call your regular Patterson contact.

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