The Affordable Care Act's “Play or Pay” Mandate: How It Works

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The Affordable Care Act added the so-called “Play or Pay” mandate or “Employer Shared Responsibility” provisions to the Internal Revenue Code (the Code). Starting in 2014, certain employers may be subject to a penalty tax, or “Employer Shared Responsibility Payment,” if (1) they fail to offer the opportunity to enroll in an employer-sponsored health plan that offers “minimum essential coverage” (MEC) to substantially all full-time employees (and certain dependents); or (2) MEC is offered but it is unaffordable or does not provide the required minimum value; and (3) at least one of the employer's full-time employees receives a premium tax credit or cost-sharing reduction for purchasing health insurance through an Exchange. This Update provides an overview of the guidance issued to date with respect to the Play or Pay mandate.

APPLICABLE LARGE EMPLOYER

The Play or Pay mandate only applies to “applicable large employers” as defined in the Code and the Internal Revenue Service’s (IRS) proposed regulations published on January 2, 2013. Under the proposed regulations, an employer is an applicable large employer for a calendar year if it employed, on average, at least 50 full-time employees, including “full-time equivalent employees” (FTEEs), both discussed below, (the 50-employee threshold) on business days during the preceding calendar year. The Play or Pay mandate is effective beginning in 2014 but the determination of whether an employer is an applicable large employer for 2014 is based on the number of employees employed by the employer this year (2013).

Employer

The employer-employee relationship is defined under the common law standard, as outlined in IRS Notice 2011-36, and adopted by the proposed regulations. “Employer” for purposes of the Play or Pay mandate includes government entity employers (e.g., federal, state, local or Indian tribal government employers) and tax-exempt organization employers, as well as private sector employers.

With respect to employers that are members of a controlled group or affiliated service group, employees of all such group members are counted for determining whether the group is considered an applicable large employer. (However, as discussed below, the calculation of penalties is determined on a member, rather than group, basis.) The proposed regulations reserve for future guidance the application of the aggregation rules to government entities, churches, and conventions or associations of churches. In the meantime, such employers may rely on a “reasonable, good faith interpretation” of the aggregation rules in determining whether an employer under those circumstances is an applicable large employer. For purposes of determining whether an employer is an applicable large employer, the term “employer” also includes a predecessor employer and a successor employer.

The 50-Employee Threshold

To calculate whether the 50-employee threshold is met with respect to a given year, the total number of full-time employees (see below) must be determined for each calendar month in the preceding year. The total number of FTEEs (see below) for each calendar month in the preceding calendar year must also be determined. The totals for both full-time employees and FTEEs for each calendar month are then added together for all months in the preceding calendar year, and then divided by 12. If the result is not a whole number, it is rounded down to the next lowest whole number. For example, an employer with an average total of 49.9 full-time employees and FTEEs for 2013 would not be treated as an applicable large employer for 2014.

Full-Time Employee

Pursuant to the statute, full-time employees are those who were employed on average for at least 30 hours of service per week (this includes not only hours worked but also hours for which the employee is paid or entitled to payment even when no work is performed, such as vacation or PTO). For a calendar month, 130 hours of service is treated as the monthly equivalent of 30 hours of service per week, provided this equivalency rule is applied on a “reasonable and consistent basis.”

Sole proprietors, partners in partnerships, 2% S corporation shareholders, employees who work outside the United States and leased employees (as defined in Code section 414(n)(2)) are generally not employees for purposes of the Play or Pay mandate. However, individuals who serve in dual roles—such as an individual who provides services as an employee and serves on the board as a director—are employees with respect to their hours of service in the role of employee.

The proposed regulations also provide a number of special rules and exceptions that apply in counting certain types of employees, such as seasonal workers and salaried employees.
Full-Time Equivalent Employees

Solely for purposes of determining whether an employer is an applicable large employer, employers are required to calculate the number FTEEs they employed during the previous calendar year and count each FTEE as one full-time employee in determining whether the 50-employee threshold has been met. To calculate FTEEs for a given month, an employer must (1) add up the total number of hours of service for all employees who were not employed on average at least 30 hours of service per week (up to a maximum of 120 hours of service per employee per month may be included); then (2) divide that total by 120. The resulting number is the number of FTEEs for that month. Fractions are taken into account for calculation purposes, but for purposes of determining whether the 50-employee threshold is met, the fraction is disregarded as described above.

New Employer Exception

Although whether an employer is an applicable large employer is determined based on the actual hours of service of employees during the prior calendar year, an exception exists for new employers that were not in existence during the entire preceding calendar year. A new employer is an applicable large employer for the current calendar year if it is reasonably expected to employ an average of at least 50 full-time employees (taking into account FTEEs) on business days during the current calendar year. The IRS mentioned in the preamble to the proposed regulations that it is considering adopting a safe harbor or presumption to assist new employers in making this determination.

Transition Relief

For 2014 only, an employer has the option to determine whether it is an applicable large employer using a reference period shorter than a full 12 months. The transition relief allows use of a period of six or more consecutive months during the 2013 calendar year, rather than the entire 2013 calendar year. The employer has the discretion to choose which months to use. Allowing an employer to count its full-time employees (and FTEEs) over a shorter period of time to determine whether the 50-employee threshold is met leaves time for it to make any necessary changes as a result of its determination, such as adjustments to its plan or to establish a plan, to comply with the Play or Pay mandate by the beginning of 2014. This transition relief is particularly helpful for those employers who may be very close to the threshold.

EMPLOYER SHARED RESPONSIBILITY PAYMENT

Although the definition of full-time employee described above generally applies for all purposes under the Play or Pay mandate, special rules come into play with respect to determining the number of full-time employees for purposes of determining the Employer Shared Responsibility Payment (the penalty tax). For example, employers need not calculate the number of FTEEs for penalty purposes, because part-time employees are disregarded for penalty purposes. Additionally, while the applicable large employer determination is made for a given year based on the prior year's full-time employee count (including FTEEs), full-time employees for these purposes are determined on a monthly basis in the current year.

Recognizing the potential for practical problems to arise, particularly for employers with employee populations working variable hours, the IRS created a special “look-back measurement method” for determining the number of full-time employees exclusively for purposes of the penalty tax. This method is an alternative option to the month-by-month method of determining full-time employee status. The details of this optional calculation method are beyond the scope of this Update. However, the proposed regulations include guidance on how to use this alternative method for:

- Ongoing employees;
- New employees, including new full-time employees, new variable hour and seasonal employees, new short-term employees, and new employees hired into high-turnover positions;
- Changes in employment status; and
- Employees who are rehired after a termination of employment or who resume work after a leave of absence.

Under the Play or Pay mandate, there are two ways that an applicable large employer could potentially become subject to a penalty tax: (1) the applicable large employer fails to provide MEC to substantially all full-time employees; or (2) MEC is provided but is unaffordable or does not provide minimum value.

Minimum Essential Coverage

In its proposed regulations issued on February 1, 2013, the IRS defined MEC as coverage under:

- A government-sponsored program, including coverage under Medicare, Medicaid, the Children's Health Insurance Program, TRICARE, CHAMPVA, the Peace Corps volunteer program and others;
An eligible employer-sponsored plan defined as, with respect to an employee, a group health plan (including both fully insured and self-insured plans) or group health plan insurance coverage offered by an employer to an employee that is (1) a governmental plan (other than those described above); (2) any other plan or coverage offered in the small or large group market within a state; or (3) a health plan treated as being grandfathered under the Affordable Care Act that is offered in the group market.

Other grandfathered health plans pursuant to the Affordable Care Act; and

Other health benefits coverage as recognized by the Department of Health and Human Services (HHS).

As a complement to the IRS proposed regulations, HHS also published proposed regulations that same day, which further defined MEC to include coverage under:

- Self-funded student health plans;
- Foreign health plans covering non-U.S. citizens provided by their home country;
- Refugee medical assistance supported by the Administration for Children and Families;
- Medicare advantage plans;
- State high-risk pools (subject to further review by HHS);
- The AmeriCorp volunteer program; and
- Other individual plans that have applied for and received approval by HHS as meeting the requirements to be recognized as MEC.

Failure to Provide Minimum Essential Coverage to Substantially All Full-Time Employees

An applicable large employer is liable for a penalty tax if, for any month, the applicable large employer fails to offer the opportunity to enroll in MEC under an eligible employer-sponsored plan to substantially all of its full-time employees (and certain dependents) and any full-time employee of such employer is certified to receive a premium tax credit or cost-sharing reduction for purchasing health coverage through an Exchange (Penalty A).

“Dependent” for purposes of the Play or Pay mandate includes a son or daughter (whether by blood or by adoption), a stepson or stepdaughter, or an eligible foster child of an employee who has not reached age 26. It does not include any other individuals, whether such individuals are considered tax dependents of the employee or not. It also does not include an employee’s spouse. Employers are allowed to rely on an employee’s representation regarding children.

For purposes of this provision only, an applicable large employer offers MEC to substantially all of its full-time employees for a calendar month if it offers such coverage to at least 95% (or, if greater, five) of its full-time employees and their dependents.

For a calendar month, the amount of Penalty A is equal to the product of (1) $2,000 (adjusted for inflation) divided by 12; and (2) the number of full-time employees of the applicable large employer minus 30. For example, an applicable large employer with 100 full-time employees who fails to offer MEC to substantially all of its full-time employees and one such employee receives a premium tax credit for purchasing health coverage through an Exchange for one month in 2014 is liable for Penalty A in the approximate amount of ($2,000/12) X (100-30) = $11,667 for that month. With respect to an applicable large employer that is a controlled group or affiliated service group, the 30-employee reduction allowance applies ratably to applicable large employer members based on the number of full-time employees each member employs.

Minimum Essential Coverage Provided Is Unaffordable or Does Not Provide Minimum Value

If an applicable large employer offers the opportunity to enroll in MEC under an eligible employer-sponsored plan to all (not merely substantially all) of its full-time employees (and certain dependents) but the employer-sponsored plan’s coverage is either (1) unaffordable, or (2) does not provide minimum value, and (3) any full-time employee of such employer is certified to receive a premium tax credit or cost-sharing reduction for purchasing health coverage through an Exchange, the employer is liable for a different penalty tax (Penalty B).

For a calendar month, the amount of Penalty B is the product of (1) $3,000 (adjusted for inflation) divided by 12; and (2) the number of full-time employees who are certified to receive a premium tax credit or cost-sharing reduction for purchasing health coverage through an Exchange, but capped at the amount the employer would pay if it were subject to Penalty A.
For example, an applicable large employer with 100 full-time employees who offers MEC to all of its full-time employees, but the coverage is unaffordable or does not provide minimum value, and one such employee receives a premium tax credit for purchasing health coverage through an Exchange for one month in 2014 is liable for Penalty B in the approximate amount of $(3,000/12) \times 1 = \$250$ for that month because it is less than $(2,000/12) \times (100-30) = \$11,667$ because Penalty B is capped at the amount the employer would pay if it were subject to Penalty A, which is less than $(3,000/12) \times (70) = \$17,500$.

If 70 such employees of that employer receive a premium tax credit for purchasing health coverage through an Exchange for one month in 2014, the employer is liable for Penalty B in the approximate amount of $(2,000/12) \times (100-30) = \$11,667$ because Penalty B is capped at the amount the employer would pay if it were subject to Penalty A, which is less than $(3,000/12) \times (70) = \$17,500$.

For any calendar month, an applicable large employer may be liable for either Penalty A or Penalty B, but cannot be liable for both penalties for the same calendar month. Neither of these penalties is tax deductible for the employer.

Affordability for Employees

In general, for purposes of the premium tax credit, coverage for an employee under an applicable large employer's plan is affordable if the employee's required contribution (i.e., the employee's self-only premium for the employer's lowest cost health coverage that provides minimum value, discussed below) does not exceed 9.5% of the employee's household income for the taxable year. To assist employers in determining whether they are potentially subject to Penalty B, the IRS has provided three affordability safe harbors because employers are generally unaware of all the variables that affect an employee's household income. These safe harbors apply only for purposes of determining liability for Penalty B, not Penalty A, and the safe harbors do not affect an employee's actual eligibility for a premium tax credit. The employer will not be subject to Penalty B with respect to a particular employee even if that employee receives a premium tax credit or cost sharing reduction if the employer satisfies the requirements of any of the safe harbors below. To take advantage of any of these safe harbors, the coverage offered must provide minimum value.

- **Form W-2 Safe Harbor.** Under this method, affordability is determined based on an employee's wages from the employer that are reported in Box 1 of Form W-2, which excludes elective deferrals that an employee makes to a section 401(k) or other similar plan and amounts excluded for section 125 cafeteria plan salary reductions. For this safe harbor, in addition to other requirements, the required employee contribution, described above, must not exceed 9.5% of the employee's Form W-2 wages for the calendar year. This safe harbor is applied after the end of the calendar year and on an employee-by-employee basis. The proposed regulations provide additional guidance regarding how to use this safe harbor in cases where an employee has Form W-2 wages for only part of a calendar year as well.

- **Rate of Pay Safe Harbor.** Under this safe harbor, the product of (1) either the employer's lowest rate of pay or the hourly rate of pay for each individual employee; and (2) 130, is the monthly wage amount used to determine affordability. The employee's monthly contribution (for the self-only premium of the employer's lowest cost coverage that provides minimum value) is considered affordable if it does not exceed 9.5% of the calculated monthly wage amount. This safe harbor can be used for salaried employees as well. For them, instead of calculating a monthly wage amount, their monthly salary would be used. This safe harbor can only be used for employees for whom the employer did not reduce wages during the year.

- **Federal Poverty Line Safe Harbor.** This method provides that coverage is affordable if the employee's monthly contribution (for the self-only premium of the employer's lowest cost coverage that provides minimum value) does not exceed 9.5% of 1/12 of the amount determined to be the Federal Poverty Line for the state in which the employee is employed for a single individual for the applicable calendar year.

Affordability for Related Individuals

On February 1, 2013, the IRS published final regulations regarding how affordability is defined with respect to coverage under an employer-sponsored plan for individuals who are eligible to enroll in the plan by reason of their relationship to an employee. The regulations specify that coverage is affordable for such related individuals if the portion of the annual premium the employee must pay, whether by salary reduction or otherwise, for self-only coverage does not exceed 9.5% of the taxpayer's household income. Because affordability for related individuals is based on the employee's contribution, not the related individual's contribution, a plan may be considered affordable for a related individual even if the employer pays nothing toward such individual's coverage.

Minimum Value

If coverage offered by an applicable large employer fails to provide minimum value, such employer's employees may be eligible to receive a premium tax credit. Minimum value is defined as coverage of at least 60% of the total allowed cost of benefits provided under the plan—it is a measure of benefits, not a measure of premium. On November 26, 2012, HHS issued proposed regulations which provided the following three methodologies for determining minimum value:

- A minimum value calculator will be created by the IRS and HHS that employers can use to input certain required information about their plans (e.g., deductibles, co-pays, etc.) to determine whether such plans provide minimum value. If a group health plan provides a benefit outside the parameters of the calculator, the plan can use an actuary to determine the value of that benefit.
particular benefit and adjust the calculated result to reflect such value.

- The IRS and HHS intend to issue further guidance under which design-based safe harbor checklists will be used to determine minimum value.

- A group health plan can seek certification by an actuary to determine its minimum value but only if neither the calculator nor a safe harbor checklist is appropriate for the plan.

**Transition Relief With Respect to Coverage for Dependents**

The IRS recognizes that a number of employers who provide health coverage for their employees do not currently provide dependent coverage. To provide these employers with sufficient time to expand their current plans to include dependent coverage, the proposed regulations include the following transition relief. Any employer that "takes steps" toward offering coverage to dependents of its full-time employees during its plan year that begins in 2014 will not be liable for a penalty tax solely on account of such employer's failure to offer coverage to such dependents for that plan year.

**IDENTIFYING LIABILITY AND PAYMENT OF PENALTY TAX**

In its Questions and Answers on Employer Shared Responsibility Provisions Under the Affordable Care Act published on its website, the IRS has explained that it will contact employers who are potentially liable for penalties and offer them an opportunity to respond. Such contact will only occur for any given calendar year after (1) the due date for employee individual tax returns for that year, and (2) the due date for applicable large employers to file the information returns required to identify such employers' full-time employees and to describe the coverage, if any, that was offered to those employees for that year. If an employer is liable for a penalty tax, the IRS will send a notice and demand for payment instructing the employer on how to pay the penalty tax.

**EMPLOYEE SHARED RESPONSIBILITY PAYMENT**

Applicable large employers are not the only ones subject to potential penalties under the Play or Pay mandate. Starting January 1, 2014, an individual who fails to maintain MEC for himself or herself, and any other nonexempt dependents must pay an "Employee Shared Responsibility Payment" as required by the Affordable Care Act. The IRS proposed regulations issued on February 1, 2013 provide guidance on this requirement.

Many categories of individuals are exempt from the requirement to maintain MEC, including:

- Members of certain recognized religious sects;
- Members of health care sharing ministries;
- Exempt noncitizens;
- Incarcerated individuals;
- Individuals with no affordable coverage;
- Individuals whose household incomes fall below the federal income tax return filing threshold;
- Indian tribal members;
- Individuals with hardship exemption certifications; and
- Individuals with certain short coverage gaps.

The maximum annual amount of the Employee Shared Responsibility Payment for a taxpayer who does not maintain MEC for any one month is the national average premium for the bronze level plan available through Exchanges that provides coverage for the applicable family size involved, which includes only the nonexempt members of the taxpayer's shared responsibility family who do not have MEC.

The IRS will notify a taxpayer of his or her Employee Shared Responsibility Payment. Upon receipt of such notice, the taxpayer must include the payment with his or her federal income tax return for the taxable year that includes the month(s) the taxpayer failed to maintain MEC. Married taxpayers filing a joint return for any taxable year are jointly liable for any shared responsibility payment imposed for the year.
HELPFUL TIPS

- Employers must ensure that adequate policies and procedures are currently in place to track the number of full-time and part-time employees, and the number of each part-time employee’s hours of service.

- Employers close to reaching the 50-employee threshold should consider the option of using a six-consecutive-month reference period rather than the entire calendar year to allow time to make adjustments to health plan coverage before 2014.

- Employers with health plans that currently do not offer dependent coverage should begin the process of establishing such coverage for future plan years.

- Employers should begin the process of determining whether current health coverage is offered to all full-time employees and, if so, whether such coverage is both affordable and provides minimum value.