

# EXPERT UPDATE



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## Pay or Play Penalty- 2016 Affordability Safe Harbor Overview

The Affordable Care Act (ACA) requires applicable large employers (ALEs) to offer affordable, minimum value health coverage to their full-time employees or pay a penalty.

This employer mandate provision is also known as the “employer shared responsibility” or “pay or play” rules. An ALE is only liable for a pay or play penalty if one or more of its full-time employees receive a subsidy for coverage under an insurance Exchange.

These employer penalties were set to take effect on Jan. 1, 2014. However, on July 2, 2013, the Treasury **delayed the pay or play penalties and related reporting requirements for one year, until 2015**. Therefore, these payments did not apply for 2014. No other ACA provisions are affected by the delay.

The IRS published [final regulations](#) in 2014 on the ACA’s employer shared responsibility rules. Under the final regulations, **ALEs that have fewer than 100 full-time employees generally will have an additional year, until 2016, to comply with the pay or play rules**. ALEs with 100 or more full-time employees must comply with the pay or play rules starting in 2015.

The final regulations also provide guidance on determining affordability of an employer-sponsored plan, including **three optional safe harbors** that employers may use.

In 2014, the IRS released [Rev. Proc. 2014-37](#) to index the ACA’s affordability contribution percentage for 2015, and further increased the contribution percentage for 2016 in [Rev. Proc. 2014-62](#).

Employer-sponsored coverage will generally be considered affordable under the pay or play rules if the employee’s required contribution for self-only coverage does not exceed:

- **9.56 percent** of the employee’s household income for the year, for plan years beginning in 2015; and
- **9.66 percent** of the employee’s household income for the year, for plan years beginning in 2016.

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# EXPERT UPDATE



EXPECT AN EXPERT

In December, IRS confirmed in [Notice 2015-87](#) that ALEs using an affordability safe harbor **may rely on these adjusted affordability contribution percentages**. It also clarified how certain amounts (such as flex contributions or HRA contributions) are counted when calculating affordability.

## Affordability Determination

The affordability of health coverage offered by an ALE is a key point in determining whether the employer will be subject to an employer shared responsibility penalty. In general, an ALE that offers health coverage to substantially all of its full-time employees (and dependents) may be subject to an employer shared responsibility penalty if the health coverage does not provide minimum value or is unaffordable.

Under the ACA, an ALE's health coverage is considered affordable if the employee's required contribution to the plan does not exceed **9.5 percent** of the employee's household income for the taxable year (**adjusted to 9.56 percent in 2015, or 9.66 percent in 2016**). "Household income" means the modified adjusted gross income of the employee and any members of the employee's family, including a spouse and dependents.

The affordability test applies only to the portion of **the annual premiums for self-only coverage**, and does not include any additional cost for family coverage. Also, if an employer offers multiple health coverage options, the affordability test applies to the lowest-cost option that also satisfies the minimum value requirement.

## Cafeteria Plan Contributions, HRA Contributions and Wellness Program Incentives

[Notice 2015-87](#) addressed how employer contributions to a cafeteria plan (flex contributions), health reimbursement arrangements (HRAs) and wellness program incentives are counted in determining the affordability of employer-sponsored coverage. (Employer contributions to health savings accounts (HSAs) do not affect the affordability of employer-sponsored coverage)

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# EXPERT UPDATE



EXPECT AN EXPERT

because HSA amounts may generally not be used to pay for health insurance premiums.)

The IRS released a [proposed rule](#) in 2013 on the premium tax credit that included guidance on how flex contributions, HRAs and wellness program incentives are counted in determining the affordability of employer-sponsored coverage. A separate [final rule](#) that addresses similar issues on the individual mandate was issued in 2014.

**In Notice 2015-87, the IRS generally clarified that the same treatment in the premium tax credit proposed rule and individual mandate final rule applies for purposes of determining affordability under the employer shared responsibility rules.**

## ***Flex Contributions***

For purposes of determining the affordability of coverage, the 2014 individual mandate final regulations provide that the required contribution is **reduced** by any contributions made by an employer (also called employer **health flex contributions**) under a Section 125 cafeteria plan that:

- May not be taken as a taxable benefit;
- May be used to pay for minimum essential coverage; and
- May be used only to pay for medical care.

Notice 2015-87 clarifies that this rule also applies for purposes of the employer shared responsibility rules. Thus, health flex contributions made available for the current plan year **are taken into account** for purposes of determining an individual's required contribution.

However, if an employee may use employer contributions to a cafeteria plan for non-health care benefits (such as dependent care or group term life insurance) or may receive them as cash, those amounts **do not reduce the employee's required contribution**.

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## Example 1: Health Flex Contribution Reduces Dollar Amount of Employee's Required Contribution

Employer offers employees coverage under a group health plan through a Section 125 cafeteria plan.

An employee electing self-only coverage under the health plan is required to contribute \$200 per month toward the cost of coverage.

Employer offers employer flex contributions of \$600 for the plan year that may only be applied toward the employee share of contributions for the group health coverage or contributed to a health flexible spending arrangement (health FSA).

### Conclusion

The \$600 employer flex contribution is a **health flex contribution** and **reduces the employee's required contribution** for the coverage for purposes of the employer shared responsibility rules (including the affordability safe harbors).

Because the \$600 employer flex contribution is a health flex contribution, the \$600 is taken into account as an employer contribution (and therefore reduces the employee's required contribution), regardless of whether the employee elects to apply the health flex contribution toward the employee contribution for the group health coverage or elects to contribute it to the health FSA.

For purposes of the employer shared responsibility rules and the related reporting under Section 6056, the employee's required contribution for the group health coverage is \$150 (\$200 - \$50) per month.

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## **Example 2: Employer Flex Contribution Does Not Reduce Dollar Amount of Employee's Required Contribution**

Employer offers employees coverage under a group health plan through a Section 125 cafeteria plan.

An employee electing self-only coverage under the health plan contributes \$200 per month toward the cost of coverage.

Employer offers employer flex contributions of \$600 for the plan year that can be used for any benefit under the Section 125 cafeteria plan (including benefits not related to health) but are not available as cash.

### **Conclusion**

Because the \$600 employer flex contribution is **not usable exclusively for medical care**, it is not a health flex contribution and therefore **does not reduce the employee's required contribution** for the coverage under the employer shared responsibility rules.

For purposes of the employer shared responsibility rules and the related reporting under Section 6056, the employee's required contribution is \$200 per month.

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# EXPERT UPDATE



EXPECT AN EXPERT

## **Example 3 (Employer Flex Contribution Does Not Reduce Dollar Amount of Employee's Required Contribution)**

Same as in Example 2, except that the employee may also elect to receive the \$600 employer flex contribution as cash or other taxable compensation.

### **Conclusion**

Same as in Example 2, because the employer's flex contribution is not a health flex contribution.

The same conclusion would apply if the employer flex contribution were available to pay for health benefits or to be taken as cash or other taxable compensation, but not available to pay for other types of benefits.

Notice 2015-87 provides **transition relief for plan years beginning before Jan. 1, 2017.**

For purposes of both the employer shared responsibility rules and the related Section 6056 reporting requirements, any flex contribution that may be used towards both health and non-health benefits will be treated as **reducing an employee's required contribution.**

This relief is not available for flex contribution arrangements offering non-health benefits that either:

- Were adopted after Dec. 16, 2015; or
- Substantially increase the amount of the flex contribution after Dec. 16, 2015.

### **HRA Contributions**

Under special rules in the 2014 individual mandate final regulations, amounts made newly available under an HRA that is integrated with an employer-sponsored plan for the current plan year

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# EXPERT UPDATE



EXPECT AN EXPERT

are taken into account only in determining affordability if the employee may either:

- Use the amounts only for premiums; or
- Choose to use the amounts for either premiums or cost-sharing.

This special rule is intended to prevent double counting the HRA amounts when assessing minimum value and affordability of employer-sponsored coverage. Notice 2015-87 clarifies that this special rule also applies for purposes of the employer shared responsibility rules.

In 2013, the Department of Labor (DOL) issued [Technical Release 2013-03](#), which provides detailed guidance on when an HRA will be considered integrated with other group health coverage.

This guidance is generally effective for plan years beginning on or after Jan. 1, 2014, although it may be applied for all prior periods. It is not required that the HRA and the coverage with which it is integrated:

- Share the same plan sponsor or the same plan document or governing instruments; or
- File a single Form 5500, if applicable.

The Technical Release contains the following guidance on including HRA contributions in determining affordability for purposes of the premium tax credit:

- Even if an HRA is integrated with a plan offered by another employer for purposes of the ACA's annual dollar limit prohibition and the preventive services requirements, the HRA does not count toward the affordability or minimum value requirement of the plan offered by the other employer.
- Additionally, if an employer offers an HRA on the condition that the employee does not enroll in non-HRA coverage offered by the employer and instead enrolls in non-HRA coverage from a different source, the HRA does not count in determining whether the employer's non-HRA coverage satisfies either the affordability or minimum value requirement.

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# EXPERT UPDATE



EXPECT AN EXPERT

According to Notice 2015-87, employer contributions to an HRA count toward an employee's required contribution only to the extent that the amount of the employer's annual HRA contribution is:

- Required under the terms of the arrangement; or
- Otherwise determinable within a reasonable time before the employee must decide whether to enroll in the eligible employer-sponsored plan.

A contribution that meets this requirement relates to the immediately subsequent period of coverage for which the employee could enroll and use the HRA contribution. For purposes of the employer shared responsibility rules and the related reporting under Section 6056, the employer contribution to an HRA (and any resulting reduction in the employee contribution) is treated as made ratably for each month of the period to which it relates.

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# EXPERT UPDATE



EXPECT AN EXPERT

## Example 4

The employee contribution for health coverage under the major medical group health plan offered by the employer is generally \$200 per month.

For the current plan year, the employer makes newly available \$1,200 under an HRA that the employee may use to:

- Pay the employee share of contributions for the major medical coverage;
- Pay cost-sharing; or
- Pay towards the cost of vision or dental coverage.

The HRA satisfies all requirements for integration with the major medical group health plan.

## Conclusion

The \$1,200 employer contribution to the HRA **reduces the employee's required contribution for the coverage.**

For purposes of the employer shared responsibility rules and the related reporting under Section 6056, the employee's required contribution for the major medical plan is \$100 (\$200 - \$100) per month because 1/12 of the \$1,200 HRA amount per month is taken into account as an employer contribution, whether or not the employee uses the HRA to pay the employee share of contributions for the major medical coverage.

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# EXPERT UPDATE



EXPECT AN EXPERT

## ***Wellness Program Incentives***

Also, according to the November 2014 individual mandate final regulations, affordability of an employer-sponsored plan is determined by **assuming that each employee fails to satisfy the wellness program's requirements**, unless the wellness program is related to **tobacco use**.

This means the affordability of a plan that charges a higher initial premium for tobacco users will be determined based on the premium charged to non-tobacco users, or tobacco users who complete the related wellness program, such as attending smoking cessation classes.

Wellness program incentives are not addressed in Notice 2015-87. However, [final regulations](#) on minimum value, published on Dec. 18, 2015, reiterate that, for purposes of affordability:

- Wellness incentives unrelated to tobacco use are treated as unearned; and
- Wellness incentives related to tobacco use are treated as earned.

## ***Opt-out Payments***

According to Notice 15-87, the IRS intends to propose regulations providing that, for purposes of the employer shared responsibility rules, opt-out payments will increase an employee's required contribution beyond the amount of salary reduction elections.

Thus, the employee's required contribution would be equal to:

- The amount the employee is otherwise required to pay for health coverage; plus
- The amount of the opt-out payment that the employee must forgo as a result of electing coverage

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# EXPERT UPDATE



EXPECT AN EXPERT

## Example 5

If an employer offers employees group health coverage through a Section 125 cafeteria plan, requiring employees who elect self-only coverage to contribute \$200 per month toward the cost of that coverage, and offers an additional \$100 per month in taxable wages to each employee who declines the coverage, Notice 15-87 provides that **the offer of \$100 in additional compensation has the economic effect of increasing the employee's contribution for the coverage.**

In this case, the employee contribution for the group health plan effectively would be \$300 (\$200 + \$100) per month, because an employee electing coverage under the health plan must forgo \$100 per month in compensation in addition to the \$200 per month in salary reduction.

This rule generally will apply only after final regulations are issued.

Before final regulations are issued, opt-out payments generally will not be treated as increasing an employee's required contribution for purposes of the employer shared responsibility rules and the related reporting requirements under Section 6056.

**However, the IRS plans to apply these rules beginning Dec. 16, 2015, for any opt-out arrangements that are adopted after Dec. 16, 2015.**

For this purpose, **an opt-out arrangement will be treated as adopted after Dec. 16, 2015**, unless:

- The employer offered the opt-out arrangement (or a substantially similar opt-out arrangement) with respect to health coverage provided for a plan year including Dec. 16, 2015;
- A board, committee or similar body or an authorized officer of the employer specifically adopted the opt-out arrangement before Dec. 16, 2015; or

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# EXPERT UPDATE



EXPECT AN EXPERT

- The employer had provided written communications to employees on or before Dec. 16, 2015, indicating that the opt-out arrangement would be offered to employees at some time in the future.

## ***Fringe Benefit Payments for Federal Contract Workers***

The Service Contract Act (SCA) and the Davis-Bacon Act (DBA) require federal contract workers to be paid prevailing wages and fringe benefits, which often may be cashed out. According to Notice 15-87, the IRS continues to consider how the SCA, the DBA and the employer shared responsibility rules may be coordinated.

However, until further guidance is issued (at least through 2016 plan years), for purposes of the employer shared responsibility rules and the Section 6056 reporting requirements, employer fringe benefit payments (including flex credits or contributions) under the SCA or DBA that may be used to pay for coverage under an eligible employer-sponsored plan will be treated as **reducing the employee's required contribution**, but only to the extent it does not exceed the amount required under the SCA or DBA.

## **Overview of the Affordability Safe Harbors**

Because an employer generally will not know an employee's household income, the IRS has provided three optional affordability safe harbors that ALEs may use to determine affordability based on information that is available to them—the Form W-2 safe harbor, the rate of pay safe harbor and the federal poverty level safe harbor.

These affordability safe harbors specifically refer to 9.5 percent as the required contribution, and do not include an adjustment mechanism. However, Notice 2015-87 clarifies that **ALEs using any of the affordability safe harbors may rely on the adjusted affordability contribution percentages for 2015 and 2016.**

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# EXPERT UPDATE



EXPECT AN EXPERT

An employer may use one or more of the affordability safe harbors if it offers its full-time employees (and dependents) the opportunity to enroll in minimum essential coverage under a health plan that provides minimum value with respect to the self-only coverage offered to the employees.

## ***Safe Harbor Application***

The three affordability safe harbors are all **optional**. An employer may choose to use one or more of the affordability safe harbors for all its employees or for any reasonable category of employees, provided it does so on a uniform and consistent basis for all employees in a category.

Reasonable categories of employees generally include:

- Specified job categories;
- Nature of compensation (for example, salaried or hourly);
- Geographic location; and
- Similar bona fide business criteria.

A listing of employees by name (or other specific criteria having substantially the same effect) is not considered a reasonable category.

The affordability safe harbors are only used to determine whether an ALE's coverage satisfies the affordability test for purposes of the employer shared responsibility penalty. **These safe harbors do not affect an employee's eligibility for an Exchange subsidy, which is based on the affordability of employer-sponsored coverage relative to an employee's household income.**

This means that, in some instances, an ALE's offer of coverage to an employee could be considered:

- Affordable (for example, based on W-2 wages) for purposes of determining whether the employer is subject to a penalty; and, at the same time,
- Unaffordable (based on household income) for purposes of determining whether the employee is eligible for an Exchange subsidy.

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# EXPERT UPDATE



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## ***Changes to the Affordability Percentage***

[Rev. Proc. 2014-37](#) adjusted the ACA's affordability contribution percentage for 2015, and [Rev. Proc. 2014-62](#) further adjusted the affordability percentage for 2016. Employer-sponsored coverage will generally be considered affordable under the pay or play rules if the employee's required contribution for self-only coverage does not exceed:

- **9.56 percent** of the employee's household income for the year, for plan years beginning in 2015; and
- **9.66 percent** of the employee's household income for the year, for plan years beginning in 2016.

Although the 9.5 percent required contribution percentage is adjusted annually for purposes of other ACA provisions, **the affordability safe harbors specifically refer to 9.5 percent as the required contribution**, and do not include an adjustment mechanism. Thus, ALEs using an affordability safe harbor generally had to measure their plan's affordability using 9.5 percent (instead of the adjusted percentage).

Notice 15-87 states that the affordability safe harbors are intended only to provide a more feasible means for employers to calculate affordability, and are not intended to otherwise alter the affordability calculation. As a result, the IRS intends to amend the employer shared responsibility regulations to reflect that the applicable percentage in the affordability safe harbors should be adjusted consistent with other ACA provisions, so that **employers may rely upon the 9.56 percent for plan years beginning in 2015, and 9.66 percent for plan years beginning in 2016.**

## **Form W-2 Safe Harbor**

Under the Form W-2 safe harbor, an ALE may determine the affordability of its health coverage by reference **only to an employee's wages from that ALE**, instead of by reference to the employee's household income. For this purpose, "wages" is the amount that is required to be reported in Box 1 of the employee's Form W-2.

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An ALE satisfies the Form W-2 safe harbor with respect to an employee if the employee's required contribution for the calendar year for the ALE's lowest cost self-only coverage that provides minimum value during the entire calendar year (excluding COBRA or other continuation coverage except with respect to an active employee eligible for continuation coverage) **does not exceed 9.5 percent (as adjusted) of that employee's Form W-2 wages** from the employer for the calendar year.

## ***Eligibility for the Form W-2 Safe Harbor***

To be eligible for the Form W-2 safe harbor, the employee's required contribution must remain a consistent amount or percentage of all Form W-2 wages during the calendar year (or during the plan year for plans with non-calendar year plan years). Thus, an ALE may not make discretionary adjustments to the required employee contribution for a pay period.

A periodic contribution that is based on a consistent percentage of all Form W-2 wages may be subject to a dollar limit specified by the employer.

## ***Timing of the Form W-2 Safe Harbor***

ALEs determine whether the Form W-2 safe harbor applies after the end of the calendar year and on an employee-by-employee basis, taking into account W-2 wages and employee contributions.

## ***Partial-year Offers of Coverage***

For an employee who was not offered coverage for an entire calendar year, the Form W-2 safe harbor is applied by:

- Adjusting the employee's Form W-2 wages to reflect the period when the employee was offered coverage; and
- Comparing the adjusted wage amount to the employee's share of the premium for the employer's lowest cost self-only coverage that provides minimum value for the periods when coverage was offered.

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# EXPERT UPDATE



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Specifically, the amount of the employee's compensation for purposes of the Form W-2 safe harbor is determined by multiplying the wages for the calendar year by a fraction equal to the number of calendar months for which coverage was offered over the number of calendar months in the employee's period of employment with the ALE during the calendar year.

For this purpose, if coverage is offered during at least one day during the calendar month, or the employee is employed for at least one day during the calendar month, the entire calendar month is counted in determining the applicable fraction.

## Rate of Pay Safe Harbor

The rate of pay safe harbor was designed to allow ALEs to prospectively satisfy affordability without the need to analyze every employee's wages and hours. **For hourly employees**, the rate of pay safe harbor allows an ALE to:

- Take the lower of the hourly employee's rate of pay as of the first day of the coverage period (generally, the first day of the plan year) or the employee's lowest hourly rate of pay during the calendar month;
- Multiply that rate by 130 hours per month (the benchmark for full-time status for a month); and
- Determine affordability for the calendar month based on the resulting monthly wage amount.

Specifically, the employee's monthly contribution amount (for the self-only premium of the employer's lowest cost coverage that provides minimum value) is affordable for a calendar month if it is equal to or lower than 9.5 percent (as adjusted) of the computed monthly wages (that is, the employee's applicable hourly rate of pay multiplied by 130 hours).

The final regulations, unlike the proposed regulations, allow an ALE to use the rate of pay safe harbor even if an hourly employee's rate of pay is reduced during the year.

**For salaried employees**, monthly salary as of the first day of the coverage period would be used, instead of hourly salary multiplied by 130 hours. However, if the monthly salary is reduced, including due to a reduction in work hours, the rate of pay safe harbor may not be used.

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## Federal Poverty Line Safe Harbor

An ALE may also rely on a design-based safe harbor using the federal poverty line (FPL) for a single individual. Employer-provided coverage is considered affordable under the FPL safe harbor if the employee's required contribution for the calendar month for the lowest cost self-only coverage that provides minimum value does not exceed 9.5 percent (as adjusted) of the FPL for a single individual for the applicable calendar year, divided by 12. The final regulations allow ALEs to use any of the poverty guidelines in effect within six months before the first day of the plan year for purposes of this safe harbor.

The FPL safe harbor allows ALEs to disregard certain employees in determining the affordability of health coverage (that is, employees who cannot receive an Exchange subsidy because of their income level or eligibility for Medicare, and therefore cannot trigger an ALE's liability for an employer shared responsibility penalty). The FPL safe harbor also provides ALEs with a predetermined maximum amount of employee contribution that in all cases will result in the coverage being deemed affordable.

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