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Health Care Reform: Employer Shared Responsibility Requirements Require Action & Exchange Notice Delayed

This alert discusses two recent regulatory developments under the Patient Protection and Affordable Care Act (PPACA):

1. The government postponed until late summer or fall of 2013 a deadline (originally March 1, 2013) for providing notices to employees about coverage options available through federal and state exchanges.
2. The IRS published proposed regulations regarding PPACA's definition of "full-time employee" and how that definition impacts the employer shared responsibility rules that become effective in 2014.

This alert focuses primarily on the employer responsibility requirements, sometimes referred to as the "play or pay" rules, that begin applying in 2014 and impose significant penalties on employers for noncompliance (potentially as high as $2,000 per full-time employee per year). Significantly, hours worked by employees this year will be used in determining if an employer is subject to the shared responsibility requirements and which of its employees must be offered coverage next year. Accordingly, employers should begin taking steps now to comply. Those steps include:

- Determining if the employer will or may be subject to PPACA's shared responsibility requirements in 2014 and, for employers close to the 50 full-time equivalent threshold, determining if actions may be taken in 2013 to avoid being treated as an applicable large employer subject to those rules in 2014
- Reviewing plan eligibility rules and determining what changes will need to be made to those rules to comply with PPACA's requirements
- Selecting initial and standard measurement periods to use for determining which employees are averaging at least 30 hours of service per week and should therefore be offered coverage
- Implementing procedures and processes for computing and tracking "hours of service" as defined under the proposed regulations
- Modifying enrollment procedures
- Reviewing plan coverage options and employee premium rates with an eye toward meeting the affordability safe harbors described in the proposed regulations

Exchange Notice Postponed

PPACA requires employers to provide a notice to their employees about the applicable state or federal health insurance exchange and explain how that exchange will work, and also explain various cost sharing and tax consequences of participating in the exchange. The statute requires the notice to be provided to employees by March 1, 2013.

However, on January 24, 2013, the Departments of Labor, Health and Human Services, and the Treasury postponed the date that employers must provide the exchange notice. The deadline is now tentatively pushed out to late summer or fall of 2013, although the agencies did not provide a firm date. The government also announced that it is considering providing a model exchange notice that employers could use to satisfy the law's requirements.

Employer Shared Responsibility Regulations

2014 is when PPACA's major provisions become effective. First, individuals will be required to maintain so-called "minimum essential coverage" (yet to be fully defined) or face tax penalties. Second, states and the federal government will begin operating insurance exchanges through which individuals and small employers (i.e., those employers with fewer than 50 full-time employees) will be able to purchase coverage. Third, the employer shared responsibility (sometimes referred to as "play or pay") requirement will begin to apply to employers with 50 or more full-time employees (known as "applicable large employers").

The employer shared responsibility requirement is important, because it could trigger significant tax penalties. PPACA imposes a $2,000 per year per full-time employee penalty if an employer fails to offer minimum essential coverage to virtually all full-time employees (and eventually their dependents). Even if an employer offers coverage to all full-time employees, it is still potentially subject to a penalty of $3,000 per year for each full-time employee who is not offered coverage that provides minimum value and satisfies the law's affordability requirements.

The preceding paragraphs use the term "full-time employee" many times for a reason. Who is a full-time employee, how that classification is determined and how many full-time employees an employer has are essential for determining whether and how the employer shared responsibility requirement applies.

The statute defines "full-time employee" as follows: "A full-time employee with respect to any month is an employee who is employed on average at least 30 hours of service per week." I.R.C. § 4980H(c)(4) (2010). The term obviously encompasses traditional 40-hour-per-week employees. However, the contours of the definition are important to understand, especially in the context of newly-hired employees, seasonal employees and so-called "variable hour employees," and will have a significant impact on health plan design, administration and costs. The proposed regulations (and previous guidance issued by the IRS) are intended to fill in the gaps in this definition.

Why Does It Matter?

Is an employer subject to the employer shared responsibility requirement?

As noted above, an employer is subject to the employer shared responsibility requirement if it is an "applicable large employer." That term is defined as an employer that employs at least 50 full-time employees on business days during the preceding calendar year. At one level, the definition is very straightforward: An employer with 50 or more traditional full-time employees throughout the year is an "applicable large employer."

At the margin, however, the definition becomes more complicated. For example, an employer may employ 40 traditional full-time employees and 20 part-time employees. Is that employer an "applicable large employer?" It depends. For purposes of determining if an employer is an applicable large employer, the statute includes a full-time equivalent (FTE) concept. The number of FTEs is calculated as follows:

(a) Calculate the aggregate number of hours of service for all employees (including seasonal employees) who were not full-time employees for that month (i.e., exclude actual full-time employees from this calculation)

(b) Divide the result in (a) by 120

Thus, if an employer had 15 employees who were each credited with 80 hours of service during the month, the employer would have ten FTE's ((15 * 80) ÷ 120). The number of FTE's are then added to the number of actual full-time employees to determine if the employer is above the 50 full-time employee threshold.

Only common law employees are taken into account, so independent contractors are disregarded. However, if it is determined that an individual was misclassified, that individual would be taken into account both for purposes of determining whether an employer is an "applicable large employer" and for purposes of determining whether an employer owes an employer shared responsibility tax (and if so, how much tax is owed).

The proposed regulations contain a limited seasonal employee exception. The proposed regulations also provide that all employees of all members of a controlled group of corporations or an affiliated service group are taken into account in determining whether the members of the controlled group or affiliated service group together constitute an applicable large employer.

Impact of Employer Shared Responsibility

If an applicable large employer does not offer at least 95% of its full-time employees the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan, the employer will generally be subject to a $2,000 annual excise tax per full-time employee (disregarding the first 30 full-time employees). Thus, if an employer had 200 full-time employees and did not offer minimum essential medical coverage to at least 95% of those 200 full-time employees, it would potentially be liable for an excise tax of $340,000 per year ((200 – 30) * $2,000).

If an applicable large employer offers at least 95% of its full-time employees the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan that, for a full-time employee, is either unaffordable or does not provide minimum value, the employer will be subject to a $3,000 annual excise tax per full-time employee who chooses to purchase coverage on an exchange and who qualifies for tax credit assistance (generally meaning that household income is less than 400% of the poverty level) in order to purchase that coverage.

Definition of Full-Time Employee

As noted above, the statute defines a "full-time employee" with respect to a calendar month as "an employee who is employed an average of at least 30 hours of service per week." The statute does not define this term with any more precision.

An employer may use a specific weekly average for the hours worked by each employee. However, the IRS notes that a precise application of the definition may be difficult and cumbersome to administer because the average calendar month consists of more than four weeks, and the first and last days of each month often occur midweek.

Accordingly, the proposed regulations provide that a monthly equivalent may be used. Thus, any employee who is credited with 130 hours of service in a calendar month would be treated as having worked the weekly equivalent of at least 30 hours per week. The hours that would be credited for this purpose are (1) each hour for which an employee is paid, or entitled to payment, for the performance of duties for the employer; and (2) each hour for which an employee is paid, or entitled to payment by the employer on account of a period of time during which no duties are performed due to vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty or leave of absence. In this regard, the concept of hours of service is similar to the concept that is used for crediting service under many qualified retirement plans.

Methods for Calculating Hours

For purposes of calculating hours of service, an employer will be required to use one of the following methodologies.

- **Calculation of hours of service for hourly employees:** For employees paid on an hourly basis, an employer is required to calculate actual hours of service from records of hours worked or credited.
- **Calculation of hours of service for salaried employees:** For salaried employees (or employees not otherwise paid on an hourly basis, such as those working on a commission basis), an employer generally is allowed to calculate the number of hours of service under any of the following three methods:

  (a) Counting actual hours of service from records of hours worked or credited

  (b) Using a days-worked equivalency method whereby the employee is credited with eight hours of service for each day for which the employee would be required to be credited with at least one hour of service

  (c) Using a weeks-worked equivalency of 40 hours of service per week for each week for which the employee would be required to be credited with at least one hour of service

However, an equivalency may *not* be used if it would result in substantially understating an employee's hours of service and cause the employee not to be treated as a full-time employee. For example, a days-worked equivalency may not be used for an employee who generally works three 12-hour shifts per week.

The IRS Lookback/Stability Period Safe Harbor For Existing Employees

Because of the difficultly of administering monthly tracking of full-time status, the IRS has proposed utilizing an approach that focuses on measuring prior service and then fixing the employee's full-time and part-time status for up to a 12-month period of time based upon that prior service. In so doing, the IRS has created a series of terms that need to be understood for the following discussion and for future planning.

Important Terms

"Standard Measurement Period"

This is the period of time between three and 12 months (chosen by the employer) that will be used for determining if an ongoing employee is a full-time employee. The Standard Measurement Period must end no more than 90 days prior to the beginning of the Stability Period (defined below). It is generally expected that employees will use a 12-month Standard Measurement Period.

"Initial Measurement Period"

This is the period of time between three months and 12 months (chosen by the employer) that will be used for determining if new Variable Hour Employees (defined below) or Seasonal Employees (defined below) are considered full-time employees. The Initial Measurement Period may begin on the date of hire or the first day of the calendar month following the date of hire. We will assume for discussion purposes that the employer chooses to use 12-month Initial Measurement Periods beginning on the first day of each calendar month.

"Stability Period"

This is the period of time between six and 12 months (chosen by the employer subject to certain limitations) during which an employee's status as a full-time employee (or not) is fixed based on the results from the average hours worked during the Standard Measurement Period (or the Initial Measurement Period in the case of a new seasonal or variable hour employee). A Stability Period must be at least as long as the Standard

Measurement Period. Thus, if an employer chooses a 12-month Standard Measurement Period, the Stability Period must also be 12 months in length. It is generally expected that the Stability Period will coincide with the plan year for the medical plan to facilitate the regular historic operation of the medical plan, including its annual open enrollment period.

“Administrative Period”

This is the period between the end of the Standard Measurement Period (or of the Initial Measurement Period) and the associated Stability Period. The Administrative Period may last up to 90 days and is envisioned to be the time during which on-going employees and newly eligible employees are provided with information about medical plan coverage options and given an opportunity to enroll. It is expected that employers will generally choose an Administrative Period of between 60 to 90 days to facilitate the operation of the enrollment process.

“Variable Hour Employee”

This is an employee for whom, as of his or her start date, it cannot be determined that he or she is reasonably expected to work on average at least 30 hours per week. Even if a new employee is reasonably expected to work at least 30 hours per week for a limited period of time, the employee may be a variable hour employee if the employment for 30 or more hours per week is reasonably expected to last for a limited duration and it cannot be determined how many hours that the employee is reasonably expected to work on average over the Initial Measurement Period.

“Seasonal Employee”

This is an employee who performs services on a seasonal basis, such as an employee hired exclusively for the holiday season. The proposed regulations do not define the term with any more specificity for purposes of the law’s shared responsibility provisions. Accordingly, through at least 2014, employers are permitted to use a reasonable, good faith interpretation of the term “seasonal employee” for these purposes.

Application of the Important Terms

On-going Employees

For employees who have been employed at least 12 months, the Standard Measurement Period is used to determine whether they are deemed to be full-time employees during the upcoming Stability Period. For example, if the employer uses a calendar-year plan year for its medical plan, and if the employer wishes to provide an annual enrollment period prior to the beginning of the Stability Period (plan year), the employer may choose a 12-month Standard Measurement Period running from, for example, November 1 through the following October 31.

An on-going employee’s full-time status is determined by dividing the number of hours of service credited to the employee during the Standard Measurement Period by the number of months during the Standard Measurement Period. For example, if an employee is credited with 1,560 hours during a 12-month Standard Measurement Period, that employee will average 130 hours per month, or 30 hours per week. That employee would be deemed to be a full-time employee (regardless of his or her actual hours) during the following Stability Period.

New Full-Time Employee

PPACA allows an employer to use up to a 90-day eligibility waiting period. Thus, if an employee is reasonably expected at his or her start date to work at least 30 hours per week, the employer must offer minimum essential coverage within three months of the employee’s date of hire, or potentially be subject to the $2,000 per full-time employee annual employer responsibility excise tax by reason of its failure to offer coverage to substantially all full-time employees.

New Variable Hour or Seasonal Employees

As noted above, for new Variable Hour and Seasonal Employees, employers are permitted to determine whether the new employee is a full-time employee using an Initial Measurement Period beginning either on the date of hire or the first day of the month following the date of hire. If the employee averages at least 30 hours of service per week during this Initial Measurement Period, an employer must offer coverage (or potentially be subject to the $2,000 annual excise tax) as of the first day of the month following the end of that period and any associated Administrative Period.

Example:

> Employee B is hired July 10, 2013, as an hourly employee with a variable work schedule, and the employer reasonably concludes that it is uncertain whether Employee B will average 30 or more hours of service per week. The employer uses a 12-month Initial Measurement Period. Employee B’s 12-month Initial Measurement Period will begin July 10 or August 1, 2013, depending upon the method selected by the employer. If Employee B averages at least 30 hours per week during the 12-month Initial Measurement Period, he or she must be offered coverage no later than September 1, 2014. If Employee B does not average at least 30 hours

per week during the Initial Measurement Period, Employee B does not have to be offered coverage at the end of the period.

The Stability Period for such employees must be the same length as the Stability Period for ongoing employees. Thus, if the Stability Period for ongoing employees is 12 months, the Stability Period for new employees must also be 12 months.

Transition from New Employee Rules to Ongoing Employee Rules

Once a new employee has been employed for both the Initial Measurement Period and one Standard Measurement Period, the employee must be tested for full-time status at the same time and under the same conditions as are other ongoing employees. Accordingly, for example, an employer with a 12-month Standard Measurement Period beginning November 1 that also uses a one-year Initial Measurement Period beginning on the first day of the month following the employee's start date would test a new variable hour employee whose start date is July 10, 2013, for full-time status first based on the Initial Measurement Period (August 1, 2013, through July 31, 2014) and again based on the November 1 Standard Measurement Period (if the employee continues in employment for that entire Standard Measurement Period) beginning on November 1 following the employee's start date; that is, for the Standard Measurement Period from November 1, 2013, through October 31, 2014.

An employee determined to be a full-time employee during an Initial Measurement Period or Standard Measurement Period must be treated as a full-time employee for the entire associated Stability Period. This is the case even if the employee is determined to be a full-time employee during the Initial Measurement Period but determined not to be a full-time employee during the overlapping or immediately following Standard Measurement Period. In that case, the employer may treat the employee as not a full-time employee only after the end of the Stability Period associated with the Initial Measurement Period. Thereafter, the employee's full-time status would be determined in the same manner as that of the employer's other ongoing employees.

In contrast, if the employee is determined not to be a full-time employee during the Initial Measurement Period, but is determined to be a full-time employee during the overlapping or immediately following Standard Measurement Period, the employee must be treated as a full-time employee for the entire Stability Period that corresponds to that Standard Measurement Period (even if that Stability Period begins before the end of the Stability Period associated with the Initial Measurement Period). Thereafter, the employee's full-time status would be determined in the same manner as that of the employer's other ongoing employees.

Leaves of Absence and Breaks in Service

In applying the lookback measurement period rules, the proposed regulations contain special requirements for the treatment of leaves of absence and breaks in service.

Standard Measurement Period Transition Rules

The IRS has established a transition rule relating to the Standard Measurement Period that will be used for purposes of determining full-time employees for 2014. As noted above, the general rule is that once an employer establishes the length of a Standard Measurement Period, the following Stability Period cannot be longer than the Standard Measurement Period. Thus, if an employer established a six-month Standard Measurement Period, the following Stability Period could not be longer than six months.

However, for purposes of 2014, an employer may establish a Standard Measurement Period that is between six months and 12 months and still utilize a 12-month Stability Period (referred to as a "Transition Measurement Period"). The Transition Measurement Period must begin no later than July 1, 2013, and must end no later than 90 days before the first day of the plan year beginning on or after January 1, 2014.

For example, an employer could establish a six-month Transition Measurement Period beginning May 1, 2013, and ending October 31, 2013, followed by a two-month Administrative Period ending on December 31, 2013, followed by a 12-month Stability Period beginning January 1, 2014, and ending on December 31, 2014.

Next Steps

A significant amount of work needs to be done in the coming months to prepare for 2014, which will usher in dramatic changes in the rules governing employer-sponsored health benefits.

Vedder Price attorneys are actively working with clients to help them formulate compliance strategies that fit their business needs and objectives. For assistance, please contact **Thomas G. Hancuch** at +1 (312) 609-7824, **Philip L. Mowery** at +1 (312) 609-7642 or any Vedder Price attorney with whom you work.

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