Health Care Reform
Pay or Play Guide

For more information contact the author of this Guide, John Barlament, or any of the Employee Benefits attorneys listed below:

John Barlament
(414) 277-5727
john.barlament@quarles.com
Marla Anderson
(414) 277-5453
marla.anderson@quarles.com
Amy Ciepluch
(414) 277-5585
amy.ciepluch@quarles.com
Sarah Fowles
(414) 277-5287
sarah.fowles@quarles.com

Angie Hubbell
(312) 715-5097
angie.hubbell@quarles.com
Paul Jacobson
(414) 277-5631
paul.jacobson@quarles.com
David Olson
(414) 277-5671
david.olson@quarles.com
Robert Rothacker
(414) 277-5643
robert.rothacker@quarles.com

Disclaimer: This Guide provides information of a general nature. None of the information contained herein is intended as legal advice or opinion relative to specific matters, facts, situations or issues. Additional facts and information or future developments may affect the subjects addressed in this document. You should consult with a lawyer about your particular circumstances before acting on any of this information because it may not be applicable to you or your situation.

 03/08/2012

Overview

The health care reform law from 2010 (the Patient Protection and Affordable Care Act, now called the "ACA" by regulators) requires certain large employers to provide health plan coverage or pay a penalty tax to the federal government. There are several requirements that must be satisfied in order to ensure that the penalty tax is avoided. We sometimes refer to this requirement as the "Pay or Play Rule".

This Guide outlines which entities are subject to the penalty tax, how the tax is calculated and how the tax can be avoided. For ease of understanding, the Guide sometimes discusses how hypothetical companies could avoid (or be subject to) the Pay or Play Rule and the related tax penalty. The Guide makes the Pay or Play Rule easier to understand by using a step-by-step explanation.

Step 1: Understand General Pay or Play Rule

The Pay or Play Rule applies to an employer with at least 50 full-time (or full-time equivalent ("FTE")) employees. The penalty under the Pay or Play Rule depends on whether an employer offers "minimum essential coverage" to <u>all</u> full-time employees and dependents (with a few exceptions). If an employer does <u>not</u> offer minimum essential coverage to all full-time employees (and their dependents) the employer must pay an annual tax of $2,000 for each full-time employee (less the first 30), if at least one full-time employee obtains federally-subsidized coverage through an "Exchange."[1] We call this the "No Offer Penalty."

If an employer <u>does</u> offer minimum essential coverage to all full-time employees (and their dependents) but at least one full-time employee obtains federally-subsidized coverage through an Exchange, the employer must pay an annual tax of the lesser of: (1) $3,000 per subsidized full-time employee; or (2) $2,000 for each full-time employee (less the first 30 full-time employees). We call this the "Unaffordable Coverage Penalty."[2] These rules are illustrated in a flowchart in Exhibit A, at the end of this Guide.

---

[1] According to the federal agencies that enforce the ACA, Exchanges "will provide competitive marketplaces for individuals and small employers to directly compare available private health insurance options on the basis of price, quality, and other factors" and will "enhance competition in the health insurance market, improve choice of affordable health insurance, and give small businesses the same purchasing clout as large businesses." U.S. Department of Health and Human Services ("HHS"), Proposed Regulations, Establishment of Exchanges and Qualified Health Plans (July 2011).

[2] The terms "No Offer Penalty" and "Unaffordable Coverage Penalty" are our terms, not Internal Revenue Service ("IRS") terms. The IRS refers to the former as "4980H(a) liability" and the latter as "4980H(b) liability". IRS Notice 2011-36, I.

Note that both penalties are determined on a month-by-month basis. So, an employer may owe a lesser amount if a penalty applies for only a portion of a year (e.g., the penalty would be one-half of the above amounts if the employer failed the Pay or Play Rule for only six months, not twelve months). The tax generally is not deductible.[3]

These general rules are subject to several exceptions as further described in this Guide.

Step 2: Determine if You are a "Large Employer"

The Pay or Play Rule applies to an "applicable large employer."[4] An "employer" is the entity that is the employer of an "employee" as determined under a common-law test.[5]

It appears that an "employer" will include all types of employers, including private employers, public employers, churches and non-profit employers.[6]

A "large" employer is an employer who employed an average of at least 50 full-time employees on business days during the preceding calendar year.[7] If an employer does not have at least 50 full-time employees, it still can be subject to the Pay or Play Rule if:

* The employer is part of a "controlled group" and the total full-time employees (or full-time equivalent ("FTE")) employees) of the controlled group at least equals 50 (see Step 2(a) in the Appendix);

* The employer is a new employer and it expects to employ an average of at least 50 full-time employees in the current calendar year (see Step 2(b) in the Appendix);

* The employer is deemed to be "large" due to a predecessor employer (see Step 2(c) in the Appendix); or

* The employer has enough FTE employees to cause the employer to be treated as a large employer (see Step 2(d) in the Appendix).

---

[3] Internal Revenue Code of 1986, as amended ("Code") Section 4980H(c)(7).
[4] Code Section 4980H.
[5] Internal Revenue Service ("IRS") Notice 2011-36, III.A. Note that Notice 2011-36 is not binding guidance. Rather, it is merely a request for comments and identifies possible future federal agency approaches.
[6] There is no apparent exclusion for governmental plans. However, there may be some issues under the U.S. Constitution if the penalty was applied to some types of these plans, such as a health plan offered by a State. It is unclear whether a State could argue that the federal government does not have authority to impose such a penalty.
[7] Code Section 4980H(c)(2).

Many employers will know (prior to examining Steps 2(a)-2(d)) that they are a "large" employer. If you know that you are a "large" employer subject to the Pay or Play Rule, you can proceed to Step 3 below (although Step 2(d)(i)'s determination of "full-time" employees will be relevant and will be addressed in Step 7). If you are not certain, proceed to the Appendix for the remainder of Step 2 (i.e., Steps 2(a)-2(d)).

Step 3: Will Any of Your Employees Receive Federally-Subsidized Exchange Coverage?

Generally, beginning in 2014 individuals will be able to obtain health insurance through an "Exchange." Exchanges are expected to be state-created marketplaces where insurance products can be easily compared. It is unclear whether all states will create an Exchange. Some states have declined to create an Exchange and announced that they would not create one. If a state does not create an Exchange the federal government could establish and operate an Exchange in that state.[8]

Some individuals who obtain Exchange coverage will be eligible for federal subsidies to help pay for health insurance coverage, or to help reduce certain health plan costs.[9] While the subsidies will be available in an Exchange established by a state, it is unclear whether these subsidies will be available in a Federally-run exchange.[10]

This is potentially a significant issue. It seems possible that, if no subsidy is available in a particular state, a large employer in that state could not face a penalty under the Pay or Play Rule. As will be explained below in more detail (and as is illustrated in Exhibit A), an employer can face a Pay or Play Rule penalty only if an employee (or, possibly, a dependent) receives subsidized Exchange coverage.

The remainder of Steps 4 through 6 will discuss when an employer could be subject to the Pay or Play Rule penalty. As will be discussed, it is possible for an employer to design its health plan so that it never pays a Pay or Play Rule penalty. However, this may require that an employer modify its current health plan design.

[8] ACA Section 1321(c).

[9] Code Section 36B, as added by ACA Section 1401. The cost-sharing provisions are found in ACA Section 1402.

[10] Proposed IRS and HHS regulations, along with certain HHS Frequently Asked Questions, suggest that the premium tax credit is available to both types of Exchanges (state-operated and federally-operated). One Senator has suggested that the premium tax credit is only available if an Exchange is "established by the state", as suggested in the ACA. See Sen. Hatch Letter, "Hatch to Obama Administration: Don't Circumvent Congress to Amend Partisan Health Law" (Dec. 1, 2011) (available at http://finance.senate.gov/newsroom/ranking/release/?id=6c2ea7e8-2a57-451c-8e02-f066e8ff92f7). Thus, this remains an open question.

What must an employer do to ensure it never pays a Pay or Play Rule penalty? In general, an employer must:

* Offer "Minimum Essential Coverage" under an "eligible employer-sponsored plan" to all its full-time employees (and dependents of those employees) whose household income is between 133% and 400% of the federal poverty level;[11]

* Ensure that the employer's plan provides "Minimum Value"; and

* Ensure that the employee's share of the premium for self-only coverage for the employer's lowest-cost, Minimum Value coverage is "Affordable".

Steps 4 through 6 discuss each of these points.

Step 4: Verify Whether You Offer Minimum Essential Coverage Under an Employer Plan

Most employers with major medical coverage will provide "minimum essential coverage" under an "eligible employer-sponsored plan", as explained in Steps 4(a) and 4(b).

Step 4(a): Verify You Provide Minimum Essential Coverage

"Minimum essential coverage" means coverage under any of the following:

(i) Certain government programs (such as Medicare Part A or Medicaid);
(ii) Coverage under an employer-sponsored plan;
(iii) Plans in the individual market within a State;
(iv) Grandfathered health plan coverage; or
(v) Other coverage recognized by HHS.[12]

Minimum essential coverage does not include coverage under certain excepted benefits.[13] Thus, if the only coverage offered by an employer consists of these benefits, the employer could face a No Offer Penalty under the Pay or Play Rule. These excepted benefits include:

(i) Coverage only for accident, or disability income insurance, or any combination thereof;
(ii) Coverage issued as a supplement to liability insurance;

---

[11] Technically, the lower level limit may be 138%. See Congressional Research Service Report, "Health Insurance Premium Credits in the Patient Protection and Affordable Care Act (PPACA)", n.11 (stating that Medicaid eligibility will be based on up to 138% of the federal poverty level, as a 5% income equivalent is disregarded from individual income).
[12] Code Section 5000A(f)(1).
[13] Code Sections 4980H(a)(1), (b)(1) and 5000A(f)(3).

(iii) Liability insurance, including general liability insurance and automobile liability insurance;
(iv) Workers' compensation or similar insurance;
(v) Automobile medical payment insurance;
(vi) Credit-only insurance;
(vii) Coverage for on-site medical clinics; and
(viii) Other similar insurance coverage, specified in regulations, under which benefits for medical care are secondary or incidental to other insurance benefits.

In addition, an employer does not provide minimum essential coverage if the only coverage offered by the employer consists of one or more of these benefits, where the benefits are provided under a separate policy, certificate or contract of insurance:

(i) Limited scope dental or vision benefits;
(ii) Benefits for long-term care, nursing home care, home health care, community-based care, or any combination thereof;
(iii) Such other similar, limited benefits as are specified in regulations;
(iv) Medicare supplemental health insurance (as defined under section 1882(g)(1) of the Social Security Act);
(v) Coverage supplemental to the coverage provided under chapter 55 of title 10, United States Code; and
(vi) Similar supplemental coverage provided to coverage under a group health plan.[14]

The following benefits also are not minimum essential coverage, but only if they apparently are offered as independent, noncoordinated benefits:[15]

(A) Coverage only for a specified disease or illness; and
(B) Hospital indemnity or other fixed indemnity insurance.

The above list includes many types of health plans which are not traditional, major medical plan coverage. For example, a typical, fully-insured dental or vision plan (which is separate from a major medical plan) is an "excepted benefit" and will not constitute "minimum essential

[14] Code Section 5000A(f)(3)(A), (B). Note that there is some slight confusion caused by the statute's language. Subsection (B) refers to a "separate policy, certificate, or contract of insurance" and also refers to PHSA Section 2791(c)(4), which only refers to a "separate insurance policy", without listing a "certificate" or "contract of insurance". It is unclear if Congress was attempting to distinguish among the different types of insurance policies or contracts.

[15] Code Section 5000A(f)(3)(B) references PHSA Sections 2791(c)(2), (3) or (4) and provides that benefits described in that section are not "minimum essential coverage" if they are provided under a separate policy, certificate or contract of insurance. It is unclear if the additional requirements of PHSA Section 2791(c)(2), (3) or (4) are also included (e.g., that the benefits be offered as "independent, noncoordinated benefits"). Presumably these additional requirements are included, but further guidance from the IRS would be helpful.

coverage." So, if an employer provides only a typical, fully-insured dental or vision plan (without providing any major medical plan) the employer is not offering minimum essential coverage and could face a penalty under the Pay or Play Rule. However, as noted in the following text box, the list seems to fail to include some plans which might be surprising.

Can Our Self-Insured Dental or Vision Plan Constitute "Minimum Essential Coverage"? Perhaps. The above definition of "minimum essential coverage" excludes many typical, fully-insured dental or vision plans. These plans are usually provided under a "separate policy, certificate or contract of insurance" and satisfy this requirement of the exception. However, a self-insured dental or vision plan is not provided under a "separate policy, certificate or contract of insurance". It appears that a self-insured dental or vision plan could be an "eligible employer-sponsored plan" (as discussed in Step 4(b), below). Thus, it appears that a self-insured dental or vision plan could be "minimum essential coverage." This suggests that an employer could avoid the penalty under the Pay or Play Rule by providing a self-insured dental or vision plan. (Note, though, that a self-insured dental or vision plan which is not an "excepted benefit" may need to comply with the full scope of the ACA, such as no dollar limits on essential health benefits.) We suspect this interpretation will not be accepted by the IRS, even though it has a basis under the statute. Further IRS guidance would be helpful.

Step 4(b): Verify You Provide Such Coverage Under an Eligible Employer-Sponsored Plan

An "eligible employer-sponsored plan" includes:

* A governmental plan;
* Any other plan or coverage offered in the small or large group market within a State; or
* A grandfathered health plan offered in a group market.[16]

Note that the above list does not include a self-funded health plan (other than, apparently, a self-funded governmental health plan). However, the preamble to certain proposed IRS regulations states that the IRS expects future regulations will include a self-funded health plan as an "eligible employer-sponsored plan".[17]

The meaning of the term "plan" is not clear. We expect that the term will likely mean an employer must have some minimum involvement with the health benefits being provided to an employee. This would be similar to the definition of "plan" under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Most employers have enough involvement with their health benefit arrangement to cause it to be a "plan".

[16] Code Section 5000A(f)(2).
[17] IRS Proposed Regulations, Health Insurance Premium Tax Credit, 76 Fed. Reg. 50931, 50935 (Aug. 17, 2011).

Bottom Line: The definitions described in Steps 4(a) and 4(b) are likely to be satisfied by most employers who provide major medical health plans to employees. Thus, we expect that most employers offering major medical health benefits to employees will be providing an "eligible employer-sponsored plan" and that these employers will satisfy Step 4.

Step 5: Ensure That Your Plan Provides "Minimum Value"

An employee could potentially receive an Exchange subsidy if the employer's health plan does not provide "minimum value."[18] The statute states that "minimum value" means the "plan's share of the total allowed cost of benefits provided under the plan is less than 60 percent of such costs."[19] No IRS (or other agency) guidance further defines this term.[20]

A few points are worth speculating about. First, the definition seems to allow an employer to exclude certain benefits and treat them as not being "provided under the plan". For example, an employer may exclude chiropractic benefits entirely under a plan. If an employee went to a chiropractor and incurred charges (e.g., $300) it appears that the charges would not be part of the calculation of the total allowed cost of benefits. That is, the $300 in charges would not "count against" the employer when it determines if its plan provided minimum value.

Second, the definition seems to focus on, with respect to covered benefits, the total amount paid by an employee or a dependent versus the total amount paid by the plan. If so, the following example could illustrate how minimum value is determined.

Possible Illustration of "Minimum Value." Client Co. offers a self-funded, major medical plan that covers many (but not all) medical services and procedures. In 2014, Client Co.'s third party administrator reports that Client Co. denied $1,000,000 worth of claims on the ground that the claims were not covered by the plan. Client Co. also paid $12,000,000 in claims, while participants and beneficiaries paid $10,000,000 in claims under the plan (e.g., through co-payments and deductibles). Did Client Co. offer "minimum value" in 2014?

Likely not. The $1,000,000 in non-covered services likely can be ignored and is not a factor in calculating the 60% ratio. The total amount paid under the plan (employer plus participant / beneficiary payments) equals $22,000,000 ($12,000,000 employer payments plus $10,000,000 participant / beneficiary payments). Of the $22,000,000, the "plan's" (presumably, this means "employer's") share of the cost was 54.5% (i.e., $12,000,000/$22,000,000). This amount is lower than the 60% that seems to be required in order to provide "minimum value." Thus, it appears that Client Co. did not provide

[18] Code Section 36B(c)(2)(C)(ii).

[19] Code Section 36B(c)(2)(C)(ii).

[20] In February 2012 the Centers for Medicare and Medicaid Services ("CMS") issued a notice which provides some guidance on how certain plans will calculate actuarial value. This determination is technically made under a separate ACA section so its terms do not directly apply to the 60 percent calculation. However, the terms are similar and may be defined in a similar manner. CMS, Actuarial Value and Cost-Sharing Reductions Bulletin (Feb. 2012) available at http://cciio.cms.gov/resources/files/Files2/02242012/Av-csr-bulletin.pdf.

"minimum value." This opens up the possibility that a full-time employee of Client Co. could obtain subsidized Exchange coverage, which could result in Client Co. having to pay a penalty under the Pay or Play Rule.

In the above example, we calculated "minimum value" on the basis of a year's worth of data. The actual time period to use (e.g., a year or a month) is not clear from the statute. Also, it is not clear whether the "minimum value" amount is determined on a current basis (e.g., the "minimum value" provided in the current year) or a retroactive basis (e.g., the "minimum value" for 2014 would be determined based on 2013 data). Presumably employers would prefer that the data be calculated on a retroactive basis. It could be very difficult for employers to make these determinations on a current year basis. Further IRS guidance would be welcome.

Step 6: Verify the Coverage is Affordable for Employee

Generally, an employee will be able to receive an Exchange subsidy only if the employee's required health plan premium contribution exceeds 9.5% of the employee's household income.[21] Hidden within this general rule, however, are some subtle nuances, such as how "household income" is calculated, what level of coverage is used in the calculation (e.g., the lowest cost plan offered by the employer versus the highest-cost plan offered by the employer) and what type of coverage is used in the calculation (e.g., employee-only versus family coverage). We discuss these nuances in this Step 6.

Step 6(a): What is "Household Income"?

In general, "household income" is the modified adjusted gross income of the employee and any members of the employee's family (including any spouse and dependents) who are required to file an income tax return.[22] "Modified adjusted gross income" means adjusted gross income (within the meaning of Code Section 62) increased by amounts excluded from gross income under Code Section 911 and by the amount of any tax-exempt interest a taxpayer receives or accrues during the taxable year.[23]

This definition of "household income" poses a problem for employers. Employers may know the income (or much of the income) of employees. However, employers usually do not know the income of an employee's spouse and dependents. Thus, an employer would have "practical difficulties" (in the words of the IRS) determining whether a health plan is "affordable" to an employee.[24]

---

[21] Code Section 36B(c)(2)(C)(i)(II).
[22] IRS Notice 2011-73, II, citing Code Section 36B(d)(2)(A).
[23] Code Section 36B(d)(2)(B).
[24] IRS Notice 2011-73, II.

Because of this practical difficulty, the IRS is expecting to issue future guidance which will assist employers. The IRS expects this future guidance will provide that an employer can determine that its health plan coverage is "affordable" by ensuring that the employee portion of the self-only premium for the employer's lowest coverage that provides minimum value does not exceed 9.5% of the employee's W-2 wages.[25]

Note that there are several important points (underlined above):

* The test only focuses on the employee portion of the cost of health plan coverage -- not the employer portion;

* The test only focuses on the cost of self-only coverage, not some other level of coverage (e.g., family coverage). This apparently means an employer could charge more than 9.5% (e.g., 10% or 15%) for self-plus-one or family coverage yet still avoid the penalty under the Pay or Play Rule;

* Coverage which does not provide minimum value is ignored; and

* An employee's W-2 wages are used, which does provide some level of employer control. However, employers may not always precisely know wages in the middle of the year due to bonuses or other variable compensation.

The IRS expects that this determination will be made at the end of the calendar year.[26] For example, an employer would determine whether it met this affordability test for 2014 for an employee by looking at that employee's W-2 wages for 2014 and comparing 9.5% of that amount to the employee's 2014 employee contribution.[27] An employer may be able to adjust an employee's health plan contributions near the end of the year in order to ensure that the employee contribution does not exceed 9.5% of the employee's W-2 wages.[28] An employer also could structure its plan to set employee contributions at a rate which could not exceed 9.5% of the employee's wages (e.g., put into the plan document a rule that "caps" employee contributions at 9.5% of an employee's wages).[29]

This "safe harbor" for employers would not apply to an employee's eligibility for an Exchange subsidy. In other words, some individuals will be deemed to have "affordable" employer coverage for purposes of the employer penalty under the Pay or Play Rule. For these

[25] IRS Notice 2011-73, II.
[26] IRS Notice 2011-73, II.
[27] IRS Notice 2011-73, II.
[28] IRS Notice 2011-73, II.
[29] See IRS Notice 2011-73, II.

employees, the employer will not owe the penalty tax. However, those same employees may still qualify for an Exchange subsidy.[30]

Step 7: Determine How Penalty is Calculated

As illustrated in Exhibit A and discussed in Step 1, two penalties are possible:

* No Offer Penalty: If an employer does not offer minimum essential coverage to all full-time employees (and dependents) the employer must pay an annual tax of $2,000 for each full-time employee (less the first 30 full-time employees), if at least one full-time employee obtains federally-subsidized coverage through an Exchange.

* Unaffordable Coverage Penalty: If an employer does offer minimum essential coverage to all full-time employees but at least one full-time employee obtains federally-subsidized coverage through an Exchange, the employer must pay an annual tax of the lesser of: (1) $3,000 per subsidized full-time employee; or (2) $2,000 for each full-time employees (less the first 30 full-time employees)

Note that the penalty is sometimes applied based on all of an employer's full-time employees and other times based on the number of full-time employees who receive an Exchange subsidy. In nearly all situations, an employer who must pay a penalty would prefer the latter (based on full-time employees who receive an Exchange subsidy) rather than the former (based on all full-time employees). The latter will nearly always be a lesser amount. (Of course, many employers will not want to pay any Pay or Play Rule penalty and will structure their plans to ensure that they do not pay any such penalty.)

Step 7(a): Determine Who is a "Full-Time" Employee for Penalty Purposes

In Step 2(d)(i) we discussed who was a "full-time" employee for purposes of determining whether an employer was subject to the Pay or Play Rule. It appears that those same rules generally will apply for purpose of the Pay or Play Rule penalty. In addition, the IRS has provided some additional guidance, especially for new employees (discussed in this Step 7(a)) and employees who are excluded based on a waiting period (discussed in Step 7(b)). This guidance is illustrated as a flowchart in Exhibit B. Note that the term "new" is not defined and could be unclear in some situations (e.g., whether a laid-off employee who is brought back would be considered a "new" employee).

[30] IRS Notice 2011-73, II. For example, an employee's household income may be less than W-2 wages due to adjustments to gross income for alimony paid or losses due to self-employment. Such an employee may qualify for subsidized Exchange coverage. The proposed IRS safe harbor would not penalize the employer in this situation.

This guidance, although incomplete, is helpful for employers. It allows employers some certainty in determining who is a new, full-time employee. In essence, the guidance allows an employer a "free look" of at least three months to determine whether a new employee is a full-time employee.[31] Note, however, that the guidance could require an employer to make a rapid calculation of this determination every three months (by examining the average hours in the prior three months). The guidance is not formal guidance and could be changed in the future.

It appears that the agencies will also allow waiting periods which are not based on a set number of days passing. Future guidance is expected to allow waiting periods based on receipt of a license, completion of a cumulative number of hours of service and perhaps other factors.[32]

Step 7(b): Determine Which Employees can be Excluded Based on Waiting Period

The ACA generally requires that a health plan cannot impose a waiting period that exceeds 90 days.[33] However, this rule will not require an employer to offer coverage to all employees after the employee has worked 90 days. For example, an employer may exclude part-time employees under the plan. This 90-day waiting period rule would not require the employer to cover part-time employees (whether or not the employees have worked for 90 days).[34]

Future agency guidance is expected to address which employees can be excluded from the 90-day waiting period rule under other situations (such as when an employee must complete 750 hours (or some other number) to participate).[35]

As illustrated in Exhibit B, this 90-day waiting period (which is essentially interpreted as 3 months, although there can be a difference) interacts with the Pay or Play Rule and usually reduces an employer's potential Pay or Play Rule penalty.

Step 7(c): Consider Nondiscrimination and Coverage Rules

Note that this Step 7 does not address an important point: nondiscrimination and coverage rules. Self-funded health plans are subject to Code Section 105(h). This Section limits an employer's ability to discriminate in favor of "highly compensated individuals."

Similarly, the ACA prohibits discrimination for non-grandfathered, fully-insured health plans.[36] This nondiscrimination rule was originally set to become effective for plan years beginning on

[31] The phrase "free look" is our term, not an agency term.
[32] Technical Release 2012-1, Q&A 7.
[33] PHSA Section 2708, as added by ACA Section 1201.
[34] Technical Release 2012-1, Q&A 6.
[35] Technical Release 2012-1, Q&A 7.
[36] PHSA Section 2716.

or after September 23, 2010 (i.e., January 1, 2011 for a calendar year plan). However, the IRS delayed the effective date until the IRS or other agencies have issued guidance.[37]

Excluding groups of individuals (such as part-time employees) can sometimes cause a plan to fail the tests under Code Section 105(h). Presumably the same will be true for fully-insured health plans. A discussion of the full requirements of these rules is beyond the scope of this Pay or Play Guide.

Step 7(d): Examples of Common Scenarios

Now that you have a good understanding of the rules, a few examples will help apply the rules to "real-world" situations.

Example 1: Seasonal Employees

City has 1,000 year-round, full-time employees. During its busy summer months, City hires 200 seasonal, full-time employees and 100 seasonal, part-time employees. City offers a good health plan (one that provides "minimum value" and is "affordable") to its year-round employees. However, City does not offer any health plan coverage to its seasonal employees (whether full-time or part-time). Will City face a Pay or Play Rule penalty?

Probably not. There will not be any penalty for the year-round, full-time employees because City has structured its plan to ensure that no penalty is possible. Also, there will not be any penalty for the seasonal, part-time employees, since no Pay or Play Rule penalty is possible for part-time employees.

The main risk for City lies with its seasonal, full-time employees. As discussed in Step 7(a) and Exhibit B, City can examine whether these employees' full-time hours are "representative" of the hours the employee will work on an annual basis. Presumably City will determine that the full-time hours are not representative. This is because the employees are not expected to be employed (much less have full-time hours) on an annual basis. Thus, City will likely not have any Pay or Play Rule penalty for these employees.[38]

Example 2: Short Duration Employees

Call Center Inc. has 2,000 full-time employees: 200 management and 1,800 call center operators. All the employees are full-time. Call Center Inc. offers a good health plan (one that satisfies the "minimum value" standard and is "affordable"). However, the health plan is only offered to management employees, not call center operators. The turnover rate among call center operators is high -- the typical length of employment is six months. Will Call Center Inc. face a risk of incurring a Pay or Play Rule penalty?

[37] IRS Notice 2011-1.

[38] A similar conclusion was reached in Technical Release 2012-1, Q&A 5, Ex. 2.

Yes, there is some risk. Call Center Inc. has structured its plan so it will not face a penalty for its management employees. For the call center operators, Call Center Inc. has a "free look" for each new employee's first 3-month period (see Exhibit B). During those first three months, Call Center Inc. cannot face a Pay or Play Rule penalty, even though the employee: (a) is full-time; and (b) Call Center Inc. is not offering any health plan coverage. Thus, Call Center Inc. will not have any Pay or Play Rule penalty during the first three months of each new call center operator's employment.

However, Call Center Inc. is at risk after the end of this 3-month period (i.e., starting in month 4 of each employee's employment). As noted in Exhibit B, the call center operators will be "full-time" employees in month 4. These employees will not be offered affordable health coverage and therefore may be eligible to obtain Federally-subsidized Exchange coverage. (Of course, Call Center Inc. could get "lucky" and none of the call center operators may go to the Exchange, or perhaps none would be eligible for subsidized Exchange coverage due to household income that exceeds 400% of the federal poverty level.)

Current guidance suggests - but does not clearly state - that Call Center Inc. may be able to impose a waiting period beyond the typical 3-month waiting period. For example, Call Center Inc. may be able to require each call center operator to work a certain number of hours before becoming eligible to participate in the health plan. Call Center Inc. should monitor this future guidance - it could allow Call Center Inc. to redesign its eligibility criteria and make it less likely it will face a Pay or Play Rule penalty.

Example 3: Pay AND Play

Generous Co. has 1,000 full-time employees. Generous Co. offers excellent health plan coverage to 990 of these employees. However, a small group of 10 employees in a remote location have never been offered coverage. All employees are full-time. Could Generous Co. face a penalty? If so, how much?

Yes, a penalty is possible. The 10 full-time employees may be eligible for subsidized Exchange coverage. Of course, there could be some exceptions. Some of the 10 employees may have been recently hired (and would still be in the 3-month "free look" period") and some may have W-2 wages which are above 400% of the federal poverty level.

If the penalty applies, Generous Co.'s annual penalty would be about:

((1,000 - 30) = 970) x $2,000 = $1,940,000

Note that we say "about" because some of Generous Co.'s 1,000 employees will probably be new employees and, presumably, the Pay or Play Rule penalty would not apply while they are in the "free look" period.

Note also that Generous Co. is facing a large penalty considering that it provides a rich health plan to 99% of its employees. In essence, Generous Co. is facing the worst of all worlds -- providing expensive health coverage for the vast majority of employees, yet still paying the Pay or Play penalty! Generous Co. should strongly consider restructuring how it treats the 10 employees in order to ensure that Generous Co. could not face a Pay or Play Rule penalty.

Step 8: Review Strategic Considerations

With a January 1, 2014 effective date for the Pay or Play Rule, employers will likely need to consider potential strategies and plan design revisions in either their 2012 or 2013 renewals, especially if the plan is collectively-bargained.

Employers will need to consider a variety of "soft" factors (e.g., non-monetary factors like employee morale) and "hard" factors (e.g., Pay or Play Rule monetary penalties). While the hard factors will be easier to quantify than the soft factors, we recommend conducting a thorough evaluation of both.

Some of the hard factors are as follows:

- Estimate Potential Penalties – Review the $2,000/$3,000 penalties and determine if you want to restructure the workforce to move more individuals from full-time to part-time status or modify plan design to ensure it provides minimum essential coverage and is affordable. Consider whether such changes raise legal concerns

- Conduct an Analysis on Current Employee Population – Estimate how many employees would likely qualify for the federal Exchange subsidy and potentially adjust contributions and/or hours worked

- Evaluate the Tax Impact – Employers currently receive up to a 40% tax savings under the employer-provided health plan system -- would an employer's tax liability increase if they no longer sponsored a health plan?

- Approximate Additional Compensation Scenarios – Would you need to increase an employee's compensation if you no longer provided health plan benefits?

Softer factors include a potential loss of control over employee health, productivity, and behavior. These could be a deterrent to employers considering eliminating health plan coverage. Other soft factors that employers could face are reduced employee morale and retention since it could be difficult to attract and retain qualified employees due to the lack of health plan coverage.

These decisions will involve sensitive human resources, benefits consulting and legal issues. We expect many employers will work closely with their benefits consultants and legal team to identify and implement a strategy. For Quarles & Brady LLP clients, we encourage you to contact one of the Employee Benefits attorneys listed on the front cover to review questions or discuss possible strategies.

Exhibit A

Will the Employer Pay A Penalty?

Note: Tech. Rel. 2012-01 not included

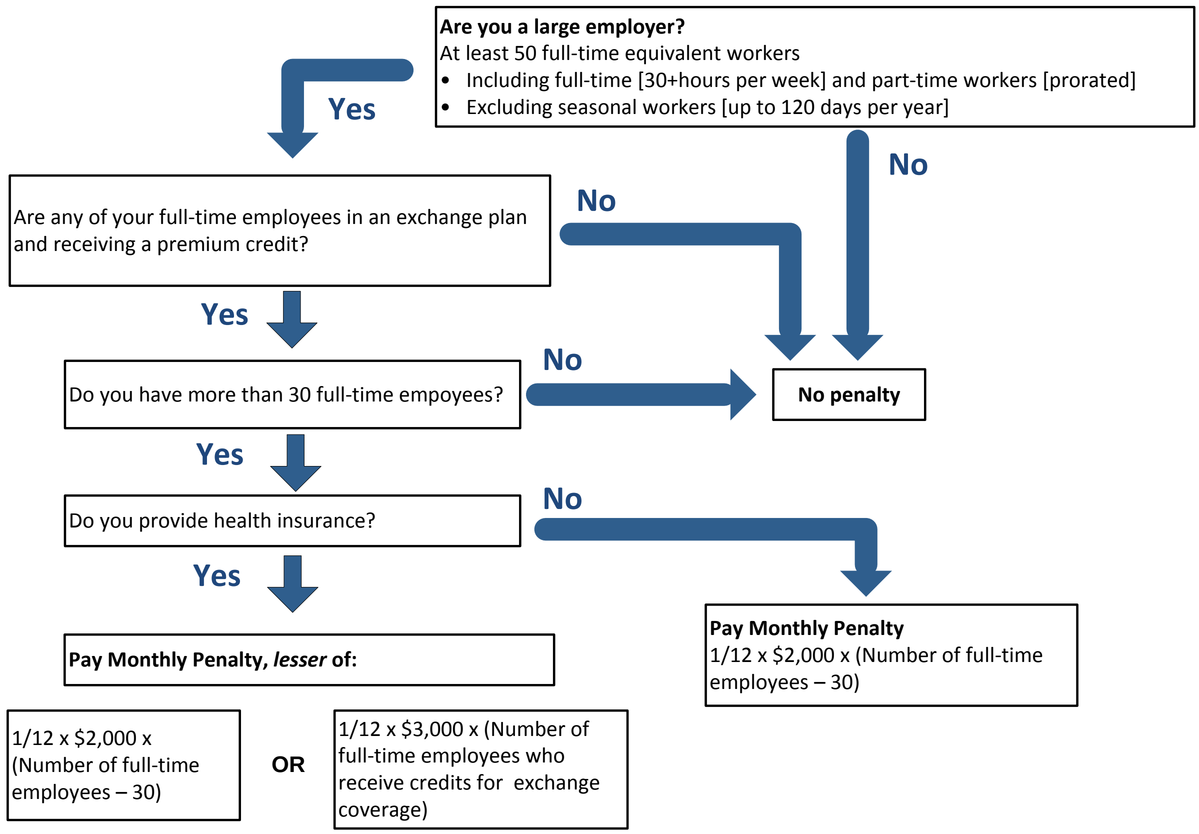
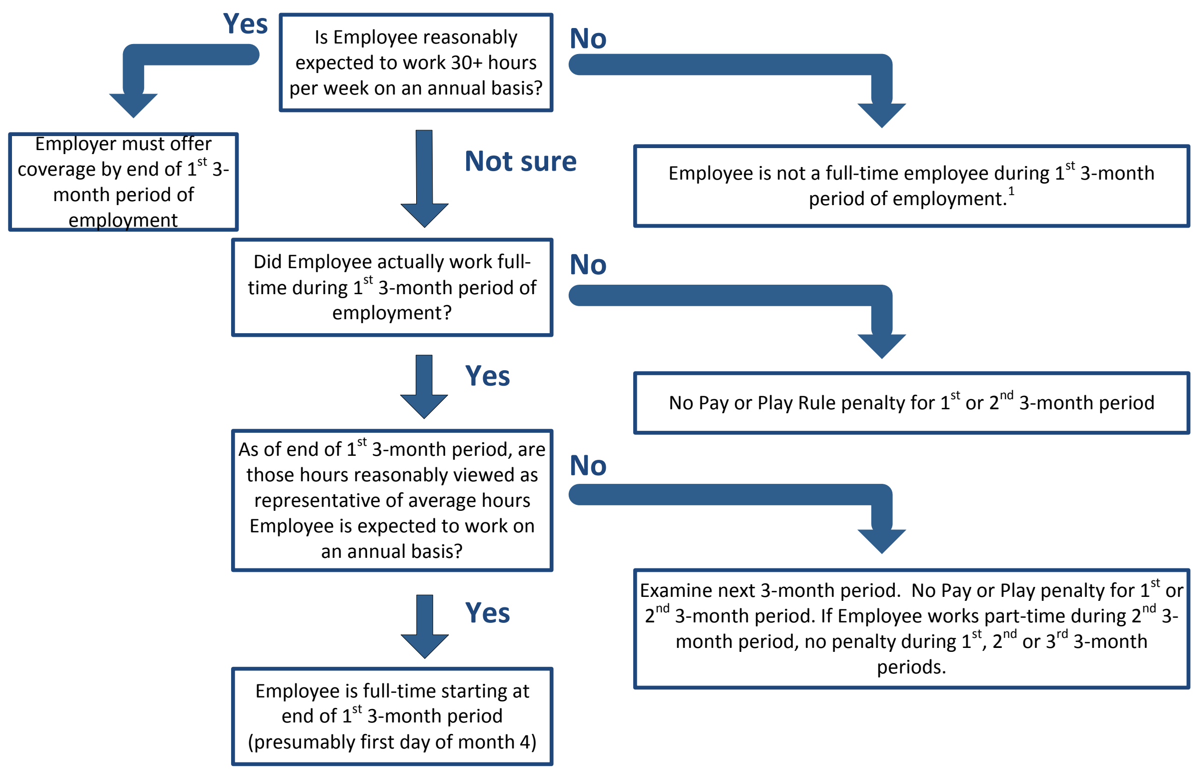


Exhibit B

Is a New Employee a "Full-Time" Employee?



[1]The test seems to focus on the employer's "reasonable expectation" of 30+ hours per week on an annual basis, not the employee's actual hours worked. Technical Release 2012-1, Q&A 5.

Appendix (Additional Detail for Step 2)

Step 2(a): Include Employees in Controlled Group

All employees of a controlled group under Code Sections 414(b) or 414(c) are considered when determining whether an employer is a "large" employer.[39] These are the "controlled group" rules which often apply in the retirement plan context (e.g., for many retirement plan nondiscrimination tests).

In addition, entities that are part of an affiliated service group under Code Section 414(m) are also included in determining whether an employer is a "large" employer.[40] An affiliated service group generally exists when multiple employers are linked together through joint activity or a combination of common ownership and joint activity.[41]

Controlled Group Rules and the Small Employer Exception. Edna the Entrepreneur has 100% ownership of Edna Inc., a company which had 200 full-time employees in 2012. Edna is very concerned about the Pay or Play Rule, as Edna Inc. does not offer health insurance. Edna proposes dividing Edna Inc. into five separate companies of 40 employees in 2013. Edna would maintain 100% ownership of all five companies. Edna believes this strategy will ensure that none of the companies will be subject to the Pay or Play Rule. Is Edna correct?

Probably not. Because Edna has 100% ownership of all five companies, there is a "controlled group" of companies. The number of full-time employees would be aggregated. If, together, all five companies had 200 full-time employees in 2013, each of the companies would be a "large" employer. This is true even though each of them, by themselves, only had 40 employees.

Step 2(b): For New Employer, Determine Expected Number of Employees

As noted above, the employer's size is generally determined based on the number of full-time employees in the prior calendar year. What if the employer did not exist for the entire prior year? The Pay or Play Rule provides that such an employer can still be a "large" employer that is subject to the Pay or Play Rule if the employer "reasonably expects" to employ an average of at least 50 full-time employees (taking into account FTEs) during the current calendar year.[42] It is unclear how an employer would determine if it "reasonably expects" to employ an average of at least 50 full-time employees. It is also unclear what happens if an employer's reasonable expectation changes over time. For example, an employer may reasonably determine in January 2014 that it will employ 48 full-time employees for the year. However, suppose that in

[39] Code Section 4980H(c)(2)(C)(i).
[40] Code Section 4980H(c)(2)(C)(i).
[41] The full definition of "affiliated service group" is complex and beyond the scope of this Guide. See Code Section 414(m)(2).
[42] Code Section 4980H(c)(2)(C)(ii).

March 2014 the employer forecasts additional sales and projects hiring 5 new full-time employees by August 2014. Is the employer's "reasonable expectation" determined on a "snapshot" basis at the beginning of the year (e.g., only in January 2014, not in March or August 2014)? Or is it determined on a "daily" basis (e.g., every day in 2014, so the answer could vary from day-to-day)? No IRS guidance clarifies this question. However, future IRS guidance is expected.[43]

Step 2(c): Consider Predecessor Employer

When determining whether an employer is subject to the Pay or Play Rule, the employer must also consider a "predecessor" employer.[44] No IRS guidance clarifies what this term means. Perhaps the rule is intended to prevent an employer from making a minor change in corporate form, then claiming that it is a "new employer" that is subject to the "new employer" rules discussed above. Further IRS guidance would be helpful.

Step 2(d): Include FTE Employees

The Code requires that FTE employees be considered when determining if an employer is a "large" employer. Many employers will employ at least 50 full-time employees during the prior calendar year. These employers need not consider FTE employees.

However, some employers will employ fewer than 50 full-time employees but have some part-time employees. These employers must engage in a mathematical determination of their "large" employer status. This FTE calculation states that an employer generally will be "large" if, with respect to the prior calendar year:[45]

[Average number of full-time employees] + [Average number of FTE employees] > 49

Each calculation is explained below.

Step 2(d)(i): Determine Average Number of Full-Time Employees

For purposes of determining whether an employer is subject to the Pay or Play Rule, a "full-time" employee is determined on a monthly basis.[46] Thus, an employee whose hours fluctuate over the year may be a "full-time employee" for some months (e.g., perhaps during a "busy season" such as October, November and December), but not be a "full-time employee" in other months (e.g., January through September). If the employee is not a "full-time employee"

[43] IRS Notice 2011-36 is a request for comments. The IRS expects to receive industry comments then provide additional guidance.
[44] Code Section 4980H(c)(2)(C)(iii).
[45] Code Section 4980H(c)(2)(A), (E).
[46] IRS Notice 2011-36, IV.B.

during some months, the individual still will count as an FTE employee during those months. Thus, you would need to "count" such an employee under Step 2(d)(ii), below.[47]

The term "full-time" means a person who is "employed on average at least 30 hours of service per week."[48] The IRS seems to believe that determining a "30 hours per week" standard may be difficult for employers. The IRS has proposed that this determination be based on 130 hours of service in a calendar month.[49]

"Hours" of service are generally determined based on hours for which an individual is entitled to payment. This can include hours actually worked, along with paid vacation hours. The proposed IRS standard is:

> (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.[50]

The IRS has also indicated that the 50-full-time-employee standard is an "average" number, determined over the course of the year. This calculation is illustrated below.

Illustration of Month-to-Month Determination. Client Co. had 49 full-time employees in 2013 and one employee, B, whose hours fluctuated significantly in 2013. The first four months B worked 100 hours per month. The next four months he worked 130 hours per month. The final four months he worked 160 hours per month. For how many months in 2013 was B a "full-time" employee? Will Client Co. be subject to the Pay or Play Rule in 2014?

B was a "full-time" employee for eight months: the four months when he worked 130 hours per month and the four months he worked 160 hours per month. Thus, Client Co. had 50 full-time employees for eight months in 2013. Client Co. also had 49 full-time employees and a FTE employee (again, B) for four months. As discussed below in Step 2(d)(ii), the FTE calculation reveals that B is treated as an .833 FTE for each of the four months when he worked 100 worked. Client Co.'s average number of full-time employees equals:

[47] IRS Notice 2011-36, IV.B. (noting that "An employee who is not a full-time employee under this standard (including a seasonal employee) for a given month is taken into account in the FTE calculation.").
[48] Code Section 4980H(c)(2)(E).
[49] IRS Notice 2011-36, IV.B.
[50] IRS Notice 2011-36, III.C. This standard is based on 29 CFR Section 2530.200b-2(a). Note that the IRS expects that no more than 160 hours of service would be counted for an employee on account of any single continuous period during which the employee was paid or entitled to payment but performed no duties. IRS Notice 2011-36, III.C.

Month	Full-time Employees + FTEs for Month
January	49.833
February	49.833
March	49.833
April	49.833
May	50
June	50
July	50
August	50
September	50
October	50
November	50
December	50
Yearly Total	599.332
Average Per Month (Yearly Total / 12)	49.94

The IRS guidance states that fractions (i.e., the ".94" here) are ignored and the number is rounded down for purposes of determining whether the Pay or Play Rule applies.[51] Thus, Client Co. has 49 total full-time plus FTE employees. Client Co. will not be subject to the Pay or Play Rule in 2014.

Note that Client Co. does not, under the month-to-month determination method, examine B's average hours over the year. If Client Co. did so, B would likely be a full-time employee for the entire year. This is because B's average hours for the year were 130 hours ((100 x 4) + (130 x 4) + (160 x 4) / 12 = 130 hours average per month). Under this calculation, B would count as a full-time employee and Client Co. would have 50 full-time (and FTE) employees. Client Co. therefore would be subject to the Pay or Play Rule. As discussed below, this "entire year" or "Stability Method" calculation method (in lieu of the month-to-month calculation method) is an option the IRS is considering.

One proposal the IRS is considering would eliminate the "month-to-month" determination of full-time employee status and replace it with a "look-back / stability period safe harbor" (the "Stability Method").[52] Under the Stability Method, an employer would determine each employee's full-time status by looking back at a defined period of work, called the "measurement period."[53] The employer could select the length of this period, as long as the period was at least three calendar months (but no longer than twelve consecutive calendar months).[54]

Illustration of Stability Method. Stable Co. uses a 6-month measurement and stability period for 2014. Stable Co. would have a measurement period running from January 1, 2014 through June 30, 2014. It also would have a stability period running from July 1, 2014 through December 31, 2014.

[51] IRS Notice 2011-36, IV.C.
[52] IRS Notice 2011-36, V. See also Technical Release 2012-1.
[53] IRS Notice 2011-36, V.
[54] IRS Notice 2011-36, V. See also Technical Release 2012-1, Q&A 4.

Like the month-to-month method discussed above, Stable Co. will determine each employee's full-time status by looking back to determine whether the employee averaged at least 30 hours of service per week from January 1, 2014 through June 30, 2014. To do so, Stable Co. will add up the total hours of service for each employee during that six-month period, then divide the total by the number of weeks in the measurement period. (The IRS guidance is not clear about how to treat partial weeks.)[55] For each employee who is determined to be a full-time employee, his or her status will remain a "full-time employee" from July 1, 2014 through December 31, 2014. This is true even if the employee significantly reduces her hours -- e.g., goes from working 40 hours per week to 10 hours per week.

If the employee terminates employment, it appears that the employee is no longer counted.[56] If so, this could present an interesting planning opportunity for employers with high-turnover workforces. Some employers may be able to have well over 50 full-time employees (e.g., 100 employees) during the look-back period but never have many of those employees "count" because the employees terminate employment prior to entering the stability period. Perhaps such an employer could avoid the Pay or Play Rule penalty. Further IRS guidance would be helpful.

As was discussed in Step 7, the IRS has provided some guidance on when a newly-hired employee will be a "full-time" employee for purposes of the Pay or Play Rule penalty. It is unclear whether this same determination would apply for determining whether an employer is subject to the Pay or Play Rule in the first place.[57]

Step 2(d)(ii): Determine Average Number of FTE Employees

If an employer has less than 50 full-time employees, as determined above, the employer must calculate the number of FTE employees it had during the prior calendar year. Any employee (including but not limited to seasonal employees) who was not a full-time employee for any month in the preceding calendar year is included in calculating the employer's FTEs for a month.[58] Thus, for each month (if the employer is using the month-to-month determination method, as discussed above) or for each look-back period (if the employer is using the Stability Method, as discussed above) an employee must be classified as either a full-time employee or an FTE -- there is no other classification.

To determine an employer's number of FTEs for each calendar month in the preceding calendar year the employer must:

---

[55] IRS Notice 2011-36, V and Example 6.
[56] IRS Notice 2011-36, V (noting that the employee's status remains fixed "so long as he or she remained an employee").
[57] For example, Technical Release 2012-1, Q&A 5 provides a special "free look" for newly-hired employees, where no Pay or Play Rule penalty will apply for failing to offer health plan coverage, even for employees who are expected to work full-time and do work full-time during the first three months of employment. However, Technical Release 2012-1 phrases the guidance in terms of the Pay or Play Rule penalty, not whether the Pay or Play Rule applies. Further guidance would be helpful.
[58] IRS Notice 2011-36, IV.C.

(1) Calculate the aggregate number of hours of service (but not more than 120 hours of service for any employee) for all employees who were not full-time employees for that month;

(2) Divide the total hours of service from Step 1 by 120. The result is the number of FTEs for the calendar month. Do not drop any fractional amounts;

(3) For each month add the total number of full-time and FTE employees;

(4) Add the numbers for each month to reach a yearly total; and

(5) Divide the yearly total by 12, then disregard any fractions. The result is the number of full-time and FTE employees. If the result is 50 or more, the employer is subject to the Pay or Play Rule.

Illustration of Calculating Number of FTE Employees. Farmer Inc. has 40 full-time employees from January through December 2013. Farmer Inc. also has 30 additional employees who assist during the busiest time of the year, a five-month period from May through September. Ten of the 30 employees work 100 hours per month during those five months, while twenty of the 30 employees work 125 hours per month. How many FTEs does Farmer Inc. have? Is Farmer Inc. subject to the Pay or Play Rule?

Farmer Inc. would calculate its FTEs as follows:

(1) Aggregate Hours. The aggregate hours for each of the five months will equal: [(10 employees x 100) + (20 employees x 120)] = 1,000 + 2,400 = 3,400 aggregate hours per month. Note that the maximum number of hours considered is 120, even though twenty of the employees actually worked more (here, 125 hours). The extra five hours (125 - 120) are ignored.

(2) Divide by 120. Divide the aggregate hours (3,400) by 120. The result is 28.33, which is the FTE number for each month.

(3) Add Full-Time Employees. Now add to the FTE number (28.33) the number of full-time employees for that month (here, 40). For May through September, Farmer Inc. has 68.33 employees who are counted (full-time plus FTE).

(4) Add Each Month. Now add up the numbers for each month.

Month	Total Counted Employees (Full-Time + FTE)
January	40
February	40
March	40
April	40
May	68.33

June	68.33
July	68.33
August	68.33
September	68.33
October	40
November	40
December	40
Total for Year	621.65

(5) Divide by 12. Now divide the yearly total by 12. 621.65 / 12 = 51.80. The fraction (.80) is disregarded. Farmer Inc. has 51 counted employees (full-time plus FTE). Farmer Inc. is subject to the Pay or Play Rule because it has at least 50 counted employees.

There is one additional exception that could exempt an employer, if the employer employs seasonal workers (as defined by 29 CFR Section 500.20(s)(1)) or retail workers employed exclusively during holiday seasons.[59] If an employer's workforce exceeds 50 full-time and FTE employees, but only for 120 days or fewer during a calendar year, and the employees in excess of 50 who were employed during that period of no more than 120 days were seasonal employees, the employer is not a large employer.[60] For these purposes, "120 days" will be treated as the equivalent of four calendar months.[61] The following example illustrates this exception.

Illustration of Calculating Number of FTE Employees. Farmer Inc.'s neighbor is Neighbor Farmer Inc. Neighbor Farmer Inc. has 40 full-time employees from January through December 2013. Neighbor Farmer Inc. has 50 (not 30, as Farmer Inc. does) additional employees who assist during the busiest time of the year, a four-month period from May through August. Twenty of the 50 employees work 100 hours per month during those four months, while thirty of the 50 employees work 125 hours per month. All the employees are "seasonal" employees within the meaning of 29 CFR Section 500.20(s)(1). How many FTEs does Neighbor Farmer Inc. have? Is Neighbor Farmer Inc. subject to the Pay or Play Rule?

Neighbor Farmer Inc. would calculate its FTEs as follows:

(1) Aggregate Hours. The aggregate hours for each of the four months will equal: [(20 employees x 100) + (30 employees x 120)] = 2,000 + 3,600 = 5,600 aggregate hours per month. Note that the maximum number of hours considered is 120, even though thirty of the employees actually worked more (here, 125 hours). The extra five hours (125 - 120) are ignored.

(2) Divide by 120. Divide the aggregate hours (5,600) by 120. The result is 46.66.

[59] IRS Notice 2011-36, IV.D.
[60] Code Section 4980H(c)(2)(B); IRS Notice 2011-36, IV.D.
[61] IRS Notice 2011-36, IV.D.

(3) Add Full-Time Employees. Now add to the FTE number (46.66) the number of full-time employees for that month (here, 40). For May through August, Neighbor Farmer Inc. has 86.66 employees who are counted (full-time plus FTE).

(4) Add Each Month. Now add up the numbers for each month.

Month	Total Counted Employees (Full-Time + FTE)
January	40
February	40
March	40
April	40
May	86.66
June	86.66
July	86.66
August	86.66
September	40
October	40
November	40
December	40
Total for Year	666.64

(5) Divide by 12. Now divide the yearly total by 12. 666.64 / 12 = 55.55. The fraction (.55) is disregarded. Neighbor Farmer Inc. has 55 counted employees (full-time plus FTE). This is above the typical 50-employee limit. However, we need to add an additional step -- Step 6, below -- to determine if Neighbor Farmer Inc. satisfies the seasonal employee exception noted above.

(6) Examine Seasonal Employee Exception. The seasonal employee exception is limited to employees who were employed for a maximum of a 120-day period. Here, the time period (May - August) technically exceeds 120 days (it equals 122 days). IRS guidance, however, provides that the extra two days are ignored, since there are only four calendar months involved. Thus, the "120-day" standard is satisfied.

Here, all the employees in excess of 50 are seasonal employees. (Remember, Neighbor Farmer, Inc. only has 40 year-round, full-time employees.) Thus, all the criteria for the seasonal employee exception are satisfied. Neighbor Farmer Inc. is not subject to the Pay or Play Rule, even though it has 55 counted employees (full-time plus FTE).