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Employee Benefits & Executive Compensation ADVISORY ■

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IRS Issues Game-Changing Regulations Interpreting Health Care Reform's Pay or Play Requirement (Updated March 26, 2013)

Beginning in 2014, "applicable large employers" become subject to new rules prescribed in Internal Revenue Code Section 4980H ("4980H Rules"), which were added by Section 1513 of the Patient Protection and Affordable Care Act (ACA). These new 4980H Rules impose a confiscatory excise tax on employers who fail to offer certain coverage to full-time employees if at least one full-time employee receives a premium tax credit or cost share reduction ("Premium Subsidy") for coverage in an "Exchange" established pursuant to the new ACA rules. These new 4980H Rules are often referred to as the "employer shared responsibility requirements" or the "pay or play" requirements. Now, less than a year before these game-changing rules go into effect, the IRS has issued comprehensive proposed regulations (the "Proposed Rules") that give much-needed substance to the new rules. The IRS also issued a set of FAQs that helps make the otherwise complex Proposed Rules more palatable.

UPDATE: Since we last issued this advisory, several key regulations have been issued by HHS and the IRS, such as regulations that address the minimum value calculation and regulations that define eligible employer sponsored plan. These regulations impact the 4980H rules; therefore, we felt it important to update the advisory to reflect these new regulations. Informal discussions with agency officials have also prompted additional clarifications in the advisory. Last, we have incorporated a chart that analyzes the differences between the hours of service rules for pension plans and the 4980H Rules.

Although questions still remain, the Proposed Rules begin to answer the following fundamental, compliance-related questions arising with respect to the 4980H Rules:

- Am I an applicable large employer? Only applicable large employers are subject to the new 4980H Rules and the Proposed Rules provide much-needed guidance on how to make that determination.

- Who are my full-time employees? 4980H penalties are assessed only with respect to coverage offered or not offered during a month by applicable large employers to full-time employees, as defined by Code Section 4980H. The Proposed Rules provide valuable assistance to employers by defining hours of service and substantially incorporating the look-back safe harbor prescribed under prior IRS guidance (in IRS Notice 2012-58).

- How much in penalties do/will I owe? There are two mutually exclusive penalties—a penalty for failing to offer minimum essential coverage under an eligible employer sponsored plan to full-time employees (the "Sledgehammer Penalty") and a smaller (at least in the aggregate) penalty (the "Tackhammer Penalty") that may apply where minimum essential coverage is offered to full-time employees during a month but it is not affordable or it doesn't provide minimum value. The Proposed Rules clarify when coverage is considered offered to a full-time employee for a month, when it is considered affordable and how to calculate the penalty, when applicable.

It goes without saying that the 4980H Rules will have a significant impact on group health plan coverage offered in 2014 and the answers to the questions above are critical to identifying that impact and strategically planning for it. The Proposed Rules go a long way toward answering those questions. This overview identifies the highlights of the Proposed Rules and provides a comprehensive summary with the goal of helping employers and their advisors better understand the 4980H Rules and the impact the rules will have.

Practice Pointer: It is tempting to consider the 4980H Rules as a mandate either to offer coverage to full-time employees or a mandate to offer full-time employees a certain level of coverage. The 4980H Rules simply prescribe penalties if certain coverage is not made available to full-time employees. Thus, compliance with 4980H is merely identifying the amount of penalty owed, if any. Applicable large employers are free to offer whatever coverage they desire to whomever they desire—albeit subject to a potential penalty identified in accordance with the 4980H Rules. Although counterintuitive, the applicable penalty may be less abhorrent in some cases than the plan-related changes necessary to avoid the penalties. Employers who view 4980H as a coverage mandate will focus primarily on avoiding the penalties, regardless of the cost, instead of identifying the potential penalties and comparing that to the cost to avoid the penalties.

A. Highlights of the Proposed Rules

The IRS has issued several key pieces of guidance and requests for comments regarding the 4980H Rules over the last two years, including but not limited to the safe harbor method for identifying full-time employees in Notice 2012-58. The Proposed Rules are a culmination of the prior guidance with critical clarifications and transition rules that should better enable employers to plan for 2014. Highlights of the Proposed Rules include the following:

- The Proposed Rules provide a transition rule for 2014 that enables employers to use a period of at least six consecutive calendar months in 2013 to determine if they are an applicable large employer for 2014—a determination that is typically based on the entire <u>preceding</u> calendar year. See the "Applicable Large Employer" section below for more details.

- The Proposed Rules confirm that the controlled group rules in Internal Revenue Code Sections 414(b),(c),(m) and (o) apply to determine if an employer is an applicable large employer subject to the 4980H Rules. Moreover, the Proposed Rules clarify that the safe harbor method for identifying full-time employees for purposes of 4980H compliance does NOT apply for purposes of the applicable large employer determination.

- The Proposed Rules largely incorporate the safe harbor method for identifying full-time employees described in Notice 2012-58, with a few clarifications. For example, the Proposed Rules clarify how breaks in service are treated for purposes of the applicable measurement and stability periods. Also, employers who generally desire to use a 12-month stability period beginning in 2014 may nevertheless use a shorter determination (or measurement) period beginning in 2013, so long as the measurement period begins on or before July 1, 2013, and is at least six months long.

Practice Pointer: Employers who must begin complying with 4980H on January 1, 2014, should not wait until July 1, 2013, to begin the standard measurement period for 2014 if they desire to have any administrative period between the measurement period and the subsequent stability period. For example, calendar year plans wishing to hold annual enrollment in October would need to start counting hours in April.

- The Proposed Rules prescribe specific hours of service rules for both hourly and non-hourly employees. Until further guidance is issued, flexibility is provided for calculating the hours of service of commissioned employees, adjunct faculty, transportation employees (e.g., airline pilots) and employees in similar positions. Also, employers are not required to consider hours of service performed outside of the United States, which is defined to include only the 50 states and D.C. See the "Identifying Full-Time Employees" section below for more details.

- The Proposed Rules do NOT provide guidance on what type of coverage qualifies as minimum essential coverage under an eligible employer sponsored plan (as generally defined in Code Section 5000A(f)(2)); however, subsequently issued proposed regulations from the IRS define "eligible employer sponsored" plan very broadly. See the "Assessing Penalties" section below for more details.

- Although applicable large employer status is determined on a controlled group basis, compliance with 4980H is determined on a controlled group member basis ("applicable large employer member"). Thus, penalties, if any, are assessed on each individual applicable large employer member based on that applicable large employer member's full-time employees—<u>and only that applicable large employer member's full-time employees</u>. As a result of this clarification, an applicable large employer member's failure to offer minimum essential coverage to its full-time employees does not jeopardize other members of the controlled group. See the "Assessing Penalties" section below for more details.

- An applicable large employer member avoids the Sledgehammer Penalty if it offers minimum essential coverage through an eligible employer sponsored plan to at least 95 percent of its full-time employees (and their dependents). NOTE: If you offer minimum essential coverage through an eligible employer sponsored plan to 95 percent of your full-time employees (and their dependents) but not to 100 percent, then you may be subject to the Tackhammer Penalty with respect to those full-time employees to whom you did not offer coverage if they enroll in the Exchange and receive a Premium Subsidy. See the "Sledgehammer Penalties" section in Part Two for more details.

- The Proposed Rules confirm that applicable large employer members who offer minimum essential coverage to their full-time employees are still at risk for the Sledgehammer Penalty unless they also offer coverage to dependents. The Proposed Rules clarify that dependents for this purpose are defined to only include children, as defined in Code Section 152(f)(1), who are under age 26. The term dependent does not include spouses or other individuals (e.g., grandchildren or domestic partners) who are not Code Section 152(f)(1) children. There is also transition relief for 2014 for plans that do not currently offer coverage to children. See the "Sledgehammer Penalties" section in Part Two for more details.

- The Proposed Rules incorporate and clarify the safe harbor rule for determining affordability based on the employee's W-2 wages from the employer. In addition, the Proposed Rules identify two additional affordability safe harbors. See the "Tackhammer Penalties" section below for more details.

- The Proposed Rules also provide transition relief for plans that operate on a fiscal plan year ("fiscal-year plans"). Generally, an applicable large employer member who maintains a fiscal-year plan on December 27, 2012 may begin compliance on the first day of the plan year that begins in 2014 with respect to any full-time employees who satisfy the fiscal-year plan's terms of eligibility in effect on December 27, 2012. That applicable large employer member could also avoid penalties with respect to other full-time employees—i.e., those who generally would not satisfy the terms of eligibility in effect on December 27, 2012—so long as the fiscal year plan satisfied specific coverage or eligibility requirements. Otherwise, compliance with respect to the "other employees" begins January 1, 2014. See "Assessing Penalties" below for more details on this transition relief.

- The Proposed Rules (and a subsequent correction issued by the IRS) provide a special transition rule through 2014 for applicable large employers that are required by a collectively bargained agreement to contribute to multiemployer plans. If an applicable large employer member is required by a collectively bargained agreement to contribute on behalf of some or all of its employees to a multiemployer plan that provides coverage in accordance with the plan's terms of eligibility and that coverage is both affordable and provides minimum value, then the applicable large employer member is not subject to a penalty for failing to offer coverage with respect to full-time employees for whom the applicable large employer is required to make a contribution pursuant to the collective bargaining agreement.
- The Proposed Rules provide a transition rule for cafeteria plans with a fiscal plan year beginning in 2013. Under the transition rule, employers may amend their cafeteria plans to allow employees to revoke their accident and health coverage election once during the fiscal plan year beginning in 2013 without a corresponding change in status or cost or coverage change. Moreover, the employer may also amend the plan to allow employees to elect to participate in accident and health coverage offered through the cafeteria plan during the fiscal plan year beginning in 2013 without a corresponding change in status or cost or coverage change. Amendments to the cafeteria plan must be made by December 31, 2014 and IRS officials have informally indicated that the transition relief does not apply to Health FSA elections.

Practice Pointer: The IRS requests comments on the Proposed Rules. The comments were due by March 18, 2013. Although the due date for comments has since passed, at least one Treasury official has informally indicated that comments submitted after that date would not necessarily be ignored.

Hopefully, the highlights prove helpful; however, a comprehensive understanding of the 4980H Rules is required in order to identify the impact the 4980H Rules will have. Thus, we provide below a more comprehensive summary of the 4980H Rules, in light of the Proposed Rules.

B. Overview of Code Section 4980H

Generally, Code Section 4980H imposes penalties on applicable large employers for any month during a calendar year in which one or more of the employer's full-time employees are certified as having received a premium tax credit or cost share reduction ("Premium Subsidy") in accordance with Code Section 36B for coverage in an Exchange AND either of the following applies:

- The applicable large employer failed to offer minimum essential coverage during that month to its full-time employees and their dependents. In this case, the employer would be liable for what we refer to as **the Sledgehammer Penalty**. The proposed rules clarify that compliance with 4980H is determined at the applicable large employer member level and that applicable large employer members avoid the Sledgehammer Penalty if minimum essential coverage through an eligible employer sponsored plan is offered to at least 95 percent of the applicable large employer member's full-time employees (and their dependents); OR

- The applicable large employer offered minimum essential coverage to its full-time employees (and their dependents) during that month but the coverage was not affordable or didn't provide minimum value. In this case, the employer would be liable for what we call the Tackhammer Penalty, because it will typically be smaller, in the aggregate, than the Sledgehammer Penalty. Also, the applicable large employer member who is not otherwise liable for the Sledgehammer Penalty will be liable for the Tackhammer Penalty with respect to full-time employees not offered coverage.

Each penalty is discussed in more detail below.

Practice Pointer: It is important to understand for planning purposes that an applicable large employer member is not liable for a 4980H penalty, regardless of the coverage offered (or not offered), if no full-time employee of the applicable large employer member receives a Premium Subsidy in an Exchange. For example, a full-time employee will not receive a Premium Subsidy if (i) the full-time employee does not enroll in an Exchange; (ii) the employee is offered coverage through an eligible employer sponsored plan that provides minimum value and is affordable; (iii) the employee voluntarily enrolls in minimum essential coverage offered by an employer, even if that coverage is unaffordable or doesn't provide minimum value; (iv) the employee is eligible for Medicare Part A, Medicaid, CHIP or TRICARE; (v) the employee has household income in excess of four times the federal poverty line; or (vi) the employee is not a citizen or legal resident.

The 4980H Rules are a minefield of unique terms of art and concepts. Employers must understand each of these terms and concepts, as defined in the 4980H Rules, in order to fully grasp the impact of the 4980H Rules. Those terms of art and concepts are:

- Applicable large employer
- Applicable large employer member
- Full-time employee
- Hours of service
- Variable-hour employee
- Seasonal employee
- Initial Measurement Period
- Standard Measurement Period
- Minimum essential coverage
- Eligible employer sponsored plan
- Affordable coverage
- Minimum value
- Sledgehammer Penalty (also referred to as the "no-offer" or 4980H(a) Penalty)
- Tackhammer Penalty (also referred to as the "nonqualified coverage" or 4980H(b) penalty)

Practice Pointer: The 4980H Rules only apply to applicable large employers. We caution small employers to pay special attention to the rules for determining applicable large employer status. The manner in which applicable large employer status is calculated creates traps that may result in the unwary small employer qualifying as an applicable large employer. For example, an employer with fewer than 50 full-time employees may be an applicable large employer if the employer is a member of a larger controlled group of corporations. Also, an employer with fewer than 50 full-time employees may be an applicable large employer if the employer has a substantial number of part-time employees.

These terms and concepts are discussed more fully below.

C. Applicable Large Employer Determination

A threshold question for many employers will be: Is my company an applicable large employer? An applicable large employer is defined generally in Section 4980H(c) as any employer who employed, on average, at least 50 full-time employees (including full-time equivalencies for part-time employees) on business days during the preceding calendar year. For many employers, there will be no doubt that they are an applicable large employer. If there is no doubt that you are an applicable large employer, you can skip to the next section, "Compliance with 4980H." Everyone else, especially smaller employers who are members of a larger, controlled group of employers or who have a substantial number of part-time employees, should continue reading.

The applicable large employer determination is based on the following fundamental concepts:

- An "employer" for purposes of the Code Section 4980H Rules includes any common law employer, including governmental entities and tax exempt entities.
- All employers that are members of a controlled group as defined in Code Section 414(b),(c),(m) or (o) are considered a single employer. Thus, a company or entity with only 10 full-time employees may still qualify as an applicable large employer if it is a member of a controlled group of employers who, in the aggregate, have 50 or more full-time employees plus full-time equivalents. It is important to note that for this purpose the separate line of business rules in Section 414(r) apparently do not apply.

Practice Pointer: Although applicable large employer status is determined on a controlled group basis, the Proposed Rules indicate that each member of the applicable large employer controlled group is independently liable for penalties based on its own full-time employees. See "Identifying Full-Time Employees" and "Assessing Penalties" below for more details on the application of the controlled group aggregation rules.

- The determination is based on the number of full-time employees employed by the controlled group employer during the preceding calendar year. If the employer was not in existence during the preceding calendar year, the employer will qualify as an applicable large employer if the employer is reasonably expected to employ on average at least 50 full-time employees AND the employer actually employs an average of at least 50 full-time employees.

Practice Pointer: The Proposed Rules provide a transition rule for determining applicable large employer status for 2014 only. Under the transition rule, employers may use any period of at least six consecutive months in 2013 to determine applicable large employer status.

- Only common law employees of the employer are considered. Thus, partners in a partnership, a two percent shareholder of an S-corporation and a sole proprietor are NOT considered employees for purpose of this rule. In addition, a "leased employee" as defined in Code Section 414(n) is NOT treated as a common law employee for purpose of the 4980H Rules.

Practice Pointer: The rule is relatively simple in theory. If the individual is a common law employee credited with an hour of service (as defined by the 4980H Rules), then the individual is considered in the 4980H analysis. There is no specific exclusion for temporary employees, seasonal employees, interns and/or other employees who have historically been excluded from plan participation because they do not have a permanent or long-term relationship with the employer. That being said, there are special rules for employees that are seasonal, paid on a commission basis, adjunct faculty or transportation employees, or employees in similar positions.

- A full-time employee is any employee who is employed on average during a month 30 hours of service or more each week. The Proposed Rules clarify that 130 hours of service is treated as the monthly equivalent of at least 30 hours of service per week during a month. Whether an employee is a full-time employee for purposes of the applicable large employer determination is based on the actual hours of service in the preceding calendar year. The Proposed Rules prescribe specific rules for counting hours of service, including an exclusion for hours of service for which the compensation paid or due constitutes income from sources outside the United States. See the "Identifying Full-Time Employees" section below for a more detailed description of hours of service.

Practice Pointer: The safe harbor for identifying full-time employees originally prescribed in Notice 2012-58 and incorporated into the Proposed Rules does not apply for purposes of the applicable large employer determination. The safe harbor is applicable only to identifying full-time employees for purposes of 4980H compliance (i.e., identifying the potential penalty).

- The employer must also count full-time equivalents in addition to full-time employees. The number of full-time equivalents is equal to the total hours of service in a month for employees who are NOT full-time employees (not to exceed 120 for each such employee) divided by 120. The number of full-time equivalents is added to the number of full-time employees to determine applicable large employer status.

Practice Pointer: The number of full-time equivalents is relevant only for purposes of the applicable large employer determination—not for purposes of compliance with 4980H. Penalties are assessed based solely on the employer's full-time employees.

- Fractions are considered in the calculation; however, once the calculation is made for the year, fractions are rounded DOWN to the nearest whole number. Thus, an employer with 49½ full-time employees would be treated as having 49 full-time employees.

- There is a special rule regarding employees who qualify as seasonal. Under the special rule, if the employer exceeds 50 employees for four calendar months (not necessarily consecutive) or 120 days (not necessarily consecutive) and the excess over 50 for those four months or 120 days are seasonal employees, then the employer is not an applicable large employer. Seasonal employee is generally defined as an employee who performs services on a seasonal basis, as defined by the Secretary of Labor, including but not limited to employees covered by 29 C.F.R. 500.20(s)(1) and retail workers employed exclusively during holiday seasons. See "Identifying Full-Time Employees" below for a more detailed discussion of seasonal employees.

Practice Pointer: There is a tendency by many to assume that seasonal employees are not considered full-time employees for any purpose under 4980H, even though the seasonal employees may be employed on average at least 30 hours of service per week during a month. This is an incorrect assumption. Seasonal employees are not excluded from the definition of full-time employee for any purpose under 4980H, including the penalty assessments (i.e., you may have to offer coverage to a seasonal employee under certain circumstances if you want to avoid penalties); however, there are special rules applicable to seasonal employees, including but not limited to the special rule discussed above regarding the impact of seasonal employees on applicable large employer status. See the "Identifying Full-Time Employees" section below for another special rule related to seasonal employees.

If, after performing the analysis above, you have determined that you are NOT an applicable large employer, you do not need to read any further—**the 4980H Rules do not apply to you**.

Practice Pointer: Even if you are not an applicable large employer, you are still not free and clear from the grasp of the ACA. Other ACA-related rules, such as the health insurance reforms (e.g., the new wellness program rules and the 90-day waiting period limitation, both of which go into effect for plan years beginning on or after January 1, 2014), the PCORI fee and the reinsurance fee may still have a significant impact on you or your plans.

But, if you have determined that you ARE an applicable large employer, you will have to comply with 4980H. The remainder of the article addresses 4980H compliance.

D. Compliance with 4980H

So, you have determined that you are an applicable large employer. You must now comply with Code Section 4980H. To help you better understand compliance with 4980H, we have broken down 4980H compliance into three categories:

- **Identifying Full-Time Employees.** As noted above, the penalties under 4980H relate only to the coverage offered or not offered to full-time employees as defined by 4980H. Consequently, employers must first identify their full-time employees in accordance with the 4980H Rules before they can determine what, if any, penalties they may pay.

- **Sledgehammer Penalties.** Once you identify your full-time employees, you must determine whether you may be liable for the Sledgehammer Penalty. One of the keys to making this determination is ensuring that full-time employees are provided an effective opportunity to enroll in minimum essential coverage through an eligible employer sponsored at least once per plan year. The Proposed Rules clarify when coverage is effectively offered for purposes of the new 4980H Rules. More importantly, the Proposed Rules clarify that an applicable large employer member avoids the Sledgehammer Penalty if minimum essential coverage through an eligible employer sponsored plan is offered to at least 95 percent of the applicable large employer member's full-time employees (and their dependents).

- **Tackhammer Penalties**. If you aren't liable for a Sledgehammer Penalty, you may still be liable for a Tackhammer Penalty. An applicable large employer member may be liable for the Tackhammer Penalty if the coverage offered to full-time employees is not affordable or does not provide minimum value. The applicable large employer member may also be liable for a Tackhammer Penalty if it fails to offer coverage to up to five percent of its full-time employees (and their dependents) and one of those full-time employees receives a Premium Subsidy in the Exchange. The Proposed Rules offer guidance regarding the affordability determination.

Each of these elements of 4980H compliance is discussed in detail below.

> **Practice Pointer:** It is critical to strategic planning that you understand not only when you may be liable for a penalty, but also how the penalties are calculated. For example, each applicable large employer member is independently responsible for compliance with 4980H and the penalties, if any, are based only on that member's full-time employees. More specifically, the Sledgehammer Penalty is assessed based on all of the applicable large employer member's full-time employees (reduced by its allocable share of 30), even those who did not receive a Premium Subsidy. The Tackhammer Penalty is based only on the full-time employees of that applicable large employer member who actually receive a Premium Subsidy. These concepts, which are discussed in more detail below, play a significant role in the strategic planning process.

1. Identifying Full-Time Employees

A full-time employee for purposes of Code Section 4980H is any employee who, on average, is employed for at least 30 hours of service per week during a month. The first step in identifying full-time employees is mastering the hours of service rules prescribed in the Proposed Rules.

Hours of Service Rules

The following is a summary of the fundamental concepts regarding hours of service calculations prescribed in the Proposed Rules:

- Hours of service means each hour for which the employee is paid or entitled to payment for performance of services AND hours for which the employee is paid or entitled to payment by the employer for a period of time, without limitation, during which no duties are performed due to any of the following (i.e., paid leave):
  - Vacation
  - Holiday
  - Illness or incapacity (i.e., disability)
  - Layoff
  - Jury duty
  - Military duty or leave of absence

The hours of service rules for periods during which no services are performed are based generally on the rules set forth in 29 C.F.R. 2530.200b-2. These are the rules under ERISA that are generally applicable to years of service calculations under retirement and pension plans. Attached is a chart that identifies the presumed differences between the retirement/pension plan rules and the 4980H rules.

> **Practice Pointer #1:** Paid leaves of absence during which employees are allocated hours of service include periods during which the compensation is paid by a third party, such as a disability insurer.

> **Practice Pointer #2:** If you are using the safe harbor method to identify full-time employees, there are special rules for employees on certain unpaid leaves of absence ("special leaves of absence"). See the "4980H Safe Harbor" section below for more details on special leaves of absence.

- Hours of service for which the compensation for such hours constitutes income from sources outside the United States in accordance with Internal Revenue Code Section 862(a)(3) are not counted. In essence, hours of service performed outside of the United States are not considered.

Practice Pointer: Oddly enough, United States is defined to include only the 50 States and the District of Columbia. United States for this purpose does NOT include possessions or territories of the United States, such as Guam or Puerto Rico. But beware—plans maintained in the territories are subject to other aspects of the ACA, including but not limited to the health insurance reforms.

- Employers must determine hours of service for hourly employees based on actual hours of service from records of hours worked and hours for which payment is due, as otherwise required by the rules.
- Employers must determine hours of service for non-hourly employees based on one of the following three methods (and only these three methods):
  - actual hours of service worked or hours for which payment is due based on the records,
  - a day's equivalency test based on labor rules set forth in 29 C.F.R. 2530.200b-2(a) (an employee is credited with eight hours of service for each day that the employee would be required to be credited with one hour of service), or
  - a week's equivalency test based on labor rules set forth in 29 C.F.R. 2530.200b-2(a) (an employee is credited with 40 hours of service for each week in which the employee would be required to be credited with one hour of service).
- The employer is NOT required to use the same hours of service calculation method for all non-hourly employees as long as the classifications are reasonable and consistently applied.

Practice Pointer: The equivalency tests may not be used if use of the tests substantially understates an employee's hours of service in a manner that would cause that employee to not be treated as full-time.

- Until further guidance is issued, any reasonable method for calculating hours of service may be used for the following types of employees:
  - Commissioned employees
  - Adjunct faculty
  - Transportation employees (e.g., airline pilots)
  - Employees in similar positions

Practice Pointer: Hours of service for adjunct faculty must be based not only on time spent teaching classes, but also time preparing for classes. Hours of service for commissioned employees would also include business travel for a traveling salesperson compensated on a commission basis.

- Hours of service calculations that result in a fraction are rounded UP to the nearest whole number.
- An employee's hours of service attributable to another applicable large employer member are considered by an applicable large employer when making a determination whether one of its employees was full-time during a month (or during a measurement period if using the safe harbor). This could cause recordkeeping issues for applicable large employers who do not share recordkeeping data (and even some who do).
- The proposed rules largely incorporate the safe harbor method for identifying full-time employees previously prescribed in Notice 2012-58. The safe harbor, which is described in more detail below, is not a required method for calculating full-time employee status. See below for a more detailed discussion of the safe harbor method.

4980H Safe Harbor

The 4980H Safe Harbor provides an optional method for applicable large employer members to use to determine full-time employee status for purposes of Code Section 4980H. The 4980H safe harbor generally operates on the following principles: applicable large employer members who choose to use the safe harbor will establish a "measurement period" that is between three and 12 months (as chosen by the employer), during which an employee's hours of service are tracked. Each employee who averages 30 hours of service per week a month during that measurement period must be treated as full-time during a subsequent stability period that is generally the same length as the measurement period (subject to limited exceptions) or six months, whichever is greater.

> **Practice Pointer:** Remember, compliance with 4980H is determined on an applicable large employer member basis—not on a controlled group basis. Thus each applicable large employer member who chooses to use the safe harbor will choose its own measurement periods and stability periods in accordance with the rules, and those periods may differ from the measurement and stability periods chosen by other applicable large employer members.

The manner in which the 4980H safe harbor is applied differs slightly depending on whether the employee is a new employee or an ongoing employee. The following summarizes the fundamental concepts set forth in the safe harbor with respect to new employees.

Applying the 4980H Safe Harbor to New Employees

The 4980H Safe Harbor applicable to new employees is based on the following fundamental concepts:

- There are two different categories of new employees: non-variable and variable/seasonal. Applicable large employer members using the safe harbor must determine which category the employee fits into in order to identify the appropriate safe harbor method to apply.
- A non-variable hour new employee is an employee for whom it can be determined on the start date that the employee is reasonably expected to work, on average, 30 hours of service or more per week during a month, generally without regard to how long the employee is expected to work. The safe harbor method does NOT apply to a new, non-variable hour employee. In this case, the employer may be liable for 4980H penalties unless the employer offers the non-variable hour employee who is determined to be full-time minimum essential coverage through an eligible employer sponsored plan before the end of the employee's initial three full calendar months of employment.

Practice Pointer #1: The regulations clarify that any such employee for whom it can be determined on the start date that the employee is reasonably expected to be employed on average 30 hours of service or more per week must be treated as a full-time employee and coverage must be offered in accordance with the 4980H Rules unless the period of employment is shorter than three months. Employers are apparently not subject to penalties for failing to offer coverage to such an employee if the employee is hired for less than three months. But beware—an employee who is hired for a period of less than three months and then later rehired may be a "continuous employee" under the break in service rules. See below for a more detailed discussion of the break in service rules.

- If the employee is a variable hour or seasonal employee, then the employer may determine full-time status by using the safe harbor. A variable hour employee is any employee for whom the applicable large employer member cannot make a determination on the employee's start date that the employee will be reasonably expected to be employed, on average, at least 30 hours of service or more a week during the initial measurement period (the period chosen by the employer to calculate hours of service following the employee's start date). An employee may be a variable hour employee even if the employee is expected to initially be employed 30 hours of service per week if the period of employment at 30 hours of service is expected to be of limited duration and it cannot be determined that the employee is expected to be employed on average at least 30 hours per week over the initial measurement period.
- An employee is a seasonal employee if he/she performs services on a seasonal basis as determined by the Department of Labor, including but not limited to employees covered by 29 C.F.R. 500.20(s)(1) and retail workers employed exclusively during the holiday seasons. Employers are permitted to use a good faith interpretation of the term "seasonal worker" and 29 C.F.R. 500.20(s)(1) (including as applied by analogy to employment positions not covered by the Department of Labor's regulations).

Practice Pointer: Applicable large employer members may be subject to penalties if they fail to offer coverage to a seasonal employee who is a full-time employee during a month. The good news is that seasonal employees hired by an applicable large employer member may be treated as a new variable hour employee, even if it can be determined on the start date that the seasonable employee is reasonably expected to have 30 hours of service or more during a month during the employment period. Without this special treatment, the seasonal employee would likely be considered a non-variable hour employee and could trigger penalties for the employer if coverage is not offered in accordance with the 4980H Rules and the seasonal employee receives a Premium Subsidy in the Exchange.

- The measurement period for new variable hour and seasonal employees is called the initial measurement period. The initial measurement period may be anywhere from three to 12 months and may begin anytime between the employee's start date (the date that the employee is first credited with an hour of service) and the first day of the month following the employee's start date. If the applicable large employer member delays the initial measurement period in accordance with the 4980H Rules, the period between the start date and the start of the initial measurement period is counted toward the maximum administrative period, which is discussed in more detail below. If the employer intends to use an administrative period after the measurement period, the length of the measurement period may be affected.

Practice Pointer: Applicable large employer members may have different initial measurement and stability periods than other applicable large employer members. But keep in mind—hours of service credited to the employee with respect to another applicable large employer member are treated as hours of service for other applicable large employer members. This seems to suggest that the start date for an employee transferred within the controlled group would be the date for which an hour of service was first credited to the employee from a prior applicable large employer member—not the date transferred to the subsequent applicable large employer member.

- If a variable hour/seasonal employee experiences a change in employment status before the end of the initial measurement period such that the employee is reasonably expected to be employed on average at least 30 hours of service per week during a month (i.e., the employee moves from a variable hour position to a new, non-variable hour position), the applicable large employer must treat the employee as full-time by no later than the first day of the fourth month following the change in status, or if earlier, the first day of the stability period if the variable hour/seasonal employee is determined to be full-time during the initial measurement period.

- If it is determined during the initial measurement period that the employee is a full-time employee, then the employee must be treated as a full-time employee during the corresponding stability period, subject to the break-in-service rules described below. The stability period must be at least six months—<u>but no shorter in duration than the initial measurement period</u>—and must begin immediately following the initial measurement period or after the expiration of any applicable administrative period.

Practice Pointer: The stability period for employees determined to be full-time during the initial measurement period must be the <u>same length</u> as the stability period for ongoing employees. See below for more details regarding the stability period for ongoing employees, including a definition of ongoing employees.

- If it is determined during the initial measurement period that the employee is not full-time, then the applicable large employer member may generally treat the employee as other than full-time throughout the stability period for such employee (i.e., there is generally no penalty for failing to offer such employee coverage during the applicable stability period). In this case, the stability period for such employee cannot be more than one month longer in duration than the initial measurement period, and in no event can it extend beyond the standard measurement and corresponding administrative period applicable to ongoing employees. Consequently, an employee who is treated as other than full-time during the stability period following the initial measurement period may have to be treated as full-time before the end of that stability period if the employee is determined to be full-time during the standard measurement period and the stability period that follows begins prior to the end of the stability period that follows the initial measurement period.

Practice Pointer: A change in employment status during the stability period does not change a continuing employee's status determined as of the start of the stability period. However, it is unclear whether an employer satisfies the coverage requirements and avoids a penalty with respect to an employee who does actually reduce his/her hours during a stability period by offering COBRA coverage to such individual. Penalties are avoided if a full-time employee is offered minimum essential coverage through an eligible employer sponsored plan and the proposed rules regarding minimum essential coverage indicate that COBRA qualifies as coverage through an eligible employer sponsored plan. Moreover, the proposed rules suggest that the affordability rule does not apply during a COBRA continuation period (although additional clarification on this point would be welcomed).

- Employers who choose to establish an administrative period must be aware of the following special rules:
  - The total administrative period (i.e., the combined period before and after the initial measurement period) cannot exceed 90 days in length.
  - In addition to any other applicable rule, the administrative period and the initial measurement period combined cannot extend beyond the last day of the first calendar month beginning on or after the employee's first anniversary of the employee's start date.
- Each applicable large employer member may vary the initial measurement and stability periods for each of the following groups of employees:
  - Employees subject to a collectively bargained agreement and employees not subject to a collectively bargained agreement
  - Each group of collectively bargained employees covered by a different collectively bargained agreement
  - Salaried and hourly employees
  - Employees located in different states

Applying the 4980H Safe Harbor to Ongoing Employees

Ongoing employees are defined in the Proposed Rules as employees who have been employed for one entire standard measurement period, which is the static period chosen by the applicable large employer member to measure the hours of service for existing employees. The 4980H safe harbor as applied to ongoing employees is based on the following fundamental concepts.

- Applicable large employer members may apparently use the safe harbor for ongoing employees that are variable hour (as defined above).
- The standard measurement period must be no less than three and no more than 12 months.
- If an employee is determined during the standard measurement period to be full-time, then the applicable large employer member must treat the employee as full-time during the associated stability period. The stability period following the standard measurement period for such employees must be no shorter in duration than the standard measurement period, but not less than six months, and it must begin immediately following the standard measurement period and any applicable administrative period.

Practice Pointer: Employers will want to establish a standard measurement period and administrative period that corresponds to the employer's plan year. Fortunately, the Proposed Rules provide a transition rule for employers that sponsor plans with fiscal-year plans that may allow employers to escape penalties for months in 2014 prior to the start of the 2014 plan year. See below for more detail on this transition rule for fiscal-year plans.

- If an employee is determined during the standard measurement period to be other than full-time, then he or she may be treated as other than full-time during a stability period that follows the standard measurement period, as well as any administrative period (i.e., there is no penalty for failing to offer coverage during that stability period). In this case, the stability period for such an employee cannot be longer than the standard measurement period (even if the standard measurement period is less than six months).
- The administrative period following the standard measurement period may not exceed 90 days.

- Applicable large employer members may vary the standard measurement period (including any administrative period) and associated stability period according to the same rules that are applicable to the initial measurement period and associated stability period. See above for a more detailed discussion of the rules regarding variable measurement and stability periods. In addition, employers may change the measurement and stability periods so long as the period has not started.
- With respect to the stability period that begins in 2014, applicable large employer members who generally wish to utilize a 12-month stability period may use a shorter measurement period during 2013, so long as the measurement period is at least six consecutive months and begins on or before July 1, 2013.

Breaks in Service

The Proposed Rules clarify the treatment of employees who experience periods during which they are not credited with any hours of service (e.g., unpaid leave, termination of employment) after which there is a period during which they are credited with hours of service (e.g. rehire, return from unpaid leave). The Proposed Rules provide the following clarifications with regard to breaks in service:

- Generally, an employee who experiences a break in service of less than 26 weeks, or a shorter period of at least four consecutive weeks that exceeds the number of weeks of that employee's period of employment with the applicable large employer immediately preceding the period during which the employee was not credited with any hours of service—and then resumes service—is treated as a continuous employee for purposes of the measurement period and stability periods. If the employee begins a break in service during a measurement period, and then resumes services as a continuous employee, the employee would go back into his or her measurement period. Unless the break in service is a "special unpaid leave" or "employment break" (as defined below), the continuous employee will have "0" hours of service during the weeks in the break in service. Likewise, if the employee begins a break in service (other than a special leave) during a stability period and resumes services as a continuous employee, the employee would be assigned the same full-time or non-full-time status assigned to that employee for that stability period prior to the break in service. However, if the employee that resumes service during either a measurement or stability period is not a continuous employee (e.g., the break in service exceeds 26 weeks), then the employee may be treated as a new employee and may be subject to a new initial measurement period.

> **Practice Pointer:** If a continuous employee resumes services during the same stability period in which he/she began a break in service, the applicable large employer member must treat the employee as a full-time employee as of the date he/she is credited with an hour of service or as soon as reasonably practical.

- If the employee takes a "special unpaid leave" or an "employment break" during which no hours of service are credited to the employee, and the employee resumes service as a "continuous employee" as described above, special averaging rules apply for the measurement period. Special leaves are defined as unpaid FMLA leave, USERRA leave, and jury duty. Special leaves are subject to the following rules:
  - An employer who uses the safe harbor must treat the duration of the special leave in one of the following ways for purpose of calculating hours during a measurement period:
    - The applicable large employer member may disregard the period that such employee was on a special leave when calculating the hours of service of the employee during the applicable measurement period

(i.e., the measurement period for such an employee will be reduced by the period the employee is on a special leave), or

- The employer may choose to treat the employee as credited with hours of service for any period of special unpaid leave at a rate equal to the average weekly rate at which the employee was credited with hours of service during the weeks in the measurement period that are not part of the special leave. Employers may use any reasonable method for calculating the average weekly rate.

- Likewise, "employment breaks" are afforded similar treatment as special leaves. Employment breaks are defined as a period of at least four consecutive weeks (disregarding unpaid special leave) during which an employee at an educational organization (as defined in 26 C.F.R. 1.170A-9(c)(1), without regard to whether they are a Code Section 501(c)(3) organization) is not credited with hours of service. Unlike special leaves, though, no more than a period of 501 hours of services are required to be excluded or credited (depending on the particular averaging method described above that is used by the employer)—excluding any periods of special unpaid leave.

Practice Pointer: Caution: the employment break rule described above applies to ANY employee of an educational organization and any period exceeding four weeks, so long as the employee is considered a "continuous" employee under the break in service rules. The employment break rules are not limited to teachers during a traditional break in the school year.

Once you have identified your full-time employees for purposes of 4980H, the next step is to identify whether you will be liable for penalties and how much.

2. Assessing Penalties

Once full-time employees are identified, penalties may be assessed on the applicable large employer member based on the coverage that it offers, or fails to offer its full-time employees. If the applicable large employer member fails to offer minimum essential coverage under an eligible employer sponsored plan to its full-time employees (and their dependents) during a month, it may be liable for a Sledgehammer Penalty. If the applicable large employer offers minimum essential coverage during a month, but the coverage is not affordable or doesn't provide minimum value, the applicable large employer member may be subject to the Tackhammer Penalty. In either case, a penalty is assessed only if one of the applicable large employer member's full-time employees receives a Premium Subsidy in an Exchange.

The following provides a more in-depth review of the penalties, the manner in which each one is triggered, how the penalty is calculated and how to avoid them.

Practice Pointer: With respect to applicable large employer members that maintain a plan or plans as of December 27, 2012, with fiscal plan years ("fiscal-year plans"), such employers may not be subject to a penalty for months in 2014 preceding the start of the 2014 plan year with respect to employees who otherwise satisfy the fiscal-year plan's terms of eligibility in effect on December 27, 2012, so long as such full-time employees are offered minimum essential coverage through an eligible employer sponsored plan that is affordable and provides minimum value by the first day of the 2014 plan year. The same transition relief may be available with respect to other employees who wouldn't otherwise satisfy the terms of eligibility in effect on December 27, 2012 and would not have been eligible for a calendar year plan in effect on December 27, 2012 ("Other Employees") so long as certain coverage or eligibility requirements are satisfied. An applicable large employer member satisfies the coverage or eligibility requirements if 25 percent or more of its employees (not limited to full-time employees) were covered under one or more plans with the same fiscal plan year as of December 27, 2012, determined as of the end of the most recent enrollment period on or before December 27, 2012, or any date between October 31, 2012, and December 31, 2012. If the coverage requirements are not satisfied, the employer may still take advantage of the transition relief with respect to Other Employees if one-third of the applicable large employer member's employees were eligible for one or more fiscal year plans with the same fiscal plan year, determined as of the most recent open enrollment period preceding December 27, 2102.

What Is the Sledgehammer Penalty?

The Sledgehammer Penalty—also known as the "no offer" penalty or the 4980H(a) penalty, is imposed in accordance with the following fundamental concepts:

- The Sledgehammer Penalty is imposed on applicable large employer members who are not otherwise exempt under the "Substantially All Test" (described below) for any month in which both of the following occur:
  - The applicable large employer member fails to offer minimum essential coverage offered through an eligible employer sponsored plan ("minimum essential coverage") to its full-time employees (and their dependents), and
  - One or more of the applicable large employer member's full-time employees enrolls in an Exchange and receives a premium tax credit or cost share reduction from the federal government ("Premium Subsidy") for that month.
- An eligible employer sponsored plan is defined in Code Section 5000A(f)(2). Proposed regulations recently issued by the IRS indicate generally that an eligible employer sponsored plan is any self-insured group health plan that would qualify as a welfare plan as defined by ERISA (without regard to whether ERISA applies) that provides "medical care," including a governmental plan and any fully insured group health plan issued in the small or large group market. An eligible employer sponsored plan does not include a plan the benefits for which constitute excepted benefits as defined in PHSA 2791(c).

Practice Pointer: Do not conflate "minimum essential coverage" with minimum value; they are not the same concepts. Minimum essential coverage offered through an eligible employer sponsored plan is the minimum coverage that must be offered by an applicable large employer member to avoid the Sledgehammer Penalty. To avoid *both* the Sledgehammer and the Tackhammer Penalty, that minimum essential coverage offered through an eligible employer sponsored plan must ALSO provide minimum value. HHS has published rules that provide more substance around the definition of minimum value for self-insured plans and fully insured plans in the large group market. HHS has also published a minimum value calculator, which you can find at http://cciio.cms.gov/resources/regulations/index.html.

- Applicable large employer members who pass the Substantially All Test are exempt from the Sledgehammer Penalty, even if a full-time employee receives a Premium Subsidy. An applicable large employer member passes the Substantially All Test if the applicable large employer member offers minimum essential coverage to at least 95 percent of its full-time employees and their dependents.

Practice Pointer: Although applicable large employer members who offer minimum essential coverage to 95 percent or more of their full-time employees (and their dependents) are exempt from the Sledgehammer Penalty, such employers will still be liable for the Tackhammer Penalty if one of the full-time employees not offered coverage receives a Premium Subsidy in an Exchange.

- The Sledgehammer Penalty for any month is equal to the product of 1/12 of $2000 ($167) multiplied by all of the applicable large employer member's full-time employees (reduced by its allocable share of the applicable large employer's 30 full-time employees). See Exhibit A to this article for a more detailed example of how the Sledgehammer Penalty is assessed.

Practice Pointer: If an applicable large employer member is liable for the Sledgehammer Penalty, the number of full-time employees of the applicable large employer member on which the penalty is based is reduced by that applicable large employer member's allocable share of 30 full-time employees. The applicable large employer member's allocation is equal to 30 allocated ratably among all the members of the applicable large employer on the basis of the number of full-time employees employed by each member during the calendar year. Fractional numbers are rounded UP to nearest whole number. See Exhibit A to this article for an illustration of this allocation rule.

- An applicable large employer member is not treated as offering coverage to a full-time employee unless coverage is offered to both full-time employees and their dependents. Dependents are defined as children (as defined in Code Section 152(f)(1)) under age 26. There is a transition rule for 2014 for employers who do not offer dependent coverage. Under the transition rule, if an applicable large employer member who did not previously offer coverage to dependents takes steps to offer coverage to dependents during the plan year that begins in 2014, the applicable large employer member will not be liable for the Sledgehammer Penalty solely on account of failure to offer dependent coverage during the 2014 plan year.

Practice Pointer: Children include only natural children, stepchildren, adopted children, children placed for adoption and children defined in the Code as "eligible foster children." Spouses and domestic partners are not included in the definition of "dependents" for purposes of the Sledgehammer Penalty assessment.

- An applicable large employer member is not treated as "offering" a full-time employee coverage during a month for purposes of the Sledgehammer Penalty if the full-time employee is not provided an "effective opportunity" to enroll at least once during a plan year. Whether a full-time employee has been offered an effective opportunity to enroll during a month is based on the facts and circumstances, including but not limited to adequacy of notice, the period of time during the election may be made and any other conditions of the offer. See 26 C.F.R. 1.401(k)-1(e)(2)(ii) for an analogous provision relating to the effective opportunity to participate.

Practice Pointer #1: Employers who conduct enrollment electronically should pay special attention to the electronic enrollment safe harbor requirements set forth in 26 C.F.R. 1.401(a)-21.

Practice Pointer #2: The Proposed Rules seem to align the 4980H Rules with the irrevocable election rules under Code Section 125. Consequently, an applicable large employer member who offers coverage to a full-time employee is not liable for the Sledgehammer Penalty solely because the employee who chooses not to enroll is not permitted to enroll again during the plan year, absent a change in status or cost or coverage change, until the beginning of the next plan year. Nevertheless, the Proposed Rule provides special transition relief for cafeteria plans that operate on a fiscal plan year that will enable plan sponsors to amend plans to let employees in or out of the plan at least once without a corresponding event. See "Highlights of the Proposed Rules" above for more details.

- Except where coverage ends during a month following termination of employment, an applicable large employer member is not treated as having offered coverage for a month unless the full-time employee is offered coverage for the entire month. In the case of a termination of employment, a full-time employee is treated as having been offered coverage during the entire month if the full-time employee would have been offered coverage for the entire month had he/she remained employed.

Practice Pointer #1: The Proposed Rules do not specifically address the impact of this entire month rule on coverage that begins mid-month due to an otherwise permissible waiting period. Additional clarification from the IRS is needed.

Practice Pointer #2: What about leaves of absence? Is coverage considered "offered" to a full-time employee for an entire month if the employee takes a leave of absence during a month and is permitted to continue coverage for the remainder of the month ONLY if the employee elects COBRA (e.g., following a personal leave of absence)? Additional clarification of this issue is needed.

- An applicable large employer member is generally not treated as failing to offer coverage for any portion of a coverage period (usually the plan year) following a termination of coverage due to failure to timely or completely pay a required premium. However, this rule applies only if the applicable large employer member applies the following premium payment rules from 26 C.F.R. 54.4980B-8, Q-5:

  – 30-day grace period rule (see Q-5(a))

  – Provider response rules regarding status of payment (see Q-5(c))

  – Insignificant shortfall rule (e.g., where payment is insufficient by the lesser of 10 percent of $50) (see Q-5(d))

  – Deemed payment rule (payment deemed received when sent) (see Q-5(e))

If the applicable large employer member is NOT subject to the Sledgehammer Penalty in accordance with the rules described above, then the applicable large employer member must still determine whether it may be liable for the Tackhammer Penalty.

What Is the Tackhammer Penalty?

The Tackhammer Penalty, also known as the "non-qualifying coverage" penalty or the 4980H(b) penalty, is imposed on applicable large employer members in accordance with the following fundamental concepts:

- The Tackhammer Penalty is imposed on an applicable large employer member for any month in which the following occur:
  - Minimum essential coverage is offered to at least 95 percent of the applicable large employer member's full-time employees and their dependents during a month, but:
    - the coverage is not "affordable";
    - the coverage doesn't provide "minimum value" (affordable and minimum value are terms of art discussed in more detail below); or
    - the coverage offered is affordable and provides minimum value, but excludes no more than five percent of the applicable large employer member's full-time employees; AND
  - One of the applicable large employer member's full-time employees receives a Premium Subsidy in an Exchange for such month.
- The Tackhammer Penalty for a month is equal to the product of 1/12 of $3,000 and the total number of full-time employees who received a Premium Subsidy during that month, or if less, the amount that could apply under the Sledgehammer Penalty. As a general rule, the Tackhammer Penalty amount will almost always be less than the potential Sledgehammer Penalty since the Tackhammer Penalty only applies with respect to employees who actually receive a Premium Subsidy. See Exhibit B for a more detailed illustration of this penalty.

> **Practice Pointer:** The significant difference between the Sledgehammer and the Tackhammer penalties is that the Sledgehammer Penalty is based on ALL of the applicable large employer member's full-time employees reduced by its allocable share of 30, without regard to how many received a Premium Subsidy in an Exchange. The Tackhammer Penalty is assessed only with respect to the applicable large employer member's full-time employees who receive a Premium Subsidy.

- Generally, a full-time employee who has been offered minimum essential coverage during a month through an employer's plan will not qualify for a Premium Subsidy if the coverage is affordable and it provides minimum value. The following is a brief overview of the affordability and minimum value rules.

When Is Coverage Affordable?

Coverage is considered affordable under the Premium Subsidy rules if the employee's contribution or premium for self-only coverage is less than 9.5 percent of his/her household income (as defined in Code Section 36B). Applicable large employer members will not know an employee's household income. Consequently, the Proposed Rules provide various, optional safe harbors below for determining affordability.

> **Practice Pointer:** In order to use any one of the following affordability safe harbors, an applicable large employer member must, as a threshold matter, offer full-time employees and their dependents minimum essential coverage that provides minimum value.

- **W-2 Safe Harbor**: Coverage is deemed affordable for purposes of the Tackhammer Penalty if the employee's share of the applicable large employer member's lowest cost, self-only coverage that provides minimum value for an entire calendar year is less than 9.5 percent of the employee's W-2, Box 1 wages from the employer for that same calendar year (other than a period during which an employee is receiving COBRA or other continuation coverage).

> **Practice Pointer:** Note that the benchmark is the employer's lowest cost option for self-only coverage that provides minimum value. We do not believe that all of the options offered by an applicable large employer member must be affordable and provide minimum value in order to avoid the Tackhammer Penalty; we believe that the applicable large employer member must only offer one option that is both affordable and provides minimum value. However, this means that the lowest cost, self-only coverage offered by the employer may not be the benchmark for the affordability standard if it doesn't also provide minimum value. In that case, the employer will have to look to the next cheapest, self-only coverage that also provides minimum value.

This W-2 Safe Harbor is subject to the following additional rules:

- If the offer of coverage is only for a portion of the calendar year, the W-2 wages must be adjusted for the period that coverage was offered during the calendar year. To adjust the W-2 wages, the Form W-2 wages are multiplied by a fraction equal to the number of months during which coverage was offered over the number of months during the year in which the employee was employed.
- The employee contribution must remain a consistent dollar amount or percentage of all W-2 wages throughout the calendar year, or if the plan operates on a fiscal year, within each portion of the plan year during that calendar year.

> **Practice Pointer:** The wages in Box 1 of the W-2 do not include pre-tax salary reductions made through certain employer sponsored plans, such as a 401(k) or cafeteria plans. Thus, the employee's wages for purposes of this affordability safe harbor will be proportionally reduced by the contribution amount used as the basis for the affordability test if the employee enrolls in and elects to pay for such coverage with pre-tax dollars. Some employers may be tempted to increase the margins by requiring such amounts to be paid with after-tax dollars, which will increase the wage base on which that affordability standard is based under this safe harbor and allow the employer to charge a higher premium. Nevertheless, we caution employers so tempted to tread cautiously. This practice, if applied to lower wage employees, would most certainly run afoul of the cafeteria plan nondiscrimination rules. Moreover, it is unlikely that the increased margins gained by increasing the wages through after-tax payroll deductions will prove more valuable than the tax savings garnered from the pre-tax salary reductions.

- **Rate of Pay Safe Harbor:** Under this safe harbor, coverage is deemed affordable for a month with respect to an employee if the required contributions for the month for the applicable large employer member's lowest-cost self-only coverage that provides minimum value does not exceed 9.5 percent of an amount equal to 130 hours multiplied by the employee's hourly rate of pay as of the first day of the coverage period (generally the first day of the plan year). For non-hourly employees, applicable large employer members must use monthly salary instead of 130 multiplied by hourly rate of pay. This safe harbor may be used only to the extent the full-time employee's hourly rate of pay or monthly wages (as applicable) is not changed during the calendar year by the applicable large employer member or any other applicable large employer to whom the full-time employee is transferred.

- **Federal Poverty Line Safe Harbor:** The affordability safe harbor is satisfied for a calendar month if the employee's contribution for the applicable large employer member's lowest cost option that provides minimum value does not exceed 9.5 percent of an amount that is 1/12 of the federal poverty line for a single individual for the applicable calendar year. Applicable large employers may use the most recently published poverty guidelines as of the first day of the applicable large employer member's plan year.

Practice Pointer: The federal poverty line affordability safe harbor is determined without regard to what the applicable large employer actually pays the full-time employee.

If it is determined that the coverage offered by the applicable large employer member during a month to full-time employees is affordable, then the next step is to determine if the coverage provides minimum value.

When Does Coverage Provide Minimum Value?

A plan provides minimum value for purposes of the Tackhammer Penalty assessment if the plan pays at least 60 percent of the total allowed costs. The Proposed Rules do not provide any substantive guidance regarding the minimum value standard; however, the IRS has issued guidance in IRS Notice 2012-31 and HHS has recently issued final regulations and other guidance that provide shape and form to the rule. For example, the regulations and guidance identify the three permissible methods for determining minimum value.

- First, employers will be able to use a minimum value calculator ("MV Calculator") similar to the actuarial value calculator established by HHS for qualified health plans in the Exchanges. The difference is that the MV Calculator would be based on continuance tables reflecting claims data of typical self-insured plans. You can find the MV Calculator at http://cciio.cms.gov/resources/regulations/index.html.

Practice Pointer: "Allowed costs" is based on the essential health benefits defined by HHS—not on the scope of covered services under the plan. Self-insured plans and fully insured plans in the large group market are not required to offer essential health benefits so the minimum value ruler permits adjustments in the event the plan does not offer essential health benefits. But plan sponsors should beware-- excluding essential health benefits will impact the plan's ability to satisfy the minimum value standard.

- Second, employers may be able to use a benefit plan design checklist. This would be available for plans that provide benefits in the four core categories (physician, hospital and emergency, pharmacy and lab) with cost sharing attributes at least as generous as any of the checklist options.

- Third, a plan with nonstandard features (the first two are for plans with standard features) that is unable to use either of the first two methods described above may obtain an actuarial certification that the plan provides minimum value.

Practice Pointer: Also, as is the case with the AV calculator, employer HSA and HRA contributions are counted, to some extent, when making the minimum value determination.

E. Next Steps

Subject to the transition rules identified above, the employer shared responsibility rules go into effect January 1, 2014, which is just around the corner. Employers must begin assessing the impact of the 4980H Rules sooner rather than later. Digesting the 4980H Rules is a good first step, but additional steps are required. While we await the issuance of final rules, we identify below key, high-level questions that employers must answer to begin the process of identifying the impact of the 4980H Rules:

- As noted above, the first question for many employers that must be answered will be: Am I an applicable large employer? For many the answer will be obvious, but not for everyone, especially small employers that are members of a controlled group of employers and/or who employ a significant number of part-time employees whose aggregate hours may add enough full-time equivalents, with the employer's full-time employees, to or over the 50 threshold.

- If you are an applicable large employer, do you want to pay or play? To answer this question, the following preliminary questions must be answered.

- Do you currently offer coverage to full-time employees? Do you offer coverage to children under age 26? If no, will the cost to offer coverage exceed the Sledgehammer Penalty? Keep in mind, the Sledgehammer Penalty is assessed against each applicable large employer member based only on that member's full-time employees and it is only assessed to the extent a full-time employee receives a Premium Subsidy in the Exchange. Moreover, the Proposed Rules prescribe a "Substantially All Test" that enables applicable large employer members to escape the Sledgehammer Penalty to the extent minimum essential coverage is offered by the applicable large employer member to at least 95 percent of the applicable large employer member's full-time employees.

- If you do offer coverage to full-time employees and their dependents, does your definition of full-time employee differ from the 4980H definition? If it differs, to what extent does it differ? Many employers define full-time employment based on a higher number of hours of service (e.g., 32). Consequently, such employers who want to play will have to close that gap by offering coverage to employees with hours of service between 30 and 32 hours of service. Those who don't should understand that they may be liable for a Sledgehammer Penalty if the percentage of the full-time employees in the "gap" (the difference between the 4980H definition and your definition) exceeds five percent of the applicable large employer member's full-time employees.

- Do I need to use the safe harbor to identify full-time employees? The safe harbor may prove valuable to you if you have classes of employees who are not defined by you as "full-time" and who are not offered coverage, but whose hours may fluctuate from month to month such that they may qualify as a full-time employee in any given month.

- If you use the safe harbor, what is the duration of your stability and measurement periods?

- If you offer coverage, is it affordable? A critical step in making this determination is identifying the affordability safe harbor that is best for you under the circumstances. If not affordable, what is the potential Tackhammer Penalty you may have to pay and will that exceed the cost to make the coverage affordable? Similar to the Sledgehammer Penalty, the Tackhammer Penalty is assessed on each applicable large employer member, except that the Tackhammer is based only on that applicable large employer member's full-time employees who receive a Premium Subsidy.

- If you offer coverage, does it provide minimum value? If not, will the Tackhammer penalty exceed the cost to provide minimum value coverage?

This advisory was written by* Ashley Gillihan*,* John Hickman *and* Dan Taylor*.

Exhibit A
The Sledgehammer

Applicable large employer member A and applicable large employer member B are the two members of an applicable large employer. Applicable large employer member A employs 40 full-time employees in each calendar month of 2014. Applicable large employer member B employs 125 full-time employees in each calendar month of 2014. Applicable large employer member A does not sponsor an eligible employer-sponsored plan for any calendar month of 2014, and receives a Premium Subsidy Certification for 2014 with respect to at least one of its full-time employees. Applicable large employer member B sponsors an eligible employer sponsored plan under which 120 of its full-time employees (and their dependents) are eligible for minimum essential coverage. Applicable large employer member B also receives a Premium Subsidy Certification with respect to two of the five employees who are not eligible for coverage provided by applicable large employer B.

In accordance with the 4980H Rules, applicable large employer member A is subject to a Sledgehammer Penalty for 2014 of $64,000, which is equal to 32 x $2,000 (40 full-time employees reduced by eight (its allocable share of the 30-employee offset ((40/165) x 30 = 7.2, rounded up to eight)) and then multiplied by $2,000).

Even though applicable large employer B did not offer coverage to all of its full-time employees, and two of the five who were not offered coverage received a Premium Subsidy, applicable large employer member B is not subject to the Sledgehammer Penalty because applicable large employer B offered coverage to at least 95 percent of its full-time employees and their dependents. Nevertheless, applicable large employer B will be liable for a Tackhammer Penalty with respect to the two full-time employees who weren't offered coverage and who received a Premium Subsidy.

Exhibit B
The Tackhammer Penalty

Applicable large employer member C and applicable large employer member D are the two members of an applicable large employer. Applicable large employer member C employs 50 full-time employees in each calendar month of 2014. Applicable large employer member D employs 100 full-time employees in each calendar month of 2014. Applicable large employer member C sponsors an eligible employer sponsored plan under which all 50 of its full-time employees (and their dependents) are eligible during each month of the year; however, the coverage is not affordable in 2014. Applicable large employer C receives a Premium Subsidy certification with respect to three of its full-time employees for 2014. Applicable large employer member D sponsors an eligible employer sponsored plan under which 96 of its full-time employees (and their dependents) are eligible for minimum essential coverage. The coverage is affordable and provides minimum value. Applicable large employer member D also receives a Premium Subsidy Certification with respect to two of the four employees who are not eligible for coverage provided by applicable large employer D.

In accordance with the 4980H Rules, applicable large employer member C is subject to a Tackhammer Penalty for 2014 of $9,000, which is equal to a $3,000 assessable payment for 2014 multiplied by the three full-time employees who received a Premium Subsidy for 2014.

Even though applicable large employer D offered affordable, minimum value coverage to 95 percent of his full-time employees and their dependents, two of the four to whom D did offer coverage received a Premium Subsidy for 2014. Consequently, Employer D is subject to a Tackhammer Penalty for 2014 equal to $6000, which is equal to a $3,000 assessable payment for 2014 multiplied by the two full-time employees who received a Premium Subsidy for 2014.

Appendix A

	Qualified Plans	Employer Shared Responsibility under PPACA
Hours of service	Units used for determining an employee's credit toward participation, vesting and benefit accrual entitlements under employee pension benefit plans.	Units used for determining the full-time status of an employee for purposes of offering an opportunity to enroll in minimum essential coverage under employer-sponsored plan. An employee is considered full-time if he/she works an average of 30 hours per week.
Relevant Period	Computation Period – generally a period of 12 consecutive months during which an employee earns hours of service towards statutory participation, vesting and benefit accrual entitlements.	Measurement Period – a period of 3 to 12 consecutive calendar months. The employee's hours of service during the measurement period are used to determine whether an employee worked on average at least 30 hours per week.
I. Hours for which employee is paid or entitled to payment for performance of service	DOL Reg. 2530.200b-2(a)(1) Required to be credited	Prop. IRS Reg. 54.4980H-1(a)(21) Required to be credited
II. Period for which employee is paid but no duties are performed	DOL Reg. 2530.200b-2(a)(2)	Prop. IRS Reg. 54.4980H-1(a)(21)
A. Vacation	Required to be credited	Required to be credited
B. Holiday	Required to be credited	Required to be credited
C. Illness	Required to be credited	Required to be credited
D. Incapacity (including disability)	Required to be credited	Required to be credited
E. Layoff	Required to be credited	Required to be credited
F. Jury duty	Required to be credited	Required to be credited
G. Military duty	Required to be credited	Required to be credited
H. Leave of absence	Required to be credited	Required to be credited
III. An hour of service for which back pay is awarded	DOL Reg. 2530.200b-2(a)(3) Required to be credited	Not specifically required under proposed regulations
IV. Period for which employee is on unpaid leave		Prop. IRS Reg. 54.4980H-3(e)(4)
A. Maternity or paternity leave	Required to be credited solely for purposes of avoiding a break-in-service. Code section 410(a)(5)(E).	An employee is required to treat these periods of special unpaid leave in one of two ways when averaging hours during a measurement period: 1. Such period of unpaid leave may be excluded from the measurement period when averaging hours; or 2. The employer may credit hours of service for such period of unpaid leave at a rate equal to the average weekly rate during the measurement period that was not part of the special unpaid leave. This rule helps to increase the average hours for those employees who incur one of these leaves during a measurement period.
B. Military leave under USERRA	Required to be credited for purposes of avoiding break-in-service, and for vesting and benefit accruals. Code section 414(u)(8)(A) and (B).	
C. FMLA	Required to be credited in order to avoid a break-in-service. Not required to be credited for purposes of benefit accrual, vesting and eligibility to participate. 20 C.F.R 825.215(d)(4).	
D. Jury duty	Not required to be credited	

	Qualified Plans	Employer Shared Responsibility under PPACA
V. Rules for determining hours for non-traditional employees	No special rule for non-traditional employees.	Section II.B.4 of the Preamble to Prop. IRS Reg. 54.4980H
A. Salespersons compensated on commission B. Adjunct faculty whose hours outside of class are not recorded C. Airline pilots whose flying hours are subject to regulatory limits		Until further guidance is issued, employers must use a reasonable method for crediting hours for such employees. Such method may not recharacterize as non-fulltime employees whose position involves more than 30 hours of service per week. The preamble gives the following guidance: 1. Travelling salespersons compensated on a commission basis must be credited for travel time. 2. Adjunct faculty members must be credited for time outside of classroom, such as preparation time.
VI. Rules for determining hours of service for periods for which employee is paid but no duties are performed	DOL Reg. 2530.200b-2(b)	Prop. IRS Reg. 54.4980H-3(b)(1)
A. Payments calculated on the basis of units of time	Number of hours of service to be credited shall be the number of regularly scheduled working hours included in the units of time on the basis on which the payment is made (such as hourly, daily, weekly, monthly). *Example*: An employee, regularly scheduled to work 40 hours a week, is paid for a week of vacation. The employer must credit the employee for 40 hours.	For hourly employees, employers must calculate from records hours for which payment is made or due. For non-hourly employees, employers may use actual hours for which payment is made or due, or use days-worked or weeks-worked equivalencies.

	Qualified Plans	Employer Shared Responsibility under PPACA
B. Payments not calculated on the basis of units of time	Number of hours of service shall equal the total payment divided by the employee's most recent hourly rate of compensation. Hourly rate shall be determined as follows: 1. If compensation is based on an hourly rate, such hourly rate shall be the most recent hourly rate. 2. If compensation is determined on the basis of a fixed rate for specified periods of time (other than hours) such as days, weeks or months, the employee's hourly rate shall be the employee's most recent rate of compensation for that time divided by the number of hours scheduled during that time. 3. If compensation is not determined on the basis of a fixed rate, the employees hourly rate of compensation shall be the lowest hourly rate in that job classification.	There is no specific guidance in the regulations regarding crediting hours for payments not based on units of time.
VII. Crediting hours of service to computation or measurement periods	DOL Reg. 2530.200b-2(c)(1)	Prop. IRS Reg. 54.4980H-3
A. Crediting hours for periods in which duties are performed	Same treatment under both qualified plans and health plans. Hours of service for performance of duties shall be credited to the computation period (in the case of qualified plans) or the measurement period (in the case of health plans) during which the duties are performed.	
VIII. Crediting hours for periods in which no duties are performed	DOL Reg. 2530.200b-2(c)(2)	Prop. IRS Reg. 54.4980H-3
A. Payments calculated on the basis of time	Same treatment under both qualified plans and health plans. Hours of service credited to an employee on account of a payment calculated on the basis of units of time (such as hours, days, weeks or months) shall be credited to the computation period or the measurement period to which the payment relates. *Example*: An employer, with a calendar year computation and measurement period, pays an employee for 40 hours of service for a week of vacation in 2012. The employer must credit 40 hours of service for the vacation in the 2012 computation and measurement period.	

	Qualified Plans	Employer Shared Responsibility under PPACA
B. Payments not calculated on the basis of time	If a payment is not calculated on the basis of time, hours of service are credited to the computation period in which the period during which no duties are performed occurs. *Example*: In 2012, an employee receives a lump sum payment of $1,000 as a result of an injury from a disability insurance plan. The employee's rate of pay is $10 per hour, and the employer uses a calendar year computation period. Under Section VI.B above, the employee must be credited with 100 ($1,000 ÷ 10) hours of service for this period of disability. These 100 hours must be credited to the 2012 computation period.	There is no specific guidance in the regulations regarding crediting hours for payments not based on units of time.
C. Back pay	Any hours of service due to back pay shall be credited to the computation period to which the back pay period pertains. *Example*: In 2013, an employee is awarded back pay for 50 hours of service performed in 2012. The employer, with a calendar year computation period, must credit the employee with 50 hours of service for the 2012 computation period.	The proposed regulations do not require crediting hours for back pay.
D. Adjusting the periods	If the period (no more than 31 days) to which the hours of service pertain extends beyond one computation period, all such hours of service may be credited to the first or second computation period. Such crediting of hours must be done consistently within the same job classifications, reasonable defined. *Example:* An employee is credited with 80 hours of service for sick leave from December 24, 2012 through January 4, 2013. The employer has a calendar year computation period. The employer has the option to credit all 80 hours of service to either the 2012 or the 2013 computation period, as long as it is done with respect to all employees within the same job classification.	To avoid a measurement period from beginning or ending in the middle of a payroll period, an employer is allowed to start and end a measurement period with certain payroll periods. *Example*. An employer uses a calendar year measurement period and has a two-week payroll period. The first day and the last day of the 2013 measurement period fall on the following payroll periods: Date — Payroll Period 1/1/2013 — 12/22/2012 – 1/4/2013 12/31/2013 — 12/21/2013 – 1/3/2014 So that a measurement period does not start or end in the middle of a payroll period, the employer is permitted to start the 2013 measurement period on 12/22/2012 and end it on 12/20/2013. Or, the employer may start the 2013 measurement period on 1/5/2013 and end it on 1/3/2014.

	Qualified Plans	Employer Shared Responsibility under PPACA
IX. Determination of service to be credited to employees	DOL Reg. 2530.200b-3(a)	Prop. IRS Reg. 54.4980H-3(b)
A. General rule	Plan must determine hours from records of hours worked and hours for which payment is made or due, or use permitted equivalency below.	For hourly employees, an employer must calculate actual hours of service from records and hours for which payment is made.
B. Use of equivalencies for determining service to be credited to employees	Different equivalencies are permitted for different classifications, as long as they are reasonable. A classification is not reasonable if applied with the intent to preclude employees from attaining statutory entitlements.	Only permitted for employees paid on a non-hourly basis. Different methods of equivalency are permitted for different classifications. May not use equivalencies if the result is to substantially understate an employee's hours of service.
X. Equivalencies based on working time	DOL Reg. 2530.200b-3(d)	Not Permitted
A. Hours worked	This equivalency method allows an employer to only consider hours of service for which an employee is paid for the performance of duties, thereby reducing the administrative burden of tracking hours for vacation, sick leave, holiday, etc. This equivalency method takes into account all hours (regular and overtime) worked for which an employee is paid for performance of duties. Under this method, 870 hours worked are treated as equivalent to 1,000 hours of service, and 435 hours worked are treated as equivalent to 500 hours of service. Hence, if an employee is credited with 870 hours worked, he must be credited with a year of service for purposes of vesting and at least a partial year for purposes of benefit accrual, as if he had been credited with 1,000 hours of service. Conversely, if he is credited with 436 hours worked, he is considered to have earned 501 hours of service for purposes of avoiding a break in service.	

		Qualified Plans	Employer Shared Responsibility under PPACA
B.	Regular time hours	This equivalency method is similar to the hours-worked equivalency method described above, but takes into account only regular time hours worked for which an employee is paid for performance of duties. Regular time hours do not include overtime hours. Under this method, 750 regular time hours are treated as equivalent to 1,000 hours of service and 375 regular time hours are treated as equivalent to 500 hours of service. Hence, if an employee works 750 regular time hours, he must be credited with a year of service for purposes of vesting and at least a partial year for purposes of benefit accrual, as if he had been credited with 1,000 hours of service. Conversely, if he works 376 regular time hours, he is considered to have earned 501 hours of service for purposes of avoiding a break in service.	
XI.	Equivalencies based on periods of employment	DOL Reg. 2530.200b-3(e)	26 CFR 54.4980H-3(b)(2) (only permitted for non-hourly employees)
A.	On the basis of days of employment	10 hours of service for each day for which the employee would be required to be credited with at least one hour of service.	8 hours of service for each day for which the employee would be required to be credited with at least one hour of service.
B.	On the basis of weeks of employment	45 hours of service for each week for which the employee would be required to be credited with at least one hour of service.	40 hours of service for each week for which the employee would be required to be credited with at least one hour of service.
C.	On the basis of semi-monthly payroll periods	95 hours of service for each semi-monthly payroll period for which the employee would be required to be credited with at least one hour of service.	Not Permitted
D.	On the basis of months of employment	190 hours of service for each month for which the employee would be required to be credited with at least one hour of service.	Not Permitted
E.	On the basis of shifts	An employee is credited with the number of hours of service included in a shift for each shift for which the employee would be required to be credited with at least one hour of service.	Not Permitted

	Qualified Plans	Employer Shared Responsibility under PPACA
F. Adjusting the periods	Periods of time used as a basis for determining service which extend into two computation periods, the plan may credit all hours for such a period to the first computation period or the second computation period, or may allocate such hours on a pro rata basis.	The proposed regulations do not give any guidance on how to allocate hours for periods of time used as a basis for determining service which extend into two measurement periods. However, the proposed regulations allow an employer to adjust the measurement period such that the measurement period does not begin or end in the middle of a payroll period. This is illustrated in more detail in the example in Section VIII.D.
	Can combine equivalencies based on working time and equivalencies based on periods of employment.	Not Permitted
XII. Equivalencies based on earnings	DOL Reg. 2530.200b-3(f)	Not Permitted
A. Compensation determined on the basis of an hourly rate	1. The employee is credited with the number of hours equal to the employee's earnings during the computation period divided by the employee's: (i) hourly rate as in effect at such times during the computation period; or (ii) lowest hourly rate during computation period; or (iii) lowest hourly rate payable to an employee in the same or similar job classification; and 2. 870 hours are treated as equivalent to 1,000 hours of service and 435 hours are treated as equivalent to 500 hours of service. Hence, if an employee is credited with 870 hours under Paragraph 1 above, he must be credited with a year of service for purposes of vesting and at least a partial year for purposes of benefit accrual, as if he had been credited with 1,000 hours of service.	

	Qualified Plans	Employer Shared Responsibility under PPACA
B. Compensation determined on the basis other than an hourly rate	1. The employee is credited with the number of hours equal to the employee's total earnings divided by the employee's lowest hourly rate during the computation period; and 2. 750 hours are treated as equivalent to 1,000 hours of service and 375 hours are treated as equivalent to 500 hours. Hence, if an employee is credited with 750 hours under Paragraph 1 above, he must be credited with a year of service for purposes of vesting and at least a partial year for purposes of benefit accrual, as if he had been credited with 1,000 hours of service. For purpose of this equivalency, hourly rate of compensation is determined by taking the employee's lowest rate of compensation for a specified period of time (such as day, week or month) and dividing it by the number of hours regularly scheduled for the performance of duties during such period of time. *Example*: An employee was paid $1,000 a month for the first half of 2012 and was paid $1,100 a month for the second half. During 2012, he was always regularly scheduled to work 100 hours in a month. For purposes of this equivalency, his hourly rate of compensation shall be $10 per hour ($1,000 ÷ 100).	

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