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Large Employers Subject to the Pay or Play Penalties

The Affordable Care Act (ACA) requires certain large employers to offer affordable, minimum value health coverage to their full-time employees (and dependents) or pay a penalty. This employer mandate provision is also known as the "shared responsibility" or "pay or play" rules. A large employer is only liable for a penalty if one or more of its full-time employees receive a premium tax credit or cost-sharing reduction for coverage under a state-based insurance Exchange.

The employer mandate provisions were set to take effect on Jan. 1, 2014. However, on July 2, 2013, the Treasury announced **the delay of the employer mandate penalties and related reporting requirements for one year, until 2015**. Therefore, these payments will not apply for 2014. On July 9, 2013, the IRS issued Notice 2013-45 to provide more formal guidance on the delay. No other provisions of the ACA are affected by the delay.

On Feb. 12, 2014, the IRS published long-awaited **final regulations** on the ACA's employer shared responsibility rules. These regulations finalize provisions in proposed regulations released by the IRS on Jan. 2, 2013. **Under the final regulations, applicable large employers that have fewer than 100 full-time employees generally will have an additional year, until 2016, to comply with the pay or play rules.** Large employers with 100 or more full-time employees must comply with the pay or play rules starting in 2015.

An important first step when assessing an employer's potential liability under ACA is to determine if the employer meets the large employer threshold. Only applicable large employers are subject to ACA's pay or play penalty.

IDENTIFYING A LARGE EMPLOYER

To qualify as a large employer, an employer must employ on average at least **50 full-time employees, including full-time equivalents (FTEs)**, on business days during the preceding calendar year. All employers that employ at least 50 full-time employees, including FTEs, are subject to ACA's pay or play rules, including for-profit, nonprofit and government employers.

A full-time employee is an individual that works, on average, **30 or more hours of service each week**. Hours worked by employees with fewer than 30 hours per week must be counted—and then divided by 120 per month—to determine the number of FTEs. The number of FTEs is then added to the actual full-time employee count.

Employers will determine each year, based on their current number of employees, whether they will be considered a large employer for the next year. For example, if an employer has at least 50 full-time employees (including FTEs) for 2013, it will be considered a large employer for 2014.

Transition Rule for Determining Applicable Large Employer Status

The proposed regulations included a special rule for employers that may be close to the large employer threshold and need to know how to prepare for 2014. Rather than being required to use the full 12 months of 2013 to measure whether it has 50 full-time employees and FTEs, an employer may measure using any **consecutive six-month period in 2013**. For example, an employer could use the period from March through August 2013, and then have from September through December 2013, to analyze the results and determine whether it needs to make changes to its health coverage.

The final regulations **extend this transition relief to apply for the 2015 calendar year**. Under this transition relief, an employer may determine its status as an ALE by reference to a period of at least six consecutive calendar months, as chosen by the employer, during the 2014 calendar year (rather than the entire 2014 calendar year).

The final regulations also include a one-year delay for medium-sized employers that satisfy certain eligibility conditions. In 2015, the ACA's employer shared responsibility provisions will generally apply to larger firms with 100 or more full-time employees. Employers with 50-99 full-time employees will have to comply starting in 2016. Thus, under the extended transition rule for 2015, employers can determine whether they had at least 100 full-time and FTE employees in 2014 by reference to a period of at least six consecutive months, instead of the full year.

Employers with Employees Working Abroad

A company that employs U.S. citizens working abroad generally will be subject to the pay or play rules only if the company had at least 50 full-time employees (including FTEs), determined by taking into account only work performed in the United States. Hours of service that must be counted when determining applicable large employer status do not include any hours for which an employee receives compensation from sources outside of the United States. For this purpose, United States includes only the 50 states and the District of Columbia, and does not include the U.S. territories.

The final regulations do not exempt employees that hold H-2A or H-2B visas from the definition of "employee" for purposes of the employer mandate. Additionally, the final regulations do not adopt a special rule classifying these workers as seasonal employees.

Employers with Seasonal Workers

An employer will not qualify as an applicable large employer if:

- The employer's workforce exceeds 50 full-time employees for 120 days or fewer during a calendar year; and
- The employees in excess of 50 who were employed during that time were seasonal workers.

The final regulations allow an employer to apply either a period of four calendar months (whether or not consecutive) or a period of 120 days (whether or not consecutive) to determine if it qualifies for the seasonal worker exception.

Under the final regulations, a seasonal worker means a worker who performs labor or services on a seasonal basis, including (but not limited to):

- **Workers covered by 29 CFR 500.20(s)(1)**. ("Labor is performed on a seasonal basis where, ordinarily, the employment pertains to or is of the kind exclusively performed at certain seasons or periods of the year and which, from its nature, may not be continuous or carried on throughout the year. A worker who moves from one seasonal activity to another, while employed in agriculture or performing agricultural labor, is employed on a seasonal basis even though he may continue to be employed during a major portion of the year."); and
- **Retail workers employed exclusively during holiday seasons**.

Employers may apply a reasonable, good faith interpretation of the term seasonal worker and a reasonable good faith interpretation of 29 CFR 500.20(s)(1) (including as applied by analogy to workers and employment positions not otherwise covered under 29 CFR 500.20(s)(1)).

New Employers

An employer not in existence throughout the entire preceding calendar year will be considered an applicable large employer for the current calendar year if it is reasonably expects to employ an average of at least 50 full-time employees (taking into account FTEs) on business days during the current calendar year. The final regulations clarify

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1/13; BK 2/14

that an employer is treated as not having been in existence throughout the prior calendar year only if the employer was not in existence on any business day in the prior calendar year.

Under the final regulations, the determination of whether a new employer is an applicable large employer during its first calendar year is based on the employer's reasonable expectations at the time the business comes into existence, even if subsequent events cause the actual number of full-time employees (including FTEs) to exceed that reasonable expectation.

The final regulations also provide that the seasonal worker exception applies to new employers, so that the employer will not be treated as an applicable large employer if it reasonably expects:

- Its workforce to exceed 50 full-time employees (including FTEs) for 120 days or fewer during the current calendar year; and
- The employees in excess of 50 employed during such 120-day period to be seasonal workers.

COUNTING FULL-TIME EMPLOYEES, FTES AND HOURS OF SERVICE

Employers average their number of full-time employees and FTEs across the months in a year to determine if they meet the large employer threshold. The averaging method takes into account fluctuations that many employers experience in their workforce numbers each year.

A **common law standard** applies to define the terms "employee" and "employer." Under this standard, an employment relationship exists when the person for whom the services are performed has the right to control and direct the individual who performs the services with respect to the result to be accomplished, along with the details and means by which it is done. This is a factual determination and is not necessarily dependent on the label the employer has placed on the relationship in the past.

In general, leased employees are *not* considered employees of the service recipient for purposes of ACA's pay or play provisions. Also, an independent contractor, a sole proprietor, a partner in a partnership and a 2-percent S corporation shareholder are not counted as employees. The final rules also clarify that the categories of workers identified in section 3508 (that is, **real estate agents and direct sellers**) are not treated as employees for purposes of the employer mandate. Therefore, the hours of service worked by these employees are not taken into account.

However, **aggregation rules apply for companies under common ownership**. All employees of a controlled group of businesses under Internal Revenue Code (Code) sections 414(b) or (c) or an affiliated service group under Code section 414(m) are taken into account to determine if an employer is subject to the pay or play rules. If the combined total meets the threshold, each separate member of the group is subject to the pay or play rules, even those companies that on their own do not have enough employees to meet the threshold.

Full-time Employees

Under ACA, a full-time employee is an employee who was employed on average **at least 30 hours of service per week**. The final regulations treat **130 hours of service in a calendar month** as the monthly equivalent of 30 hours per service per week.

Full-time Equivalents (FTEs)

Under the ACA, a full-time equivalent employee (FTE) means a combination of employees, each of whom individually is not treated as a full-time employee because he or she is not employed on average at least 30 hours of service per week with an employer, and who, in combination, are counted as the equivalent of a full-time employee solely for purposes of determining whether the employer is an applicable large employer.

An employer must calculate the number of FTEs it employed during the preceding calendar year and count each FTE as one full-time employee for that year. The proposed regulations provide a calculation method for FTEs.

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1/13; BK 2/14

Under this method, all employees who were not full-time employees for any month in the preceding calendar year are included in calculating the employer's FTEs for that month by:

- Calculating the aggregate number of hours of service (but not more than 120 for any employee) for all employees who were not employed on average at least 30 hours of service per week for that month; and
- Dividing the total hours of service determined above by 120.

The result is the number of FTEs for a calendar month. Fractions are taken into account in determining the number of FTEs for each calendar month. The final regulations provide, as an option, that an employer may round the resulting monthly FTE calculation to the nearest one hundredth. For example, an employer with a calculation of 30.544 FTEs for a calendar month may round that number to 30.54 FTEs.

Hours of Service

To determine an employee's hours of service, an employer must count:

- Each hour for which the employee is paid, or entitled to payment, for the performance of duties for the employer; and
- Each hour for which an employee is paid, or entitled to payment by the employer, on account of a period of time during which no duties are performed due to vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military leave or leave of absence.

Under the final regulations, all periods of paid leave must be taken into account; there is no limit on the hours of service that must be credited. Also, all hours of service performed for all entities treated as a single employer under the Code's controlled group and affiliated service group rules must be taken into account. However, if compensation for hours of service is foreign source income, those hours of service should not be included in an employee's hours of service.

Hourly Employees

For employees paid on an hourly basis, an employer must calculate hours of service from records of hours worked and hours for which payment is made or due for vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty or leave of absence.

Non-hourly Employees

For employees not paid on an hourly basis, employers are permitted to calculate hours of service by:

- Counting actual hours of service from records of hours worked and hours for which payment is made or due;
- Using a days-worked equivalency method under which an employee is credited with eight hours of service for each day with at least one hour of service; or
- Using a weeks-worked equivalency method under which an employee is credited with 40 hours of service per week for each week with at least one hour of service.

Employers may use different methods for non-hourly employees based on different classifications of employees if the classifications are reasonable and consistently applied. Employers may change methods each calendar year. However, employers may not use the days-worked or weeks-worked equivalency methods if those methods would substantially understate the hours of service of a single employee or a substantial number of employees.

Under the final regulations, service performed in certain capacities will not be counted as an hour of service. The Treasury Department and the IRS continue to consider additional rules for the determination of hours of service with

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respect to certain categories of employees whose hours of service are particularly challenging to identify or track or for whom the final regulations' general rules for determining hours of service may present special difficulties.

- Volunteer Employees: The term hour of service does not include any hour for services performed as a bona fide volunteer. For this purpose, a bona fide volunteer is an employee of a government entity or a tax-exempt organization whose only compensation from that entity or organization is in the form of (1) reimbursement for (or reasonable allowance for) reasonable expenses incurred in the performance of services by volunteers; or (2) reasonable benefits (including length of service awards), and nominal fees, customarily paid by similar entities in connection with the performance of services by volunteers.

- Work-study Program: The term hour of service does not include any hour for services to the extent those services are performed as part of a Federal Work-Study Program or a substantially similar program of a state or political subdivision thereof. However, the final regulations do not include a general exception for student employees or paid interns or externs.

- Members of Religious Orders: Until further guidance is issued, a religious order is permitted to not count as an hour of service any work performed by an individual who is subject to a vow of poverty as a member of that order when the work is in the performance of tasks usually required (and to the extent usually required) of an active member of the order.

- Foreign-source Income: If compensation for hours of service is foreign source income, those hours of service should not be included in an employee's hours of service.

Until further guidance is issued, employers of other employees whose hours of service are particularly challenging to identify or track or for whom the final regulations' general rules for determining hours of service may present special difficulties (such as adjunct faculty, employees with layover hours (including the airline industry), employees with on-call hours, commissioned salespeople, etc.) are required to use **a reasonable method of crediting hours of service that is consistent with section 4980H**.

A method of crediting hours is not reasonable if it takes into account only a portion of an employee's hours of service with the effect of characterizing, as a non-full-time employee, an employee in a position that traditionally involves at least 30 hours of service per week.

The following examples provided by the IRS describe methods of crediting hours of service that are (or are not) reasonable to use with respect to adjunct faculty, layover hours (including for airline industry employees) and on-call hours. These examples are not intended to constitute the only reasonable methods of crediting hours of service. Whether another method of crediting hours of service in these situations is reasonable is based on the relevant facts and circumstances.

Adjunct Faculty

With respect to adjunct faculty members of an educational organization who are compensated on the basis of the number of courses or credit hours assigned, the Treasury and the IRS have determined that, until further guidance is issued, one (but not the only) method that is reasonable for this purpose would credit an adjunct faculty member of an institution of higher education with:

- **2 1/4 hours of service** (representing a combination of teaching or classroom time and time performing related tasks, such as class preparation and grading of examinations or papers) per week for each hour of teaching or classroom time (in other words, in addition to crediting an hour of service for each hour teaching in the classroom, this method would credit an additional 1 1/4 hours for activities such as class preparation and grading); and, separately

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- **An hour of service per week** for each additional hour outside of the classroom the faculty member spends performing duties he or she is required to perform (such as required office hours or required attendance at faculty meetings).

Although further guidance may be issued, this method may be relied upon at least through the end of 2015. If future guidance modifies an employer's ability to rely on this method, the period of reliance will not end earlier than Jan. 1 of the calendar year beginning at least six months after the date the guidance was issued (but in no event earlier than Jan. 1, 2016).

Layover Hours for Airline Industry

It is not reasonable for an employer to not credit a layover hour as an hour of service if:

- The employee receives compensation for the layover hour beyond any compensation that the employee would have received without regard to the layover hour; or
- The employer counts the layover hour towards the required hours of service for the employee to earn his or her regular compensation.

For example, if an employer requires that an employee perform services for 40 hours per week to earn full salary, and credits "layover hours" towards the 40 hours, then it would not be reasonable for the employer to fail to credit the layover hours as hours of service.

For layover hours for which an employee does not receive additional compensation and that the employer does not count towards required hours of service, it would be reasonable for an employer to credit an employee with eight hours of service for each day on which an employee is required to stay away from home overnight for business purposes (that is, eight hours each day, or 16 hours total, for the two days encompassing the overnight stay).

The employee must be credited with his or her actual hours of service for a day if crediting eight hours of service substantially understates the employee's actual hours of service for the day (including layover hours for which an employee receives compensation or that the employer counts towards required hours of service). Other methods of counting hours of service may also be reasonable, depending on the relevant facts and circumstances.

On-Call Hours

For purposes of calculating on-call hours, it is not reasonable for an employer to fail to credit an employee with an hour of service for any on-call hour for which:

- Payment is made or due by the employer;
- The employee is required to remain on-call on the employer's premises; or
- The employee's activities while remaining on-call are subject to substantial restrictions that prevent the employee from using the time effectively for the employee's own purposes.

MORE INFORMATION

Please contact Pacific Group for more information on ACA's pay or play requirements.

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1/13; BK 2/14