Healthcare Financial Management Association

Washington-Alaska Chapter
February 25, 2016

AFFORDABLE CARE ACT UPDATE AND ISSUES FOR HEALTH CARE EMPLOYERS[1]

By:

Steven D. Nofziger, Esq.* **©2016**
Garvey Schubert Barer, P.C.
121 SW Morrison Street, Suite 1100
Portland, OR 97204
Email: snofziger@gsblaw.com

***Steven D. Nofziger is an Owner in Garvey Schubert Barer, P.C., a regional law firm with offices in Portland, Oregon; Seattle, Washington; Washington, D.C.; New York, New York; Anchorage, Alaska; and Beijing, China. He works in the firm's Portland, Oregon office. Mr. Nofziger practices in the areas of taxation and employee benefits and is a frequent speaker and author on tax and benefit matters. He is presently a member of the Tax Section of the Oregon State Bar Association and is the Significant Issues Chair of the Portland Chapter of the Western Pension & Benefits Council. Mr. Nofziger received a B.S. (summa cum laude) from Linfield College and a J.D. (Order of the Coif) from the University of Oregon School of Law.**

---

[1] These materials are for educational purposes only and should not be construed as legal or tax advice or a legal or tax opinion relative to any specific situation.

INDEX

I. INTRODUCTION 1

II. CURRENT AND FUTURE ISSUES 1

A. IRS Form 1094/1095 Reporting 1

B. Cadillac Tax Update 2

C. Elimination of Auto-Enrollment Requirement 3

III. SELECTED ISSUES AND CONSIDERATIONS (AND PITFALLS TO AVOID) 3

A. Employer Payment Plans and Premium Reimbursement Arrangements: You Have Been Warned! 3

B. Threshold Issues Under the ACA Penalty Framework: Worker Classification and Who is the "Employer"? 7

1. Controlled and Affiliated Service Group Analysis: Who is the "Employer?" 7

b. Affiliated Service Groups 8

c. Ownership Attribution, Anti-Abuse and Employee Leasing Rules 10

2. Worker Classification: Who is the "Employee"? 10

3. The Evolving Common Law Definition of Employee 11

a. Behavioral Control Factors 11

b. Economic Control Factors 12

c. Relationship Factors 13

d. Additional Considerations 13

4. Conclusion 14

C. Interaction of COBRA and the ACA; Coverage Affordability Issues 14

1. Termination of Employment 14

2. Reduction in Hours/Leave of Absence, but No Termination of Employment 14

3. Affordability Issues 15

D. Hours of Service; Breaks in Service; Special Unpaid Leave; "On Call" Hours 15

1. Hour of Service 15

2. Breaks in Service 15

a. Break of 13 or More Consecutive Weeks 16

b. Rule of Parity 16
3. Special Unpaid Leave 16
4. "On Call" Hours 17
E. Recordkeeping Issues 18
IV. CONCLUSION 19

I. INTRODUCTION

The Affordable Care Act ("ACA") is a complex web of legal, tax and insurance rules. Many new requirements have taken effect over the past several years, and several requirements have yet to take effect. Although many employers are adjusting to the new framework, there are many potential pitfalls, and there is little guidance in many aspects of the law.

These materials will provide an update on certain aspects of ACA faced by employers who are in the health care industry and highlight other issues that are of key importance.

II. CURRENT AND FUTURE ISSUES

A. IRS Form 1094/1095 Reporting.

Employers with 50 or more full-time equivalent employees are "Applicable Large Employers" ("ALE's") and subject to a variety of ACA requirements, including the employer-shared responsibility penalties under Code Section 4940H and the new annual coverage reporting requirements. Employers that were ALEs in 2015 or those with self-insured health plans are first subject to the ACA's new IRS Form 1094/1095 reporting requirements in 2016. These employers must provide employees with an IRS Form 1095 describing the coverage offered and provided during 2015. The employers must also file Form 1095 with the IRS along with a new Form 1094 transmittal. (These forms are conceptually much like Forms W-2 and W-3 that employers must file to report employee wages.)

Although these forms are conceptually simple to complete with respect to most employees, there are a number of nuances that should be reviewed carefully (e.g., with respect to employees and dependents on (or offered) COBRA coverage and certain safe harbors for "Qualifying Offers" of coverage and "transition relief"). Employers should be sure to obtain advice if they have questions whether they are eligible to take advantage of these safe harbors since IRS Form 1094 is signed under penalties of perjury.

Recognizing that employers, insurers and other providers of health coverage are needing additional time to comply with the reporting deadlines, the IRS recently issued Notice 2016-4,[2] which extends the due dates to provide IRS Form 1095 and to file copies with the IRS.

Under Notice 2016-4:

- ALEs now have two additional months—until March 31, 2016—to provide employees with copies of Forms 1095-B and 1095-C (as applicable). The prior deadline was February 1, 2016.

- Applicable Large Employers now have three (a)dditional months to file the applicable Forms 1094 and 1095 with the IRS. The new deadlines are May 31, 2016, for employers not filing electronically, and June 30, 2016, for employers

[2] A copy of Notice 2016-4 may be found at: https://www.irs.gov/pub/irs-drop/n-16-04.pdf.

filing electronically. The prior deadlines were February 29, 2016, and March 31, 2016, respectively.

In light of these extensions, the notice states that existing rules regarding automatic and permissive extensions of the deadline for filing these forms will not apply to the extended due dates. Failure to comply with these extended due dates may result in penalties. However, the IRS has previously stated that penalties may be waived if an employer has made reasonable, good faith efforts to prepare for these new reporting requirements and provide the necessary information to employees and the IRS.

The IRS has also stated that, due to the delay, individuals who file their income tax returns prior to receiving Form 1095, but using other information about their coverage from their employer or coverage provider, will not be required to file amended tax returns for 2015 once they receive Form 1095. Rather, they merely need to keep the information with their tax records.

B. Cadillac Tax Update.

On December 18, 2015, President Obama signed into law the 2016 Consolidated Appropriations Act. Among its numerous provisions, the Appropriations Act included two key changes to the IRC Section 4980I "Cadillac Tax":

- Cadillac Tax Delay. The Cadillac Tax is a 40% excise tax that will be imposed on the value of employer-sponsored health plans over certain dollar thresholds. The tax was scheduled to be effective for tax years starting on or after January 1, 2018. The Appropriations Act delays the effective date until tax years beginning on or after January 1, 2020. Commentators have noted that given intense criticism and repeal efforts surrounding this tax since the ACA's enactment, the delay arguably gives opponents two (2) more years repeal it, and it also establishes a precedent for near-permanent postponement via successive delays in the manner that Congress typically extends "temporary" provisions in a year-end "extenders" bill. The Congressional Budget Office projects the two-year delay will result in a $17.7 billion revenue loss over 10 years. A recent Towers Watson analysis[3] that was issued prior to the delay estimated that almost half (48%) of large employers were expected to be subject to the ACA's "Cadillac Tax" in the 2018 percentage, with that percentage expected to rise to 85% by 2023.

- Cadillac Tax to be Deductible. As originally enacted, the Cadillac Tax was a nondeductible tax under IRC § 275(a)(6). The Appropriations Act removed the Cadillac Tax from the list of nondeductible taxes. Thus, when the tax eventually is effective in 2020, any payments will be deductible for income tax purposes.

In his current budget proposal, President Obama has also proposed modifying the Cadillac Tax by allowing for state-by-state cost thresholds to address regional differences in the cost of health care

[3] *See* https://www.towerswatson.com/en/Press/2014/09/nearly-half-us-employers-to-hit-health-care-cadillac-tax-in-2018-with-82-percent-by-2023.

coverage. It will be interesting to see if this idea gains traction or addresses the concerns of its opponents.

C. Elimination of Auto-Enrollment Requirement.

The Bipartisan Budget Act of 2015 signed into law November 2, 2015, by President Obama, repealed the ACA's automatic enrollment requirement for large employers.

The ACA originally contained a requirement under which employers with 200 or more full-time employees that offered a group health plan would be required to automatically enroll employees in the health plan. Employees would have been allowed to opt-out of coverage and, similar to 401(k) plans with automatic enrollment provisions, there would have been a corresponding employee notice requirement to provide information about the automatic enrollment process, the plan in which they would automatically be enrolled, and the opportunity to opt-out of coverage.

The provision was intended to encourage enrollment by employees who might otherwise forgo coverage if they had to take action to enroll on their own. However, the requirement never took effect because it was unpopular, a low government priority, and the DOL and IRS had not yet issued regulations to address implementation issues.

Employers and advisors saw two key problems with the rule:

- If employees were automatically enrolled in their employer's health plan but had other coverage (e.g., through their spouse's plan), they could end up with (and pay for) double coverage they did not need or want.

- New employees could potentially lose access to long-time health care providers if the providers were not 'in-network" with the employer's health plan.

Thus, with the repeal, larger employers will not have to deal with one more future regulatory burden.

III. SELECTED ISSUES AND CONSIDERATIONS (AND PITFALLS TO AVOID)

A. Employer Payment Plans and Premium Reimbursement Arrangements: You Have Been Warned!

Through a series of notices and FAQs, the IRS and DOL have been putting employers on notice that certain "employer payment plans"—i.e., arrangements where the employer pays or reimburses employees for their individual health insurance premiums—are noncompliant with the ACA's market reform provisions and can lead to penalties of $100 per employee per day.

In IRS Notice 2013-54,[4] the IRS first provided guidance on these arrangements. The IRS explained that although employer payment or reimbursement of employee health insurance premiums on a pre-tax basis is generally allowed under Internal Revenue Code ("IRC") Section 106, the ACA contains two market reform provisions that limit the ability of employers to pay for

[4] IRS Notice 2013-54, available at: https://www.irs.gov/pub/irs-drop/n-13-54.pdf.

employees' individual health insurance premiums. Among the ACA's various market reforms, all group health plans must provide first-dollar preventive care and must not be subject to lifetime or annual limits on essential benefits. The IRS and DOL consider a plan under which an employer pays for or reimburses employees for the cost of an individual health insurance policy purchased by the employee as a type of group health plan. Thus, even though the individual policy may comply with the ACA's preventive care and not limit essential benefits, it cannot be "integrated" with the employer plan that pays for the individual policy. Thus, the employer plan is deemed noncompliant.

In FAQs,[5] the DOL subsequently provided guidance addressing three scenarios: (1) employers offering employees cash reimbursements for the cost of their individual health insurance policies; (2) employers offering employees with high claims risk cash to opt out of the employer's group health plan; and (3) vendors marketing a product to employers claiming that employers can cancel their group policies and set up a "IRC Section 105" reimbursement plan under which health insurance brokers help employees select individual insurance policies for which the employer reimburses the employee for all or a portion of the coverage and for which eligible employees may obtain subsidized Marketplace coverage. In all three scenarios, the DOL said the programs violated the ACA's market reform provisions and could subject employers to penalties of $36,500 per year (i.e., $100 per day) per employee.

The FAQs explained first situation was previously addressed in IRS Notice 2103-54, but the DOL reiterated it again. In discussing the second situation, the DOL stated that such cash-or-coverage arrangements offered only to employees with a high claims risk is not permissible "benign discrimination" and will violate HIPAA's nondiscrimination provisions, regardless of whether (1) the cash payment is treated by the employer as pre-tax or post-tax to the employee, (2) the employer is involved in the selection or purchase of any individual market product, or (3) the employee obtains any individual health insurance.

In addressing the third scenario, the DOL noted that was aware of some benefits consultants and vendors marketing these types of products. In no uncertain terms, it stated that such arrangements are group health plans and, therefore, employees participating in them are ineligible for subsidized Marketplace coverage. It also reminds employers (and promoters of these plans) that the mere fact that the employer does not get involved with an employee's individual selection or purchase of an individual health insurance policy does not prevent the arrangement from being a group health plan, since the existence of a group health plan is based on facts and circumstances, including the employer's involvement in the overall scheme and the absence of an unfettered right by the employee to receive the employer contributions in cash.

Finally, in Notice 2015-17,[6] the IRS provided one last bit of "transition relief" and supplemental guidance related to employer payment plans. Under this guidance:

---

[5] DOL FAQs About Affordable Care Act Implementation (Part XXII), available at http://www.dol.gov/ebsa/faqs/faq-aca22.html.

[6] IRS Notice 2105-17, available at: https://www.irs.gov/pub/irs-drop/n-15-17.pdf.

- General Employer Payment Plan Guidance.

    - Small employers offering employer payment plans were granted relief from the penalty until June 30, 2015, due to the slow implementation of Small Business Health Options Program (SHOP) Marketplace, which is intended to provide small employers with better health plan alternatives. Notice 2015-17 specifically states that employers will be liable for penalties after July 1, 2015.

    - The IRS also specifically noted that employers may increase an employee's compensation for the purpose of assisting the employee with purchasing individual health care insurance so long as it does not condition payment of the additional compensation on the purchase of health insurance or otherwise endorse a particular policy, issuer, or form of coverage. Thus, the IRS endorsed this approach as a "way out" for employers—just give everyone additional taxable compensation.

    - The IRS stated that it intends to publish additional guidance in the future on how employers should handle reimbursements for 2–percent S corporation shareholders and that, until such guidance is issued, such arrangements will not be subject to the aforementioned penalties.

- Medicare and TRICARE Reimbursement Plan Guidance.

    - The notice also explained that the following arrangements constitute an employer payment plan subject to the ACA's market reforms if they covers two or more active employees:

        - A Medicare premium reimbursement arrangements under which an employer pays or reimburses Medicare Part B or Part D premiums for employees.

        - An HRA under which an employer pays or reimburses medical expenses for employees covered by TRICARE.

    - An employer payment plan may not be integrated with Medicare coverage to satisfy the market reforms because Medicare coverage is not a group health plan. However, an arrangement of this nature may be integrated with another employer group health plan for purposes of satisfying the ACA's market reforms if:

        - The employer offers a major medical (i.e., non-excepted benefits) group health plan that provides minimum value;

        - The employer payment plan is offered only to employees enrolled in Medicare Parts A and B or D;

        - The employee participating in the employer payment plan is actually enrolled in Medicare Parts A and B; and

        - Reimbursements are limited to Medicare Part B or D premiums and excepted benefits, including Medigap premiums.

    - Similarly, an HRA may not be integrated with TRICARE to satisfy the market reforms because TRICARE coverage is not a group health plan. However, an arrangement of this nature may be integrated with another employer group health plan for purposes of satisfying the ACA's market reforms if:

        - The employer offers a major medical (i.e., non-excepted benefits) group health plan that provides minimum value;

        - The HRA is offered only to employees enrolled in TRICARE;

        - The employee participating in the employer payment plan is actually enrolled in TRICARE; and

        - Reimbursements are limited to cost sharing and excepted benefits, including TRICARE supplemental premiums.

    - The IRS also noted that any such Medicare reimbursement arrangements and TRICARE HRAs may be subject to other laws including Medicare Secondary Payer rules and rules prohibiting offering incentives to TRICARE-eligible employees to decline employer-provided group health coverage.

Given the amount of guidance on the issue of employers attempting to pay employees' individual health insurance premiums, the IRS and DOL view this problem as a significant concern. Moreover, their comments aimed specifically at certain arrangements promoted by certain consultants and insurance vendors means that employers should be very wary of anyone promoting these types of arrangements. These plans and vendors are ripe for audit and will likely be targeted due to the perceived abuses. The hammer will likely be swift and the penalties severe.

One aspect of these arrangements many employers may not be thinking about is in the context of employment agreements and severance packages. In is common for employers to pay or reimburse retiring or terminated executives for the costs of their individual coverage. Such provisions are often part of an employment contract or severance package. Employers should be aware that these arrangements could potentially run afoul of the foregoing rules.

Rather than agreeing to reimburse a retiring/terminated executive for the cost of individual insurance coverage, a recommended approach would be: (a) to agree to pay for the cost of COBRA coverage for remaining on the employer's plan for as long as the retiring/terminated employee remains COBRA eligible; and (b) after COBRA coverage ends, or in lieu of COBRA initially, to agree to pay a <u>fixed</u> monthly taxable amount, which the executive can use to purchase coverage,

if desired, but not require that the executive actually purchase coverage. Such an arrangement complies with the foregoing guidance.

B. Threshold Issues Under the ACA Penalty Framework: Worker Classification and Who is the "Employer"?

It is all too easy for employers to make assumptions about or overlook two (2) key threshold aspects of the shared responsibility penalty provisions under the Affordable Care Act: (1) who is the "employer" for these purposes; and (2) whether the employer has properly classified its workers as employees or independent contractors.

All entities treated as a single employer under IRC Sections 414(b), (c), (m), or (o) are generally treated as a single employer for purposes of the ACA, including the employer shared responsibility penalties under Code Section 4940H. Thus, the employees of all employers within a controlled group of trades or businesses and/or an affiliated service group are taken into account in determining whether the group is an ALE.

1. Controlled and Affiliated Service Group Analysis: Who is the "Employer?"

There are several types of controlled groups and affiliated service groups. These rules are extremely complex and take into account ownership attribution by related parties. The following is a brief overview of the basic concepts.

a. Controlled Groups.

There are three (3) types of controlled groups: a parent-subsidiary group; a brother-sister group; and a combined group.

- Parent-subsidiary group**:** A parent-subsidiary group is chain of trades or businesses in which there is at least 80% ownership (direct or indirect) by a common parent.

Example: A owns 80% of B. B owns 80% of C. A, B and C form a controlled group.

- Brother-sister group: A brother-sister group exists if:

  (1) the same five or fewer persons own at least 80% of each trade or business; and

  (2) taking into account the ownership of each such person only to the extent his ownership is identical with respect to each of the trades or businesses, these persons own more than 50% of each trade or business.

Example:

	Organizations						
Individuals	L	GHI	M	W	X	Y	Z
A	100%	50%	100%	60%	40%	20%	60%
B	0	40%	0	15%	40%	50%	30%
C	0	0	0	0	10%	10%	10%
D	0	0	0	25%	0	20%	0
E	0	10%	0	0	10%	0	0

4 Controlled groups exist:

- GHI, X and Z (via ownership by A and B)
- X,Y and Z (via ownership by A, B and C)
- W and Y (via ownership by A, B, and D)
- L and M (via ownership by A)

- Combined Group: Any combined group is a group of three (3) or more organizations if: (1) each such organization is a member of either a parent-subsidiary group or a brother-sister group; and (2) at least one such organization is the common parent organization of a parent-subsidiary group and is also a member of a brother-sister group.

b. Affiliated Service Groups.

While the controlled group rules focus on a high degree of common ownership, the affiliated service group rules focus on a combination of common ownership and the nature and extent of services performed by one organization on behalf of, or for the benefit of, another organization or its clients.

An "affiliated service group" is a group consisting of a "First Service Organization" and:

- One or more A Organizations;
- One or more B Organizations; or
- One or more A Organizations and one or more B Organizations.

A Organization: A service organization is an A Organization if it:

- is a partner or shareholder in a First Service Organization that provides ***professional services*** (i.e., those performed by accountants, actuaries, architects, attorneys, medical doctors, dentists, professional engineers, optometrists, osteopaths, podiatrists, psychologists, and veterinarians); and

- regularly performs services for the First Service Organization, or is regularly associated with the First Service Organization in performing services for third persons.

Example – A Organization: Physician N is incorporated, and the corporation is a partner in a medical practice. Physician N and his corporation are regularly associated with the medical practice in performing services for third persons. The medical practice is a first service organization and the corporation is an A Organization.

B Organization: A service organization is a B Organization if:

- a significant portion of the business of the organization is the performance of services for the First Service Organization, for one or more A Organizations determined with respect to the First Service Organization, or for both;

- those services are of a type historically performed by employees in the service field of the First Service Organization or the A Organizations; and

- ten percent (10%) or more of the interests in the organization are held, in the aggregate, by persons who are officers, highly compensated employees, or common owners of the First Service Organization or of the A Organizations.

An organization may be a B Organization even though it is not a service organization.

Example - B Organization: Partnership R is a dental practice that has 11 partners. Each partner of R owns five percent (5%) of the stock in Corporation D, a dental lab. The corporation provides services to the partnership of a type historically performed by employees in the dental practice and a significant portion of the business of the dental lab consists of providing services to the dental practice. The partnership is a first service organization and the corporation is a B Organization.

Multiple Affiliated Service Groups: If an organization is a First Service Organization with respect to two or more A Organizations or two or more B Organizations, or both, all of the organizations shall be considered a single affiliated service group, or there may be multiple affiliated service groups.

c. Ownership Attribution, Anti-Abuse and Employee Leasing Rules.

In addition, there are also highly technical rules providing for ownership attribution from and to family members, partnerships, corporations, limited liability companies, estates and trusts, as well as anti-abuse rules and rules surrounding employee leasing. Affiliated service groups are common among health care and other professional practices. Employers should obtain legal advice if they have questions whether they are part of a controlled group or affiliated service group.

2. Worker Classification: Who is the "Employee"?

Proper worker classification is more important than ever, given the ACA's shared responsibility penalty regime. Employers face significant additional risks for misclassifying workers. ACA penalties can arise in several misclassification scenarios, which can be best described through examples:

> ***EXAMPLE 1***: Employer X does not offer health insurance coverage and concludes that it is not an ALE because it employs only 45 full-time equivalent employees. However, the results of an IRS audit indicate Employer X misclassified eight (8) of its full-time workers as independent contractors. Thus, Employer X is actually an ALE subject to the ACA's penalty and reporting regime. In addition to other taxes and penalties, Employer X faces substantial ACA penalties due to the misclassification of $46,000 per year[7] for failing to offer coverage to its full-time employees and additional penalties for failing to file the required information returns.

> ***EXAMPLE 2***: Employer Y is an ALE that provides affordable, minimum value coverage to 190 of its 200 full-time employees. Employer Y also utilizes a group of 20 independent contractors that the IRS later reclassifies as employees. In addition to other taxes and penalties, Employer Y could be subject to penalties of $380,000 per year[8] due to misclassifying these few workers.

> ***EXAMPLE 3***: Employer Z is an ALE that provides affordable, minimum value coverage to all 200 of its full-time employees. Employer Z also utilizes a group of 10 independent contractors that the IRS later reclassifies as employees. Four of the misclassified workers obtained subsidized coverage through the federal healthcare exchange. In addition to other taxes and penalties, Employer Z could be subject to ACA penalties of $12,000 per

[7] Assumes the IRC Section 4980H(a) penalty applies because no coverage has been offered. The IRC Section 4980H(a) penalty is calculated as the total number of full-time employees (53) less 30, multiplied by $2,000. That is, $2,000 x (53-30) = $46,000.

[8] Assumes the IRC Section 4980H(a) penalty applies because coverage has been offered to less than 95 percent of full-time employees (190/220 = 86%). The IRC Section 4980H(a) penalty is calculated as the total number of full-time employees (220) less 30, multiplied by $2,000. That is, $2,000 x (220-30) = $380,000.

year[9] because it failed to offer these workers the opportunity to enroll in its health plan.

As you can see, the ACA penalty regime significantly increases the potential misclassification liability for larger employers. Financial risks are compounded by the fact that reclassification may be retroactive. Because the ACA looks to whether a worker is a common law employee, a brief review of the common law employee rules is worthwhile.

3. The Evolving Common Law Definition of Employee.

Under federal common law rules, an employment relationship generally exists when the person for whom the services are performed has the ***right to control*** and direct the individual performing the services, not only as to the result to be accomplished, but also as to the ***details*** and ***means*** by which that result is accomplished. It is <u>not</u> necessary for the employer to ***actually*** direct or control the manner of performance.

If an individual is subject to the control or direction of another person merely as to the ***result*** to be accomplished and <u>not</u> as to the ***means*** and ***methods***, then the individual is likely an independent contractor. Designation of the relationship by the parties as independent contractor status is not controlling if an employment relationship actually exists.

The IRS issued Revenue Ruling 87-41 in 1987. This ruling was intended to provide guidance as to the factors used to determine whether an employment relationship exists. It identified 20 common law factors used by the IRS and courts up to that time and became the standard by which subsequent determinations were made.

Since issuing Revenue Ruling 87-41, the IRS has modified and updated its approach to worker classification. In an attempt to ensure the focus is on the "right to control," the IRS now encourages its agents to look beyond the 20 factors in Revenue Ruling 87-41 and to focus on three categories of factors—Behavioral Control Factors, Economic Control Factors, and Relationship Factors.

IRS Publication 1779 outlines the various factors, including:

a. Behavioral Control Factors.

Factor 1: Instructions. A worker who is required to comply with another person's instructions as to when, where, and how the work is to be performed is ordinarily an employee.

Factor 2: Training. Training a worker as to the method and manner of performing services indicates control and the existence of an employment relationship.

[9] Assumes that: (a) the IRC Section 4980H(a) penalty does not apply because the 10 misclassified workers do not cause the employer to have failed to offer coverage to at least 95% of its full-time employees; and (b) the IRC Section 4980H(b) penalty applies with respect to the 4 employees receiving subsidized coverage. The IRC Section 4980H(b) penalty is calculated as the total number of full-time employees receiving subsidized coverage through a health care exchange multiplied by $3,000. That is, $3,000 x 4 = $12,000.

Factor 3: Hiring, Supervising, and Paying Assistants. If the person for whom the services are performed hires, supervises, and pays all assistants, then an employment relationship is generally indicated.

Factor 4: Setting Hours of Work. The establishment of set hours of work by the person requesting the services is a factor indicating control and the existence of an employment relationship.

Factor 5: Full Time Requirement. If the worker must devote substantially full time to the business of the person requesting the services, the worker is impliedly controlled and restricted from performing other gainful work, which indicates the existence of an employment relationship.

Factor 6: Work on Taxpayer's Premises. Work performed on the premises of the person requesting the services indicates the latter person has control over the manner of performance, especially if such work could be performed elsewhere.

Factor 7: Work Order or Sequence. If another person can require a worker to perform services in a certain order or sequence (or follow established routines or schedules), then the worker is subject to control, which indicates an employment relationship exists

Factor 8: Requiring Reports. If a worker is required to submit regular or written reports to the person for whom services are performed, then the latter person has some degree of control over delivery of the services, which may indicate an employment relationship exists.

b. Economic Control Factors.

Factor 9: Tools and Materials. An employment relationship is indicated if the person for whom services are performed furnishes significant tools, materials, and other equipment to the person performing the services.

Factor 10: Significant Investment by Worker. If a worker invests in facilities or equipment used to perform services and which are not typically maintained by employees, independent contractor status is indicated.

Factor 11: Payment of Expenses. If the person for whom services are performed pays the worker's business or travel expenses, the worker is ordinarily an employee.

Factor 12. Payment by the Hour, Week, or Month. Payment by the hour, week, or month generally indicates an employment relationship; provided, however, that this method of payment is not merely a convenient way of paying an agreed-upon lump sum for the particular job. Payment of straight commission or payment by the job or task generally indicates the worker is an independent contractor.

Factor 13: Economic Risk of Profit or Loss. A worker who can realize a profit or loss from the performance of services over and above the profit or loss ordinarily realized by an employee is

generally an independent contractor. The worker who cannot realize such profit or loss is generally an employee.

Factors 14 and 15: Making Services Available to the General Public; Working for Multiple Persons. These factors are interrelated. Independent contractor status is indicated when workers make their services available to the general public on a regular and consistent basis. A worker performing services for multiple unrelated parties at the same time is likely an independent contractor, while a worker performing services for one person or performing services for several persons as part of the same service arrangement is likely an employee of such person(s).

c. Relationship Factors.

Factor 16: Integration. The degree to which a worker's services are integrated into the business operations of the purported employer generally shows the extent to which the worker is subject to direction and control. More extensive integration indicates the existence of an employment relationship.

Factor 17: Personal Rendering of Services. When services must be rendered personally, the person requesting the services is presumably interested in both the result and the methods used to accomplish the result, which indicates the existence of an employment relationship.

Factor 18: Continuing Relationship. A continuing relationship between the worker and the person requesting the services, including performance at frequently-recurring but irregular intervals, indicates the existence of an employment relationship.

Factors 19 and 20: Right to Discharge; Right to Terminate. These factors are also related. The right to discharge a worker indicates an employment relationship. An independent contractor typically cannot be discharged so long as he or she produces a result that meets the parties' contracted specifications. Similarly, if a worker has the right to terminate the relationship at any time without liability, an employment relationship is indicated.

d. Additional Considerations.

In addition to the twenty factors of Revenue Ruling 87-41, courts have also looked to factors such as:

- Industry practice or custom;
- The intent of the parties;
- The existence of written, signed independent contractor agreements;
- The provision of employee benefits; and
- Whether the work requires special skills.

4. Conclusion.

Proper worker classification and controlled group/affiliated service group analysis is imperative. Employers who fail to properly address these threshold issues run the risk of significant adverse consequences, including the ACA's shared responsibility penalties under Code Section 4980H. Employers should consider undertaking an internal audit of their workforces to ensure workers are properly classified and seek legal advice when necessary. The risks of misclassification are great.

C. Interaction of COBRA and the ACA; Coverage Affordability Issues.[10]

There are a number of interrelated issues arising out of COBRA and the ACA.

1. Termination of Employment.

Termination of employment is generally a COBRA-qualifying event, so the employee generally should be offered COBRA coverage. Since the individual is no longer an active employee, the ACA's shared responsibility penalties under IRC Section 4980H no longer apply with respect to the terminated employee.

2. Reduction in Hours/Leave of Absence, but No Termination of Employment.

If an employee has a change in status (i.e., full time to part time), a reduction in hours, or leave of absence, but is still considered an employee, a COBRA-qualifying event will generally occur if the status change, reduction in hours, or leave results in a loss of coverage under the employer's group health plan. In these situations:

- If the individual was a full-time employee during the most recent measurement period, the ACA requires the employer to still offer qualifying coverage to the employee throughout the remainder of the current "stability period" or be subject to shared responsibility penalties for failing to do so.[11]
- An offer of COBRA coverage qualifies as an offer of coverage for ACA purposes. Thus, an offer of COBRA coverage satisfies the ACA requirement and protects an ALE from penalties under IRC Section 4980H(a).[12]
- An ALE may still potentially be subject to penalties under IRC Section 4980H(b)[13] if the COBRA coverage is "unaffordable" and the employee declines COBRA

[10] These scenarios assume that the employer is offering qualifying "minimum essential coverage" that provides "minimum value" (i.e., covering 60% or more of total health care costs).
[11] This assumes that the employer uses the ACA's "look back" method for determining full-time and part-time status under the IRC Section 4980H regulations.
[12] The IRC Section 4980H(a) penalty applies if an ALE fails to offer coverage to at least 95% of its full-time employees.
[13] The IRC Section 4980H(b) penalty can apply if an employer offers minimum essential coverage to enough full-time employees to avoid the IRC Section 4980H(a) penalty, but that coverage is either "unaffordable" or does not provide "minimum value" so that one or more employees still qualifies for, and actually purchases, subsidized Marketplace coverage.

coverage and instead purchases subsidized Marketplace coverage. (See below for discussion of affordability.)

- If an employee enrolls in COBRA coverage but then loses coverage because the employee fails to pay the required COBRA premium, no ACA penalties should apply to the employer.

3. Affordability Issues.

Coverage is deemed unaffordable for purposes of the ACA's employer shared responsibility penalties if it exceeds a specified percentage of the employee's household income (9.56% in 2015; 9.66% in 2016). Affordability is evaluated based solely on the employee's required contribution for employee-only coverage. Thus, if employee-only coverage is affordable because the employer pays enough of the premium so that the employee-only cost is not greater than the specified percentage (9.66% in 2015) of household income, there is no penalty under IRC Section 4980H(b). This is true even if the employee actually purchases full family coverage and the employee's share of that cost exceeds the specified (9.66%) income threshold, which could happen if the employer pays little or nothing of the cost to add a spouse and dependents.

To avoid a possible penalty under IRC Section 4980H(b), an ALE could decide to subsidize the employee-only COBRA premium to make it "affordable."

D. Hours of Service; Breaks in Service; Special Unpaid Leave; "On Call" Hours.

There are a number of issues arising out of the ACA's rules for counting and crediting hours of service for purposes of determining whether an employee is part time or full time.

1. Hour of Service.

An "hour of service" is any hour for which an employee is paid or entitled to payment from the employer (including periods in which no duties are performed due to vacation holiday, illness, incapacity disability, layoff, military duty, or leave of absence). This includes: (a) paid leaves of absence; and (b) payments by insurers on the employer's behalf, such as long term disability insurance. Thus, paid leaves (including disability leave) need to be taken into account, accordingly.

2. Breaks in Service.

An employee who returns to work following a period of unpaid absence (including a termination) may be considered either a new employee or a continuing employee after the break. This distinction is important.

- If the employee is considered a <u>continuing employee</u> and returns to work within a stability period during which the employer was otherwise required to offer coverage, then the employer must offer them coverage as of the <u>first day</u> the employee returns to work, or as soon thereafter as administratively practicable.

- If, however, the employee is considered a new employee, the employer must only offer coverage after the waiting period required for newly hired employees.

The IRC Section 4980H regulations provide the following two methods of determining when an employee returning to work after an unpaid absence is considered a continuing employee:

a. Break of 13 or More Consecutive Weeks.

If the employee resumes employment after a period of at least 13 consecutive weeks in which the employee was not credited with an "hour of service," the employer can treat them as a new employee.

b. Rule of Parity.

An employer can also elect to treat an employee as a new employee if the period (measured in weeks) during which the employee was not credited with any "hours of service" is:

- at least 4 weeks long (but not longer than 13 weeks); and
- exceeds the number of weeks of employment immediately preceding the period in which no services are performed. (For example, an employee is employed for 5 weeks and then has an unpaid break in service of 6 consecutive weeks.)

3. Special Unpaid Leave.

There is also a rule intended prevent an employee from being considered part time due to taking certain qualifying types of unpaid leave. "Special unpaid leave" is defined as unpaid leave under the FMLA, USERRA or jury duty.

The regulations prevent the special unpaid leave from effectively reducing an employee's average hours of service during a measurement period, thus preventing the employee from being considered part time solely due to the special unpaid leave.

Under these rules, an employer can either:

- calculate the employee's average hours of service during the measurement period by excluding any periods of special unpaid leave during the measurement period; or
- impute hours of service during the periods of special unpaid leave at a rate equal to the average weekly hours of service for weeks that are not part of any period of special unpaid leave.

Example: An employee has 4 weeks of special unpaid leave during a 12-month measurement period. Under the first approach, the employer would calculate the employee's average hours of service during the measurement period by excluding the 4-week period of special unpaid leave from both the numerator and the denominator of the calculation (i.e., the employee's total average

weekly hours of service = total hours of service during the measurement period ÷ 48 weeks (rather than 52)).

4. "On Call" Hours.

One aspect of the ACA frequently faced by employers that are health care providers is how to address "on call" hours for purposes of determining whether an employee is full time or part time. The applicable IRS regulations under IRC 4980H do not specifically address on call hours, and the IRS has acknowledged the need to provide formal guidance on this issue.

In the interim, the IRS has stated that until further guidance is issued, employers are required to use a "reasonable" method to track on call hours. The preamble to the IRS regulations[14] contains examples of methods that the IRS would consider reasonable (or unreasonable)—noting that other methods could also be reasonable depending on the facts and circumstances. It also states that 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 an employee in a position that traditionally involves at least 30 hours of service per week as part-time employee.

Specifically with respect to "on call" employees, the preamble states:

- 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;
    - for which the employee is required to remain on-call on the employer's premises; or
    - for which 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.
- Providing partial-hour credit for each on-call hour is also not reasonable.

In informal comments, IRS officials have indicated that if an employee is paid any amount for on-call hours or is severely constrained in personal activities while on-call, then the employer must credit those hours.

Employers with "on call" employees should review their practices to determine if they are properly crediting "on call" employees with hours of service. It is possible some employees who were previously considered "part time" because they were not receiving credit for "on call" hours may actually be "full time" employees if "on call" hours are properly credited.

[14] T.D. 9655 (Feb. 13, 2014).

E. Recordkeeping Issues.

Employers are responsible to maintain all records necessary to document compliance with or exemption from the various ACA requirements. For example, an employer that is audited may be required to show that all applicable notices were provided and all applicable fees were paid on a timely basis and that all applicable reporting requirements were timely met. Employers that cannot prove compliance may be subject to penalties.

The shared responsibility penalty rules under IRC 4980H are a certain audit target once the IRS begins auditing employers for ACA compliance. Employers who are ALEs should be prepared to rebut an IRS claim that additional shared responsibility penalties are due. Employers that are not ALEs should maintain documentation of their non-ALE status. For example, an employer with a workforce that consists of a significant number of temporary or part-time employees or that utilizes a significant number of independent contractors should be prepared to show that it properly classified all workers (as employees or independent contractors) and properly counted full-time employees and full-time employee equivalents. Mistakes can be costly.

For these reasons, employers should maintain records documenting:

- **Notices.** That all applicable ACA notices were provided on a timely basis. For example, employers maintaining a grandfathered plan should keep records necessary to prove the plan maintained grandfathered status and that they provided notice of grandfathered status in all plan materials describing benefits.

- **Reporting.** Compliance with all applicable reporting rules on a timely basis. For example, ALEs subject to the shared responsibility rules and IRS Form 1094/1095 reporting requirements should keep records of:

    - The counting rules used to determine ALE status and what related entities are aggregated for purposes of the ALE employer determination;

    - The categorization of employees (full-time, part-time, seasonal, variable hour) and workers considered independent contractors;

    - The applicable measurement periods, stability periods and administrative periods used to determine the employees (and their dependents) that the employer must offer coverage to;

    - The hours of service for each employee; and

    - All other items required to be reported IRS Form 1094/1095.

As additional guidance is issued on various ACA requirements, employers should determine whether they need to maintain additional records to document compliance with or exemption from such requirements.

IV. CONCLUSION.

The ACA is a complex web. Careful planning and can help employers avoid the pitfalls. Employers should involve their attorneys, accountants and benefits consultants in the planning process. By utilizing their team of advisors, employers will be able to more fully understand their obligations, analyze their options and determine the best course of action.

GSB:7533371.1