AFFORDABILITY under the Employer Shared Responsibility Provisions of the ACA

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Background
Under the Employer Shared Responsibility provisions of the Affordable Care Act (ACA), a “large” employer may be subject to penalties under IRC section 4980H(a) if it does not offer Minimum Essential Coverage (MEC) to substantially all full time employees and dependents. “Substantially all” means 70% in 2015 and 95% in 2016 and beyond. “Dependents” are defined as an employee’s children under age 26.

If an employer offers MEC to substantially all full-time employees and dependents (thus avoiding the 4980H(a) penalty), but that coverage does not meet ACA requirements for “affordability” and “minimum value,” the employer may be subject to different penalties under IRC section 4980H(b). For more information on these penalties, see our Leavitt article: Penalties under Employer Shared Responsibility.

To meet minimum value, the plan must pay at least 60% of the actuarial value of benefits covered under the plan. This means that on average a plan participant pays not more than 40%, via deductibles, coinsurance, copayments and other out-of-pocket amounts. This does not include the participant’s monthly premium payments. For more information on Minimum Value, see our Leavitt Article: How to Determine Minimum Value.

To meet affordability, each full-time employee’s share of the cost for employee-only coverage cannot be more than 9.5% of his or her income. If an employer identifies its lowest paid full-time employee and calculates 9.5% of that employee’s income, it will meet affordability for all full-time employees.

Note that the affordability test is based on the employee cost for single coverage. This is true even if the employee has a family and needs family coverage. There is no separate affordability test for dependent or family coverage. This point is significant because it affects family members’ eligibility for a subsidy if they buy insurance in the Exchange/ Marketplace. If employer-provided coverage is available – even if not affordable for a family —family members will not be eligible for a subsidy as long as single coverage provided meets the Affordability requirement.

An employer need only have one plan that meets affordability. In other words, an employer can offer additional plans that do not meet affordability, so that employees have an option to “buy up” to a more expensive plan.

Under the ACA, the 9.5% affordability test was defined as 9.5% of “household income” – defined as “adjusted gross income” (or AGI) on the employee’s tax return. However, since employers will not know this amount, subsequent guidance established three “safe harbors” or methods employers can use to calculate the 9.5% test. Each safe harbor uses a different base to which the 9.5% is applied; consequently, each method results in a different maximum dollar amount. This dollar amount is the maximum employee contribution that meets the affordability test. Thus, it is important to carefully consider each method and opt for the best method based on an employer’s specific employee demographics, as well as the employer’s goals and budget.
Important note: the information reporting requirements (under Code section 6056) include several different methods by which an employer can report, and some of them require that the employee contribution not exceed a specific affordability safe harbor. This might affect an employer’s choice of affordability test and maximum employee contribution amount.

**The Three Affordability Safe Harbors**

The Employer Shared Responsibility final regulations include clarification of how the three affordability safe harbor methods apply. Compliance with a safe harbor means that an employer will be deemed compliant with the law and cannot be subject to penalties, assuming the employer applies the safe harbor method correctly.

The three optional safe harbors methods to calculate 9.5% are:

- W-2 income
- Rate of Pay (Monthly)
- Federal Poverty Line (FPL)

**W-2 Safe Harbor**

This method allows the employer to use each employee’s W-2 income (Box 1) from the current year to determine affordability.

**How to Calculate:**

- Each employee’s annual contribution for self-only coverage cannot exceed 9.5% of that employee’s W-2 (Box 1) income for the current year. Since this amount will not be known until the end of the year, an employer who uses this method must estimate as of January 1 of each year what a full-time (or potential full-time) employee’s annual W-2 amount will be at the end of each year. If an employee’s compensation decreases during the year (e.g., due to reduced hours or to a reduced hourly rate), the employer will have to reduce the employee’s contribution at that time if the contribution was initially set at or just below the affordability threshold.

- The final regulations provide that the employee’s required contribution during the year must remain a consistent dollar amount or a consistent percentage of all Form W-2 wages during the year (the calendar year, or the plan year for non-calendar year plans). An employer is not permitted to make discretionary adjustments for a pay period, nor can an employer “frontload” the monthly employee cost and then reduce it later in the year. One possible strategy for an employer who uses the W-2 safe harbor is to set each employee’s cost for self-only coverage at 9.5% of the employee’s W-2 wages for the month, but also set a maximum monthly amount. This will ensure the employee contribution meets “affordability” for lower-paid employees and will also ensure that higher-paid employees are not charged excessive monthly amounts. For example, an employer might want to set the employee cost for self-only coverage as “9.5% of each eligible employee’s W-2 wages, not to exceed $150 per month.” This strategy will complicate payroll administration, however.

- To calculate affordability for full time employees not employed the full year, multiply the W-2 wages for the calendar year by a fraction equal to the months for which coverage was offered to the employee over the months the employee was employed (a month is counted if offered or employed at least one day during a calendar month). For example, an employee worked eight months of a calendar year, and was offered coverage during five of those months. At the end of the year, the employee received a Form W-2 reflecting wages of $24,000. To calculate, multiply $24,000 by 5/8 to get adjusted W-2 wages of $15,000. Then calculate 9.5% of $15,000, which equals $1,425.
Considerations for Different Employers

- An employer may want to use the W-2 method if it has a very stable workforce comprised mostly of regular full-time employees who work 40 hours per week and whose compensation is unlikely to decrease during the year.
- An employer might not want to use the W-2 method if it has variable hour or seasonal employees, or if it has employees whose hours of service or compensation vary over the course of the year, because it is difficult to estimate income at the beginning of the year for this category of employees.
- If an employer uses the Look-Back Measurement Method and the W-2 safe harbor, and employees with coverage during the Stability Period are working significantly fewer hours than during the prior Measurement Period, the employer may have to reduce the employee cost for employee-only coverage in order to meet the W-2 Affordability test.
  
  - For example, if the Measurement Period is 2014 and the Stability Period is 2015, and a full-time hourly employee earned $10/ hour in 2014 and worked on average 40 hours per week, but during 2015 that employee averages only 20 hours per week (still earning $10/hour), coverage during 2015 is affordable only if it is not more than 9.5% of the employee’s W-2 income in 2015. This 2015 income would be half as much as the 2014 W-2 income.
- An employer cannot use the W-2 safe harbor for those employees for whom the employer will use the “qualifying offer” alternative method for Information Reporting (under Code section 6056). Rather, the employer must use the FPL safe harbor for those employees.

Disadvantages of W-2 Method:

- Box 1 income does not include pre-tax contributions for 401(k) or cafeteria plans, so if an employee makes these pre-tax contributions this will reduce the maximum affordable amount.
- The W-2 form used must be for the current tax year, not the prior year. That is, to determine affordability for 2015, the 2015 Form W-2 that must be used. The practical difficulty is that at the beginning of 2015, the employer must project the amount that will be in Box 1 at the end of 2015.
- This is calculated on an employee-by-employee basis, and may have to be changed before the end of the year if actual W-2 income varies from the amount projected at the beginning of the year. This can be administratively burdensome and time consuming.
- The employer must always be aware of the hourly rate of the lowest-paid full-time employee.

Advantages of W-2 Method:

- The W-2 income safe harbor generally will result in a higher monthly premium “affordable” amount. This is because the W-2 method includes all hours the employee actually worked and hours for which no work was performed but the employee was paid or entitled to payment (e.g., paid holidays and vacation, paid leave and disability). It is not limited to 130 hours/month, as in the Rate of Pay safe harbor below.

Rate of Pay (Monthly) Safe Harbor
This design-based method allows the employer to calculate affordability on a monthly basis.

How to Calculate:

- For hourly employees, 130 hours multiplied by the employee’s hourly rate as of the first day of the plan year or the lowest hourly rate of pay during each calendar month. See below under “Examples” for maximum amounts an employer can charge under the Rate of Pay method at various hourly rates.
• For non-hourly employees, use the employee’s monthly salary as of the first day of the plan year (regardless of hours on which is based).
• An employer can use the “rate-of-pay” safe harbor even if the employer reduces an employee’s hourly rate of pay during the plan year, but the rate-of-pay safe harbor will apply separately for each month. This means if the rate of pay is reduced in a following month, affordability needs to be recalculated based on the new lower rate of pay. This will result in a lower maximum “affordable” rate for those months an employee’s hourly rate has been reduced. Note that if an employer uses the rate of pay of the lowest-paid employee and multiplies this by 9.5%, the resulting monthly amount will meet the test for all employees.

**Considerations for Different Employers**

• Note that an employer need not recalculate under this method if the employer reduces monthly hours an employee works or if an employee has periods of unpaid leave, but only must recalculate if hourly rate is reduced.

  o For example, if a full-time hourly employee earns $10 per hour in a calendar month (and earned at least $10 per hour at the beginning of the year), coverage is affordable if the employee cost for employee-only coverage is not more than 9.5% of $10 x 130 hours (this would equal $123.50), even if the employee has a significant amount of unpaid leave or otherwise reduced hours in one or more calendar months.

• An employer cannot use the Rate of Pay safe harbor for those employees for whom the employer will use the “qualifying offer” alternative method of information reporting (under Code section 6056). Rather, the employer must use the FPL safe harbor for those employees.

**Disadvantages of Rate-of-Pay Method:**

• The employer can only multiply the hourly amount by 130 hours per month, even if employees actually work more hours.
• If hourly rate of pay is reduced after determining affordability, the threshold amount will need to be recalculated during the year and therefore the monthly amount charged for single coverage will need to be reduced.
• The employer must always be aware of the hourly rate of the lowest-paid full-time employee.

**Advantages of Rate-of-Pay Method:**

• Although technically this is calculated on an employee-by-employee basis, it can also be a “fail-safe” design-based safe harbor because if this affordability test is met for the lowest-paid employee each month, then it will also be met for all other employees.
• This affordability calculation will apply even if an employee works fewer hours or is on leave during some months. See the example above under “How to Calculate.”
• The employer can calculate the maximum amount for affordability as of the beginning of the plan year (and on a monthly basis if hourly rate is reduced during the year), and need not wait until after the end of the year to determine it (as required under W-2 method).
Federal Poverty Line Safe Harbor
This method allows the employer to use 100% of the Federal Poverty Line (FPL) income (for a household size of one) to determine affordability. For 2014, this amount is $11,670 and for 2015 this amount is $11,770.

How to Calculate:
- The employee contribution for self-only coverage cannot exceed 9.5% of the FPL for one. To calculate the monthly maximum, divide the annual amount by 12. For example, for 2014, 9.5% of $11,670 (the FPL for one person) is $1,108.65, divided by 12 equals $92.39 per month; and for 2015, 9.5% of $11,770.00 is $93.18 per month. This means the monthly amount an employee must pay for single coverage cannot exceed these amounts, to meet affordability.
- An employer can elect to use the FPL rate in effect six months prior to the start of the plan year, rather than at the start of the plan year.

Considerations for Different Employers
- This safe harbor may be most useful for employers who use the Look-Back Measurement Method and have numerous variable hour or seasonal employees. Employers whose lowest paid employee is a “moving target” may have to check affordability each month throughout the year unless they use this “100% of FPL” method.
- This safe harbor may also be useful to employers with employees whose hours of service are higher earlier in the year and are reduced later in the year.
- An employer who will use the “qualifying offer” simplified method of information reporting (under Code section 6056) must use the FPL safe harbor for those employees for whom the employer will use the “qualifying offer” method.

Disadvantage of FPL Method:
- This method typically provides the lowest threshold allowed for the monthly premium. For example, as noted above, in 2014 the maximum employee monthly contribution (for self-only coverage) using this safe harbor would be only $92.39 and for 2015 would be $93.18. Other methods allow a higher monthly premium charge. An example of an exception to this statement is where an employee is working full-time at the federal minimum wage rate of $7.25 per hour and the employer elects the Rate of Pay method. In that situation, the maximum employee contribution would be only $89.54 per month.

Advantages of FPL Method:
- This is not a separate calculation for each employee. It is a “fail-safe” safe harbor that will apply even if the amount is less than a particular employee’s actual income for the month or year. An employer who uses this safe harbor will always meet the affordability standard each month.
- The final regulations allow an employer to use the FPL rate in effect six months prior to the start of the plan year, rather than at the start of the plan year. This is helpful because employers generally set rates three to six months before the start of the plan year; however, the FPL rate will likely be slightly lower six months prior to than at the start of the plan year.
Examples for Each of the Three Safe Harbor Methods

Assumptions:
Assume that as of January 1, 2015, an employee earns $8/hour and is regularly scheduled to work 40 hours/week and 52 weeks/year (or 50 weeks/year plus two weeks of paid vacation). This would equate to annual compensation of $16,640 ($8 x 40 hours = $320 x 52 weeks).

Example for W-2 Method:
The employer doesn’t know until the end of 2015 whether the employee actually will work these hours at this rate of pay. If the employee does, indeed, work as scheduled during 2015, the maximum employee contribution (for self-only coverage) per month would be $131.73. (9.5% of annual compensation of $16,640 equals $1,580.80, and one-twelfth of that would be $131.73.)

As noted previously, however, the Box 1 amount on the W-2 could actually end up to be more if an employee worked overtime or if the pay rate increased during the year, but less if an employee made pre-tax 401(k) or cafeteria plan contributions. If the employee’s monthly contribution in this example was set at $131 per month and the actual W-2 amount was higher than projected, the affordability threshold would be higher, so $131 per month would be fine. However, if the actual W-2 amount was only $15,000, the maximum employee contribution could not be more than $1,425 annually (9.5% x $15,000) or $118.75 monthly, so the coverage would not be affordable for this employee. If the employee declined coverage and instead went to the Exchange, the employee would be eligible for a subsidy and the employer would be subject to a penalty of $250 per month for this employee.

Example for Rate of Pay Method:
Based on $8.00 per hour and 130 hours per month, the maximum employee contribution (for self-only coverage) per month would be $98.80. ($8 x 130 hours = $1,040, x 9.5% = $98.80.)

Examples of maximum amounts an employer can charge under the Rate of Pay method at various hourly rates are:
- $ 7.25 per hour = maximum monthly charge of $89.54.
- $ 8.00 per hour = maximum monthly charge of $98.80
- $ 9.00 per hour = maximum monthly charge of $111.15
- $10.00 per hour = maximum monthly charge of $123.50
- $11.00 per hour = maximum monthly charge of $135.85
- $12.00 per hour = maximum monthly charge of $148.20
- $13.00 per hour = maximum monthly charge of $160.55
- $14.00 per hour = maximum monthly charge of $172.90
- $15.00 per hour = maximum monthly charge of $185.25

Example of the Federal Poverty Level Method:
As noted above, the maximum amount for 2014 is $92.39 per month and for 2015 is $93.18 per month. This applies regardless of an employee’s hourly rate.
## How HRAs, HSAs, and Wellness Program Incentives Affect Affordability and Minimum Value

The following matrix summarizes how the minimum value (MV) and affordability determinations are affected by employer credits to HRAs, employer contributions to HSAs, and by financial incentives under “results-oriented” wellness programs. Additional detail is provided following the matrix. The numbers in the matrix correspond to the numbered explanations following the matrix.

<table>
<thead>
<tr>
<th>HRA, HSA, or Wellness Program Incentive</th>
<th>How this Counts Toward MV</th>
<th>How this Counts Toward Affordability</th>
</tr>
</thead>
<tbody>
<tr>
<td>HSA: Employer current-year contributions</td>
<td>Count in the MV calculation</td>
<td>Do not count in the affordability calculation (^1)</td>
</tr>
</tbody>
</table>
| HRA: Employer credits for the current year to HRA integrated with employer major medical plans. | Count in the MV calculation only if the amounts may be used only for cost-sharing and not to pay insurance premiums | Count only in determining affordability (and do not also count toward MV) if either:  
  - Employer amounts may be used only to pay insurance premiums, or  
  - Employees can elect to use the amounts either for cost-sharing or to pay premiums |
| Incentives for tobacco cessation/reduction wellness program \(^2\) | Assume all employees meet the terms of the program, so the reduced cost-sharing they receive counts toward MV calculation | Assume all employees meet the program requirements, so premium amount used in affordability calculation is the lower premium for non-smokers, not the higher premium that smokers must pay |
| Incentives for other wellness programs | Assume all employees fail to meet the terms of the program, so the higher cost-sharing they have counts toward MV calculation. | Assume all employees fail to meet the terms of the program, so the premium amount used in the affordability calculation is the higher premium paid by those who fail to meet the requirement. |

1. Employer contributions to HSAs do not count toward affordability because HSA amounts cannot be used to pay premiums, but can only be used toward the participant’s (or his/her tax dependents’) medical costs (i.e., cost-sharing expenses under the group health plan, or other medical expenses under code section 213(d) that are not covered under a group health plan).

2. Under a nondiscriminatory “results-based” wellness program, the financial incentives to employees to satisfy the terms of the wellness program might be lower premiums and/or reduced cost-sharing. The maximum incentive for tobacco cessation wellness programs is 50% of the total cost of coverage.
under the group health plans, and for other wellness programs it is 30%. Note that the effect on MV and affordability differs for tobacco cessation/reduction wellness programs versus all other types of “results-oriented” wellness programs.

A Note about ACA Provisions for Information Reporting

Information Reporting using Forms 1094-C and 1095-C requires, among other things, details about the affordability of the health coverage an employer offers. Therefore, it is important to document and keep record of the affordability safe harbor option the employer selects.

For example, under the Information Reporting rules (found in IRC section 6056) a large employer may qualify to use an alternative reporting method such as the “Qualifying Offer” method or the “98% Offer” method for some of its employees. To use the “Qualifying Offer” method, one of the requirements is that coverage must be affordable under the Federal Poverty Line affordability safe harbor. For other reporting methods, the employer may use ANY affordability safe harbor.

Information Reporting allows an employer to use different affordability safe harbors within different “reasonable” categories of employees as long as the application of the safe harbor is uniform and consistently applied for all employees in a particular category. The final regulations clarify that “reasonable” categories generally include specified job categories, nature of compensation (e.g., salaried or hourly), geographic locations, and similar bona fide business criteria. However, listing employees by name would not be a reasonable category. Although an employer may use different affordability methods for different categories, it is less complex and less administratively burdensome to use one affordability safe harbor for all categories of employees.

For more information on Information Reporting, view the Leavitt webinar on Reporting which is dedicated solely to the rules associated with this provision of the ACA.