

ACA excise tax compliance

The crunch is here in 2016





As 2016 begins, employers have had one year of experience with the Affordable Care Act's (ACA) pay-or-play excise tax and compliance. This year, the risks associated with failing to comply with the excise tax ratchet up dramatically. Even companies that did a good job in 2015 still face dangerous traps.

Although the "Cadillac Tax" for generous health benefit plans has been delayed to 2020, the reporting requirements and potential excise tax penalties for providing inadequate health care remain for 2016 and present challenges in the current year.

Now the law applies to even more employers, and an even higher percentage of employees must be offered coverage. During 2015, Applicable Large Employers (ALEs) were required to offer coverage to at least 70% of all full-time common-law employees or face a significant excise tax. As of 1 January 2016, that bar has been raised to 95% for calendar year plans.

If an employer misses those required percentages and even one employee obtains coverage on a state insurance exchange with a tax subsidy, the indexed pay-or-play excise tax (originally \$2,000, \$2,080 for 2015, and \$2,160 for 2016) is levied not just for that employee, but on **every full-time employee in the Applicable Large Employer (ALE)**, whether they were offered coverage or not.

The ACA's employer mandate includes daunting requirements for determining whether an employee is full-time and, therefore, is entitled to an offer of coverage. In 2016, this most basic determination of who an employee is becomes even more critical.

The increased offer-of-coverage threshold also requires a more rigorous compliance effort for employers including workforce analysis of Form W-2 employees and contingent workers. Prior to ACA, the definitions for "benefits-eligible" or "full-time" varied from employer to employer. Now, employers are required to follow the full-time employee definition provided in the regulations and to follow very specific methodologies for calculating 30 hours per week.

This definition requires the counting of actual hours rather than scheduled hours, does not provide exceptions for students or temporary workers, requires employers to count hours on leave of absence and provides a very complex averaging methodology

for variable and seasonal employees. One of the key compliance challenges comes in the form of determining which hours of service should be counted to meet the required offer of coverage to 95% of common-law employees who work an average of at least 30 hours per week. Employers may need to perform a rigorous analysis of pay codes to determine whether an hour of service should be counted under the regulations.

The use of a common-law employee standard for determining full-time employees creates challenges for many employers. Most employers do not typically consider workers provided by vendors, staffing agencies and their independent contractors (contingent workers) to be their common-law employees. If a large enough number of the contingent workers should be considered common-law employees and are not offered health care coverage, the employer could become subject to the punitive annual excise tax under Section 4980H(a) (i.e., \$2,160 multiplied by all full-time employees of the employer).

How the excise tax works

The ACA's excise tax requirement, often called pay-or-play, requires employers to either offer insurance or pay a tax to cover employees who get insurance from the state and federal insurance exchanges.

The excise tax is evaluated on monthly basis. To calculate the estimated excise tax (for potential accrual in the financial statements), use this formula: $(\$2,160 \times \# \text{ of full-time employees}) \div 12$.

The full amount is assessed if even one full-time employee goes to the exchanges and buys a policy that comes with a subsidy.

If an employer does not offer coverage to enough of its workforce (including potentially misclassified non-employees), the company will face the \$2,160 excise tax for every employee in that particular business entity. For a company with 1,000 employees, that is a \$2.16 million, nondeductible maximum penalty.

The good news is that this is a monthly tax. Mistakes in Q1 can be fixed for Q2. It's not too late to get it right.

Another element of the ACA exposes employers to risk in the form of fines. Every year, the organization must compile data for the previous calendar year and provide every full-time employee with a Form 1095-C, which enumerates employer-provided coverage.¹ The forms generally must be furnished to employees by the end of January and the completed forms sent to the IRS by the end of March, if filed electronically (with filing extensions given for the first year in 2015). Employers that fail to meet these filing requirements could face additional penalties of \$250 per form, capped at \$3 million per entity. With penalties applying separately for both requirements – the requirement to furnish to recipients and the failure to file with IRS – employers could face penalties of up to \$6 million per legal entity.²

Failure to comply may be material to the financial statements

Before passage of the ACA, auditors didn't ask about workforce demographics or health care coverage. Today, a tax liability that could be as high as \$2,160 per full-time employee is often material to a company's financial statements. As of Q1 2016, outside auditors may find that exposure to the excise tax could require an accrual of a liability, which is often an unfavorable position that most companies would like to avoid.

Under ASC 450 (previously FAS 5), a probable and estimable contingent liability must be recorded on a company's financial statements. Finance and accounting departments should assess, implement and document the company's internal controls to demonstrate that they mitigate the risk of liability of these excise taxes. These controls can include information systems, scheduling, manager overtime approval and controls that focus on the contingent workforce. The company's internal audit unit should also consider testing compliance and related controls.³

It is important to assess the company's exposure to this financial risk using ASC 450 or other liability accounting and to report any expected accrual of ACA excise tax liability on annual and quarterly financial statements. That position should be documented with both a calculation and a memorandum, because auditors **will** ask about financial exposure under the ACA. A company that does not anticipate an excise tax accrual must document why it is not subject to the excise tax to satisfy independent auditors. Many human resources managers

- 1 www.irs.gov/pub/irs-pdf/f1095c.pdf, Internal Revenue Service Form 1095-C and instructions, accessed 4 December 2015.
- 2 Tom Bernard, Alan Ellenby and Tim Parrish, www.shrm.org/hrdisciplines/benefits/articles/pages/aca-reporting-insights.aspx, ACA Information Reporting: Insights for the Journey, Society for Human Resources Management, 17 November 2015.
- 3 Juliette Meunier, www.readperiodicals.com/201405/3321704361.html, ACA Mythbuster: Running Afoul of Mandate Can Spell Hefty Penalties, Cal CPA, 1 May 2014, registration required.

are not aware of these implications and assume that they meet financial reporting requirements simply because they offer generous coverage. In this new environment, that is not going to be sufficient. Finance and accounting functions must determine whether their company is accruing a liability that could be material to the financial statements and prove it with adequate documentation.

Human resources, finance, information technology, payroll, legal and accounting departments all need to be aware of the implications of the financial risk. So this is a chance to create a cross-functional team with representatives from each of these departments to ensure compliance. The team should make sure that every department is aware of all the data streams that must come together to report accurately and completely and to provide documentation to support the financial statement position.

The end of other transition relief

In addition to the increase of the offer of coverage threshold from 70% to 95%, the IRS had provided additional transitional relief of certain ACA requirements during 2015 that are no longer effective as of 1 January 2016.

- ▶ ALE definition. – The employer mandate offer of coverage applies to Applicable Large Employers, a distinction that increases from 100 or more full-time equivalent employees for 2015 to 50 or more full-time employees for 2016 and beyond. (Note: ALEs in the 50 to 99 full-time employee category were under the reporting requirements for 2015.)
- ▶ Penalty calculation under Section 4980H(a). – For 2015, the penalty for not covering at least 70% of full-time employees was calculated by excluding 80 employees from the employer's total number of full-time employees. For example, if an ALE had 1,000 full-time employees, a penalty could be up to \$2,160, before indexing, times 920. For 2016 and beyond, this excise tax calculation will exclude only 30 employees from the calculation. (It should be noted that for entities that were part of a "controlled group," the 80 employee exclusion (30 for 2016 and thereafter) is allocated between group members in proportion to the number of their full-time employees.)
- ▶ Penalty calculation under Section 4980H(b). – If an employer offers coverage to its full-time employees but the coverage (i) does not meet the minimum value standards (i.e., cover

at least 60% of the expenses under the plan) or (ii) is not considered affordable to the employee (i.e., the employee's required contribution for the lowest cost plan for self-only coverage is not more than 9.5% of household income or the cost satisfies one of the three safe harbors) and the employee receives coverage through a marketplace with a premium tax credit, the employer will be subject to an excise tax penalty. The penalty, originally of \$3,000 per affected individual, was indexed to \$3,120 for 2015, and \$3,240 for 2016. Again, this penalty is assessed on a month-by-month basis, meaning the cost for incurring this penalty for a single employee for a single month in 2016 will be \$270. The total penalty under Section 4980H(b) is not to exceed the total penalty detailed above under Section 4980H(a).

- ▶ Marketplace/Exchange Notices. – Some marketplaces issued Marketplace/Exchange Notices in 2015, but the vast majority did not. Recently, the federally facilitated exchanges announced that they intend to begin issuing Marketplace/Exchange Notices in spring 2016. The Marketplace/Exchange Notices communicate that a Section 4980H(b) penalty may be imposed upon an employer with respect to an employee who has obtained coverage and a premium tax credit from the marketplace. An employer can appeal the Marketplace/Exchange Notice within 90 days of the date the letter is issued by the exchange (regardless of when it is actually received). Appeals processes may differ by state (although they are anticipated to be fairly standard for the federally facilitated exchanges).

What should employers do?

The traps for the unwary in the ACA excise tax are many and painful. What do employers need to do **now** to make sure they do not fall into any of these pits? Beyond creating a cross-functional team, here are a few of the most important ways to get into compliance and avoid the costly tax penalties.

Employee classification

Evaluate and offer coverage immediately to meet the 95% threshold to avoid the 4980H(a) punitive excise tax. This may include some employees who might not have been considered full-time employees in the past.

Who is a full-time employee? At first glance, this seems obvious. Unfortunately, it's not. For example, here are some types of workers who may now be considered employees under the ACA:

- ▶ Employees on leave of absence
- ▶ Interns and co-ops
- ▶ Students, graduate assistants and adjunct faculty⁴
- ▶ In-patriates still on home country payrolls
- ▶ Employees hired by staffing agencies
- ▶ Contingent workers
- ▶ Temporary or seasonal workers
- ▶ Variable hour employees
- ▶ Per diem workers

While gathering the entire universe of the workforce, employers must consider the accounting standard of completeness to ensure that they have captured all potential full-time common-law employees. When doing so, it is important to track how these lists are pulled and organized, even if HR has never had to do this kind of tracking before, so that external auditors can review the work that has been done. This often includes pulling reports such as badge access and remote network access as elements of determining the full universe of potential full time common-law employees.

One key to evaluating whether an individual is a common-law employee for ACA purposes is understanding who directs and controls that person's day-to-day work schedule and job duties. A common-law employer-employee relationship could exist between an entity contracting for services and an individual if that entity controls not just outcomes but also the means by which that result is accomplished. Employers do not actually need to control every step of the process. It could be enough just that the employer has the **right** to control it.⁵

The IRS's three types of control lay out the requirements for determining categories of control. However, the bottom line is that if the control is with the company, people could be common-law employees even if they are theoretically hired and paid by a staffing agency, vendor, contractor or the like.⁶

The IRS divides the facts that help determine whether a worker is an employee into three categories:

- 1. Behavioral:** Does the company control or have the right to control what the worker does and how the worker does his or her job?
- 2. Financial:** Are the business aspects of the worker's job controlled by the payer?
- 3. Type of relationship:** Are there written contracts or employee-type benefits (e.g., pension plan, insurance and vacation pay)? Will the relationship continue, and is the work performed a key aspect of the business?

Source: Internal Revenue Service, *Independent Contractor (Self-Employed) or Employee?*

In addition to whether or not a worker is an employee, it must be determined which employees are full-time. Employees who work, on average, 30 hours or more are generally considered full-time.

This sounds simple, but even defining "one hour of service" is now very complicated. For example, it has to account for hourly variations such as overtime or whether an employee's paid time off is counted as hours of service. These calculations have to be made for all employees, pay code by pay code. The ACA defines full-time as averaging 30 hours of actual work, not just scheduled, and includes complicated averaging rules found in the regulations.

In addition to these complex calculations, employers must meet the ACA's IRS reporting requirements for coverage of every full-time employee in every single legal entity across the organization, although the penalty will only affect the entities in noncompliance.

Since the exposure for compliance failure is potentially enormous and penalties are potentially significant, careful attention to compliance is imperative.

Data collecting and reporting

Going forward, nothing is more critical to ACA compliance than getting the right data on the right forms at the right time.

The complex calculations of risk under the ACA require collecting the HR/benefits department's employment data and analyzing it

⁴ Meunier et al., op cit.

⁵ Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes* (JCX-26-07), 7 May 2007. This publication is also available online at www.house.gov/jct.

⁶ www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Independent-Contractor-Self-Employed-or-Employee, Independent Contractor (Self-Employed) or Employee?, Internal Revenue Service, accessed 11 December 2015.

with the granularity that the tax, legal and finance departments need – both to calculate play-or-pay excise tax risk and to ensure compliance with IRS filings.

Form 1095-C requires employers to provide the following for each full-time employee on a monthly basis:

- ▶ Whether an offer of coverage was made to the employee
- ▶ To whom the coverage was offered (e.g., employee only, spouse, dependents)
- ▶ The lowest-cost monthly premium for self-only coverage available to the employee
- ▶ Whether the employee and his or her dependents were enrolled in self-insured coverage
- ▶ Waiting periods, safe harbors and enrollment data

Reporting this information requires the selection of IRS-prescribed indicator codes from a list of 18 different codes, so it is critical to have an information system that translates employee payroll and benefits data into the applicable indicator codes.⁷

Departments across the organization should be involved in collecting this data, including human resources, benefits, tax, finance, legal and information technology.

Right now, companies are working diligently to get the right data on these IRS forms. In 2015, IRS said that if companies made a **reasonable effort** to gather and report accurate data in the first year, they would not face accuracy penalties. In 2016, that relief goes away.

By now, much of the basic work should have been completed. In 2015, employers should have identified the right kind of data, combined the data and tested it to ensure that they produce

the required information. What came out might not have been perfect; it might have come from five different systems and may not have been clean. The key, however, is that the critical departments should have learned what to expect. They should now know what data elements are needed and where that data should go on the filings.

In early 2017, covered employers must provide employees and the IRS with an annual report on the minimum coverage aspects of health care plans at the same time that Forms W-2 are issued – on or before 31 January 2017. Filings with the IRS for large employers required to file electronically will be due on or before 31 March 2017.

The monthly analysis required in connection with the 1095-C typically involves calculations and documentation of the employer's insurance coverage offer dates to its employees. Processes should be articulated for important components of the ACA, such as determining eligibility for health coverage, onboarding of contingent workers and tracking hours.⁸

In terms of legacy systems, all data must be retained and accessible for the full length of time associated with any potential IRS audits (typically, seven years) to measure full-time status over past years and to ensure that all IRS inquiries and audits can be properly managed.⁹ In addition, the current technology must be nimble enough to accommodate possible changes in legislation. In all of these efforts, the quality of the cross-functional team that manages the flow of information is critical.

⁷ Bernard et al., op cit.

⁸ Tax risks and opportunities for executives and boards, recent developments, Legislative Hot Topics, November 2015, slide 2

⁹ Bernard et al., op cit.

Conclusion

This increased offer-of-coverage threshold for 2016 and beyond requires a much more rigorous compliance effort for employers to make sure that they are offering affordable health coverage to substantially all their full-time employees to avoid the hefty Section 4980H(a) excise tax penalty. It also forces employers to scrutinize all their classifications of workers to identify any potential risk populations. Companies need to start thinking through their employee data for accuracy and cleanliness, considering the ACA implications of merger and acquisition transactions and thinking through and documenting internal processes and controls for financial statement purposes.

Additional sources

Audit considerations for the Affordable Care Act's employer mandate provisions, Ernst & Young LLP, 12 March 2015.

EY Tax webcast, www.ey.com/GL/en/Issues/webcast_2014-02-04-1700_implementation-of-the-affordable-care-act-aca.

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