ACA AFFORDABILITY SAFE HARBORS: A PRIMER

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QUICK FACTS

- The Affordable Care Act (ACA) requires all applicable large employers (ALE) to offer their full-time employees (and dependent children to age 26) affordable, minimum value health coverage or face an employer shared responsibility penalty (ESRP).
- The ACA states that coverage will be considered affordable if it does not exceed a certain percentage of an employee's household income.
- The ACA originally set the affordability threshold at 9.5% of an employee's household income, and the IRS has adjusted it annually; for 2020 the affordability threshold is 9.78%.
- The IRS has approved three safe harbors – W-2, rate of pay and federal poverty line – on which employers may rely to determine whether the health coverage they offer meets the current applicable affordability percentage.

BACKGROUND

The ACA requires ALEs to offer full-time employees and their dependent children to age 26 affordable, minimum value health coverage or pay a penalty – the so-called play-or-pay mandate. To avoid potential penalties, an ALE must ensure that the employee's share of the cost for the lowest-level self-only coverage it offers does not exceed a certain percentage – 9.78% for 2020 – of an employee's household income. The problem for employers is they generally have no way to know an employee's household income. The IRS recognized this challenge and created three safe harbors for employers to determine whether they have offered affordable coverage.

An employer has the option to choose any of the three affordability safe harbors as long as it applies the safe harbor consistently and uniformly to all employees in an acceptable category. The IRS has stated that acceptable classes include specified job classifications, hourly vs. salaried, geographic location or any other legitimate business criteria. Listing employees by name is not an acceptable classification. An employer is not forever locked into a safe harbor; it may choose a different safe harbor in the future as long as it applies the change consistently and uniformly to all affected individuals.

Though neither the ACA nor the IRS require an employer to use an affordability safe harbor, doing so will help shield an employer from employer shared responsibility penalties (ESRP). If applying the chosen safe harbor results in a coverage offer being affordable, the employer will face no ESRP even if an individual's overall household income qualifies him or her for a premium tax credit (PTC) for Marketplace coverage under the formula used to determine PTC eligibility. So an employer who receives a letter of proposed ESRP from the IRS (Letter 226-J) will have a ready defense if it can show that its safe harbor calculation was affordable.

W-2 SAFE HARBOR

Under the W-2 safe harbor, an employer's 2020 offer of coverage will be deemed affordable if his or her share of the cost for the lowest-level self-only coverage is no more than 9.78% of the employee's wages as reported in Box 1 of Form W-2.

Bear in mind, however, that this safe harbor will not guarantee that coverage is affordable for all full-time employees because certain adjustments to income during the year cannot be forecast. For example an employee's Box 1 wages could be lower than expected due to elective contributions to a 401(k) plan, health care flexible spending account or health savings account. Because an employer cannot know an employee's Box 1 wages until after the year ends, it could discover too late that the cost of offered coverage exceeded the applicable percentage of an employee's wages. If such an employee received a PTC for Marketplace coverage, the employer could face an ESRP of $321.67 for each month for which the employee did not receive an offer of affordable coverage.

IRS rules allow an employer to adjust an employee's wages under the W-2 safe harbor if the employee was full-time for less than the full calendar year. In this case an employer may multiply an employee's wages by a fraction equal to the number of months the employer offered the employee coverage divided by the number of months the employee was employed. If the employee's cost for those months was no more than the applicable affordability percentage, the coverage is affordable.

RATE-OF-PAY SAFE HARBOR

Under the rate-of-pay safe harbor, an employer's 2020 offer of coverage will be deemed affordable if the cost for the lowest-level self-only coverage is no more than 9.78% of an employee's regular rate of pay. For hourly employees, an employer will assume a rate of 130 hours worked per month (regardless of the number hours actually worked by the hourly employees) multiplied by an employee's hourly rate. In 2020, for example, an employer can charge no more than $127.14/month for the lowest-level self-only coverage for an employee earning $10/hour ((130 x $10) x .0978).

An employer could minimize its risk of an ESRP assessment by setting contribution rates for the lowest-level self-only coverage by multiplying either the lowest hourly rate in the employer's workforce or the lowest applicable minimum wage for the employer's workforce by 130 hours and the applicable affordability percentage.

For salaried employees, the employer can charge no more than 9.78% of an employee's salary as of the first day of the applicable coverage period. In 2020, for example, an employer can charge no more than $244.50/month for the lowest-level self-only coverage for an employee earning $30,000/year (($30,000/12) x .0978).

IRS regulations clarify that an employer with employees whose entire compensation is based on tips or commissions may not use the rate-of-pay safe harbor. For employees in these situations, the employer may use either of the other affordability safe harbors.

Keep in mind that an employer can use the rate-of-pay safe harbor only if an employee's required contribution for health coverage is the same (or is the same percentage) for the entire plan year, which may be the calendar year or, for non-calendar year plans, the portion of each calendar year that includes the plan year. Also, an employer must base any monthly affordability on the lowest rate of pay for any month in which an hourly employee's rate of pay decreases. If a salaried employee's salary decreases during a month, the employer may not use the rate-of-pay safe harbor.

FEDERAL POVERTY LINE SAFE HARBOR

Under the federal poverty line (FPL) safe harbor, an employer's 2020 offer of coverage under a calendar year plan will be deemed affordable if an employee pays no more for the lowest-level self-only coverage than 9.78% of the annual individual mainland FPL published as of July 1, 2019, divided by 12.

Regulations allow an employer to use the published FPL rate in effect six months prior to the beginning of the plan year, so a non-calendar year plan could have a slightly different affordability threshold if it chose to use the FPL table published in January 2020.

For 2020 calendar year plans, an employer can charge no more than $101.79/month for the lowest-level self-only coverage (($12,490/12) x .0978).

The FPL safe harbor is the easiest safe harbor to implement, and it will assure an employer that its offer of coverage is affordable. Having said that, the FPL safe harbor generally will require a greater employer spend on its health coverage.

EMPLOYER ACA REPORTING

An employer who uses one of the accepted affordability safe harbors should be careful to report the safe harbor accurately to IRS on any required Form 1095-C. The following codes can be used on Line 16: W-2 safe harbor, Code 2F; FPL safe harbor, Code 2G, and rate-of-pay safe harbor, Code 2H. These will apply to situations where an employee declines an offer of coverage since there's no code to indication declination. Using these codes can help avoid the IRS mistakenly issuing an ESRP assessment due to an individual improperly self-reporting to the Marketplace that he or she received no employer offer of affordable health coverage.

KEY TAKEAWAYS

The approved affordability safe harbors are a valuable tool for employers to use in setting contribution rates for group health coverage. Using one of the safe harbors and, more importantly, being able to demonstrate that an offer of coverage passes one of the safe harbors, will go a long way in helping an employer avoid costly and time-consuming IRS assessments.

As an employer begins planning and budgeting for its upcoming health plan renewal, it should examine its workforce carefully to assess which affordability safe harbor might make the most sense, and which would be easiest to manage and most likely to help the employer avoid costly ESRP assessments. As noted above, the W-2 safe harbor is based on earnings for the current year rather than the past year. Therefore, the W-2 safe harbor might make more sense for a workforce where there are no pre-tax elections for things like 401(k) plans or HSAs. The rate-of-pay safe harbor could be well-suited for a population with a large number of hourly employees since it assumes a rate of 130 hours per calendar month no matter how many hours an employee actually works. An employer with lots of low-wage earners might want to use the FPL safe harbor to avoid having a high number of individuals for whom a contribution is unaffordable under another safe harbor.

If you have any questions regarding the affordability safe harbors or any other aspect of ACA compliance or your group health plan offering, please contact a member of your EPIC client service team.

EPIC Employee Benefits Compliance Services

For further information on this or any other topics, please contact your EPIC benefits consulting team.