

## ALERT: HEALTH CARE REFORM BILL

May 2010 – Vol. 3, No. 5

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### HEALTH CARE REFORM: IMPACT ON SMALL EMPLOYERS

Recently enacted health care reform legislation\* includes provisions that bring dramatic and virtually immediate changes for small employers. Although small businesses are subject to exemptions from certain mandates, numerous other provisions zero in on the smaller employer. Complicating matters further is the fact that Congress chose not to apply a consistent use of the term “small employer.” Therefore, employers must apply a careful section-by-section examination of possibly applicable health care reform provisions before reaching a definitive conclusion about applicability. For example, for companies not providing health insurance in 2014, applicable health care reform penalty rules define a small business as one with fewer than 50 full-time equivalent employees while a small business for the purpose of the tax credit is one that employs fewer than 25 full-time equivalent employees.

Consequently, as our *Alert* examines health care reform from the small employer perspective, our objective exceeds simply describing provisions that affect small employers. We will also identify the application of the term “small employer” in its correct context.

\* Please note that for purposes of this *Alert* we will often refer to the health care reform law as the Patient Protection and Affordable Care Act (PPACA). However, the final enacted version of the law incorporates three component pieces: (1) The PPACA, (2) a PPACA “manager’s amendment” and (3) the “fixer” measure passed through the budget reconciliation process (HR 4872), the Health Care and Education Affordability Reconciliation Act of 2010 (HCEARA). For purposes of simplicity though, we will refer to the entire package of law as either health care reform, or PPACA.

### HEALTH PLANS, REPORTING AND DISCLOSURE REQUIREMENTS AND HEALTH ACCOUNTS

#### SIZE MATTERS - SOMETIMES

Although PPACA introduced numerous substantive changes that apply without regard to *group size*, some plans will still manage to avoid these new requirements for reasons other than group size. Specifically, a key distinction among group health plans rests on whether the group is a “grandfathered” or a “non-grandfathered” plan. In other words, apart from being a grandfathered or non-grandfathered plan, there is no distinction as to complying with the many substantive changes based on size of the plan sponsor (e.g., status as a small or large employer). Any plan (whether small or large) that qualifies for treatment as a grandfathered plan by virtue of its existence on March 23, 2010 (the date of PPACA signing) is shielded from some health care reform provisions.

A variety of reporting and disclosure requirements must be satisfied without regard to group size. In addition, changes affecting tax favored health accounts (i.e., Archer Medical Savings Accounts (MSA), Health Savings Accounts (HSA), Health Reimbursement Accounts (HRA) or health Flexible Savings Accounts (FSA) as to reimbursement for over-the-counter medications (except insulin and except where directed for use through a prescription) do

not take into consideration whether the employer is small or large. Similarly, the size of the employer has no bearing on the limitation of no more than \$2,500 in salary reduction contributions to a health FSA (a rule that becomes effective as of January 1, 2013).

## SMALL BUSINESS TAX CREDIT

### TRANSITIONAL CREDIT AVAILABLE FROM 2010 THROUGH 2013

An eligible small employer may claim a tax credit for premiums it pays toward health coverage for its employees in tax years beginning in 2010 through 2013. This credit is generally available to for-profit and non-profit eligible small employers with **fewer than 25 full-time equivalent employees** as long as the **average annual compensation of these employees is not greater than \$50,000**.

### HOW DOES THE CREDIT WORK?

An employer substantiates its status as an eligible small employer each tax year by measuring its workers' average hours as follows: An organization's FTEs are calculated by dividing the total hours worked by all employees during the employer's tax year by 2080. (The law uses a 40-hour workweek for 52 weeks to arrive at the number 2080.)

For this purpose, the maximum number of hours that are counted for any single employee is 2080 (rounded down to the nearest whole number). The number of hours of service worked by, and wages paid to, a seasonal worker of an employer is not taken into account in determining the full-time equivalent employees and average annual wages of the employer unless the seasonal worker works for the employer on more than 120 days during the taxable year.

**NOTE:** The PPACA directs application of highly technical control group rules in determining whether a particular organization should be considered one employer. Thus, due to certain business relationships, an employer for purposes of the

PPACA may not be a "small employer." An employer should consult with its legal or tax adviser as to its status as a "small employer."

Because the PPACA's "small business tax credit" has several twists and turns, it is best described in the following outline:

### TRANSITIONAL CREDIT OUTLINE FOR-PROFIT SMALL EMPLOYER ORGANIZATIONS

- Employer must pay at least 50% of the health plan cost for employees at the single (employee-only) coverage rate (employer contributions shall not include employee contributions made pursuant to a salary reduction agreement under a cafeteria plan).
- Credit is 35% of employer's contributions to health insurance.
- Credit is in the form of a general business credit against income tax:
  - If there is no tax liability, there is no benefit available
  - If the tax liability is inadequate, the full benefit will not be available

Since this transitional credit is a general business credit, an unused credit amount can generally be carried forward up to 20 years. Employers should discuss with their tax advisers how this credit would apply to them.

### NON-PROFIT SMALL EMPLOYER ORGANIZATIONS

- Employer must pay at least 50% of the health plan cost for employees at the single (employee-only) coverage rate (employer contributions shall not include employee contributions made pursuant to a salary reduction agreement under a cafeteria plan).
- Credit is 25% of employer's contribution to health insurance.
- Credit is taken against payroll taxes (income and Medicare tax).

### 2014 TAX CREDIT

- Credit is available for any tax year beginning after 2013 during the current credit period. The credit period is the two consecutive tax year periods beginning with the first tax year in which the employer offers a qualified health plan.
- Tax credit can only be claimed for two additional tax years.
- The employer must offer a qualified health plan through the exchange.
- Credit is equal to 50% (35% for non-profit) of the **lesser** of:
  - Employer contributions for premiums for a qualified health plan offered through an exchange
  - Employer contributions that would have been made if each employee had enrolled in coverage with a "benchmark premium"

**NOTE:** The "benchmark premium" is multiplied by the number of employees enrolled in coverage, and then

multiplied by the uniform percentage that applies for calculating the level of coverage selected by the employer (which must be at least 50%).

As tax issues can be complicated and uniquely dependent on organizational circumstances, it is strongly advised that employers obtain professional tax guidance to assess the timing and availability of these credits.

### TAX CREDIT PHASE OUT AND REDUCTION

The government imposes a tax credit “phase-out” applicable by both group size and average income. The credit is reduced for employers with more than 10, but not more than 25, full-time employees. The credit is also reduced for an employer that pays its employees an average wage of between \$25,000 and \$50,000.

The credit is reduced 6.67% for each full-time employee in excess of 10 employees and by 4% for each \$1,000 that annual average compensation paid to the employees exceeds 25,000.

The following table shows the percentage by which the credit amount is reduced if an employer maintains a workforce of more than 10 full-time equivalent employees.

#### CREDIT AMOUNT REDUCTION FOR EMPLOYERS WITH MORE THAN 10 FULL-TIME EQUIVALENT EMPLOYEES

NUMBER OF FULL-TIME EQUIVALENT EES	CREDIT AMOUNT REDUCTION %
1-10	0.00%
11	6.67%
12	13.34%
13	20.00%
14	26.668%
15	33.335%
16	40.002%
17	46.669%
18	53.336%
19	60.003%
20	66.670%
21	73.337%
22	80.004%
23	86.671%
24	93.338%
25 or more	100%

#### CREDIT AMOUNT REDUCTION FOR EMPLOYERS WITH ANNUAL AVERAGE FULL-TIME EMPLOYEE COMPENSATION IN EXCESS OF \$25,000

AVERAGE ANNUAL COMPENSATION	CREDIT AMOUNT REDUCTION %
\$25,000 or less	0.00%
\$26,000	4%
\$27,000	8%
\$28,000	12%
\$29,000	16%
\$30,000	20%
\$31,000	24%
\$32,000	28%
\$33,000	32%
\$34,000	36%
\$35,000	40%
\$36,000	44%
\$37,000	48%
\$38,000	52%
\$39,000	56%
\$40,000	60%
\$41,000	64%
\$42,000	68%
\$43,000	72%
\$44,000	76%
\$45,000	80%
\$46,000	84%
\$47,000	88%
\$48,000	92%
\$49,000	96%
\$50,000 or more	100%

## EXAMPLE

ABC Company's employer contribution for qualified health insurance coverage for its 20 full-time employees is \$180,000. Of that amount, ABC Company contributes half the cost (\$90,000). ABC's tax credit must be reduced by the number of employees it exceeds by 10. In this case, based on the above schedule, ABC's \$90,000 tax credit must be reduced by 66.67% or \$60,000. Thus the tax credit available for ABC is \$30,000 (\$90,000-\$60,000 = \$30,000).

This credit could be further reduced if the average annual wages of the employees exceeded \$25,000.

## EXAMPLE

Using the same scenario as above, add the fact that the employee's average annual wages are \$27,000. The average compensation paid by ABC exceeds the applicable dollar amount by \$2,000 (\$27,000-\$25,000=\$2,000). ABC's tax credit must be further reduced by 8% (based on the table above) of the credit amount or \$7,200 (\$90,000 x 8% = \$7,200). Thus, the full credit ABC is entitled to is \$22,800 (\$90,000 -\$60,000-\$7,200 = \$22,800).

The IRS has posted **information regarding this tax credit on its website**, including **responses to frequently asked questions** that provide details on which small employers qualify and how they go about claiming the credit.

The White House published additional hypotheticals that can be found by **clicking here**.

Although there is no formal guidance yet, the IRS has provided educational resources for small businesses wishing to claim the credit this year. Additional information can be found by **clicking here**.

## SIMPLE CAFETERIA PLANS (EFFECTIVE JANUARY 1, 2011)

The new health care reform law promotes the use of cafeteria plan programs to encourage small employers to offer tax-free benefits to employees – particularly health insurance coverage benefits. The law does so by relaxing applicable nondiscrimination tax rules. Specifically, a “safe harbor” from the nondiscrimination requirements for cafeteria plans is made available for qualified small employers.

The definition of a “small employer” for simple cafeteria plan sponsorship is an employer that employed an average of 100 or fewer employees on business days during either of the two preceding years. A year may only be taken into account if the employer was in existence throughout the year. Start-up companies can use the average number of employees reasonably expected to be employed in the current year.

If the employer maintained a simple cafeteria plan for its employees for a year, then, for each subsequent year during which the employer continues, without interruption, to maintain the cafeteria plan, the employer is deemed to be an eligible small employer until the employer employs an average of 200 or more employees on business days during any year preceding any such subsequent year.

Controlled group rules, where all members of the controlled group are treated as a single employer, will apply for determination of whether an employer is an eligible small employer.

## CLASSIC CAFETERIA PLAN NONDISCRIMINATION REQUIREMENTS

Generally, a cafeteria plan can only provide certain qualified benefits and may not discriminate in favor of highly compensated participants. A cafeteria plan:

- Cannot discriminate in favor of highly compensated individuals generally as to benefits eligibility and contributions and benefits
- Must prevent the provision of disproportionate benefits to key employees through a cafeteria plan
- Must ensure that both the cafeteria plan and each qualified benefit satisfies the relevant nondiscrimination requirements

Failure to satisfy the nondiscrimination rules generally results in a loss of the tax exclusion by the highly compensated individuals.

## EXPLANATION OF PROVISION OF A SIMPLE CAFETERIA PLAN

- Small employers are provided with a safe harbor from otherwise applicable nondiscrimination requirements for cafeteria plans as well as from the nondiscrimination requirements for specified qualified benefits offered under a cafeteria plan.

- Under the safe harbor, a cafeteria plan and the specified qualified benefits are treated as satisfying nondiscrimination rules if the cafeteria plan complies with minimum eligibility, contribution and participation requirements.

## ELIGIBILITY REQUIREMENT

The eligibility requirement is met only if all employees (other than excludable employees) are eligible to participate, and each employee eligible to participate is able to elect any benefit available under the plan (subject to the terms and conditions applicable to all participants).

## MINIMUM CONTRIBUTION REQUIREMENT

- Employer provides a minimum contribution for each non-highly compensated employee in addition to any salary reduction contributions made by the employee.
- The minimum contribution must be available for application toward the cost of any qualified benefit (other than a taxable benefit) offered under the plan.
- The minimum contribution is permitted to be calculated under either the non-elective contribution method or the matching contribution method, but the same method must be used for calculating the minimum contribution for all non-highly compensated employees.
- The non-elective minimum contribution equals a uniform percentage (not less than 2%) of each eligible employee's compensation for the plan year, determined without regard to whether the employee makes any salary reduction contribution under the cafeteria plan.
- The minimum matching contribution is 1) the lesser of 100% of the amount of the salary reduction contribution elected to be made by the employee for the plan year or 2) 6% of the employee's compensation for the plan year.
- A simple cafeteria plan is permitted to provide for matching contributions in addition to the minimum required, but only if matching contributions with respect to salary reduction contributions

do not discriminate in favor of highly compensated employees.

- Nothing in this provision prohibits an employer from providing qualified benefits under the plan in addition to the required contributions.

## EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2010.

## GRANT FOR COMPREHENSIVE WORKPLACE WELLNESS (2011-2015)

PPACA authorized funding for small employers to provide employees with comprehensive workplace wellness programs. For purposes of these grants, **small employers** are those that **employ fewer than 100 employees who work 25 hours or more per week**, and also did not provide a workplace wellness program prior to March 23, 2010. (Unfortunately, this requirement effectively penalizes those otherwise qualifying employers who had the foresight to implement wellness programs prior to March 23, 2010.)

PPACA specifies several requirements that must be included to qualify as a "comprehensive workplace wellness program." To qualify, a wellness program must include:

- Health awareness initiatives (such as health education, preventive screenings and health risk assessments)
- Efforts to maximize employee involvement and participation
- Initiatives (such as counseling, seminars and self-help materials) to change unhealthy behaviors and lifestyle choices
- Workplace policies to encourage healthy lifestyles, healthy eating, increased physical activity and improved mental health

Wellness grants are available on a limited basis because the program has only been allocated \$200 million in funding for the 2011-2015 period. Unless Congress allocates supplementary funding, the program is expected to dry up quickly on a first-come-first-served basis.

Although specific details about the application process remain pending at the time we prepared this document, we do know that when regulations governing the program are published, eligible employers must submit an application to the HHS, outlining a proposal to implement a comprehensive wellness program that meets the above criteria.

## EMPLOYER-SPONSORED COVERAGE THROUGH THE INSURANCE EXCHANGES

In providing workforce health benefits, small employers face unique challenges that larger employers may not necessarily encounter, such as lack of bargaining power to negotiate with insurance companies, or not having a broad employee base to offset the costs of older, or otherwise less optimally healthy workers. Some key PPACA provisions are intended to address those small employer issues. Among other initiatives, PPACA launches a new competitive market outlet with standardized plans that promises improved access to health care, lower administrative costs, and a level health coverage premium playing field as compared to larger employers.

Starting in 2014 PPACA allocates funds for states to operate health insurance “exchanges” to assist in the purchase of qualified health care insurance for both individuals and small employers. Qualified health care is coverage that complies with new federal standards for “essential health benefits.” The scope of benefits offered in an essential health benefits package must be equivalent to the scope of benefits offered under the “typical” employer-sponsored plan. Although at this time, specifics have yet to be defined, plans generally must at a minimum offer:

- Ambulatory patient services
- Emergency services
- Hospitalization
- Maternity and newborn care
- Mental health and substance abuse disorder services
- Prescription drugs
- Laboratory services
- Rehabilitative and habilitative services
- Preventive and wellness services
- Pediatric services (including oral and vision care)

The exchange plans, though delivering essential benefits, will also have available various levels of choice based on the cost-sharing provisions for the benefits. Thus, the exchange will offer several different plans based on benefit levels: bronze (60% value of the plan), silver (70% value of the plan), gold (80% value of the plan) and platinum (90% value of the plan).

For the purposes of the insurance exchange a **small employer is defined as maintaining a workforce of between one and 100 employees.**

A note of caution: for plan years beginning before January 1, 2016, any state may elect to restrict the definition of “small employer” for purposes of PPACA, and limit the availability of the exchange to employers with no more than 50 employees. Therefore, before making any decision regarding an exchange benefit, a small employer will need to check with its state exchange as to local participation requirements.

## STATE EXCHANGE PROGRAMS AND CAFETERIA PLANS (2014)

A cafeteria plan is an employee-sponsored plan under which workers have the option of selecting benefits or cash. Employees can select the qualified tax-free benefits that best suit their particular situations or may receive taxable cash payments instead of receiving benefits that they do not select. Generally, only benefits for which exclusion is already granted by the Internal Revenue Code can be offered as “qualified benefits” as a part of a cafeteria plan.

However, under PPACA, for tax years beginning after December 31, 2013, a cafeteria plan cannot offer a qualified health plan offered through an insurance exchange. Even though PPACA requires each state to establish an exchange program (which facilitates the purchase of qualified health plans), for purposes of cafeteria plans, exchange programs are *not* deemed a qualified benefit.

There is an exception to this prohibition in the case of exchange-eligible employers offering employees the opportunity to enroll in a qualified health plan through an exchange. An exchange-eligible employer is, in tax years beginning after December 31, 2013, a small employer electing to make all of its full-time employees eligible for one or more qualified health plans offered in the small group market through an exchange. A **small employer** is an employer who **employed an average of at least one, but not more than 100, employees on business days during the preceding calendar year and employs at least one employee on the first day of the plan year.**

The “small group market” is the health insurance market under which employees obtain health insurance

coverage through a group health plan maintained by a small employer. This exception will permit small employers to offer “qualified health plans” through an exchange as a part of a cafeteria plan in tax years beginning after December 31, 2013.

## SMALL BUSINESSES AND EMPLOYER PENALTIES

While there is no mandate for an employer to provide health care coverage, beginning January 1, 2014, the new law imposes penalties on certain businesses for either not providing coverage or offering coverage considered unaffordable by an employee.

Known as the “pay or play” requirement, most small businesses won’t have to worry about this provision, because small businesses of fewer than 50 full-time equivalent employees are not subject to the penalty. As noted, the threshold for a small employer is 50 “full-time equivalent” employees; thus, an employer has to take into consideration its part-time – and possibly even its seasonal – employees to see if it meets this threshold. Solely for purposes of determining employer size, part-time employees are aggregated to full-time equivalents by dividing total monthly part-time hours by 120. Seasonal workers are not included in determining employer size if the excess employees were seasonal employees and the workforce did not exceed the limit for more than 120 days during the calendar year.

Penalty assessments are based on several factors. Specifically, penalties will depend on whether the large employer provides health coverage, on the cost of that employer coverage, and then, regardless of that coverage, whether an employee still purchases health insurance through a state exchange with respect to which a premium tax credit or cost-sharing reduction is allowed or paid to the employee. For purposes of determining the penalty, the first 30 full-time employees are excluded.

For a large employer who does **not offer insurance** and who **has at least one employee** eligible for premium tax credits or cost sharing reductions through the exchange, a penalty is imposed. The penalty is \$2,000 per full-time employee per year (not counting part-time employees), with an exclusion for the first 30 full-time workers. Thus a firm with no more than 30 full-time workers would not pay a penalty even if part-time workers caused them to be classified as large.

If a large firm **offers coverage** but **one or more of those employees receives a premium tax credit or cost-sharing reduction**, the payment is \$3,000 for each of those employees. The penalty for not providing insurance is imposed on a monthly basis. Furthermore, the **penalty is always the lesser** of \$3,000 for each employee receiving a credit or \$2,000 for each full-time employee.

Complicated rules apply in determining whether a particular organization will incur PPACA penalties. Strategic plan design will be critical in structuring a program to minimize possible penalty exposure.

**NOTE:** PPACA generally uses the controlled group rules, where all members of the controlled group are treated as a single employer. Thus, due to certain business relationships, an employer should consult with its legal or tax adviser as to its status as a “small employer” and the applicability of any penalties.

## AUTOMATIC ENROLLMENT FOR EMPLOYEES OF LARGE EMPLOYERS

This is another example of the law where the size of the employer determines compliance with a certain provision. **Employers with more than 200 full-time employees** and that offer one or more health benefits plans are required to automatically enroll new employees in a plan. Subject to any waiting period permitted by law, current employees will continue to be enrolled, and new full-time employees will be enrolled automatically. As part of its program, employers must provide adequate notice and opportunity for an employee to opt out of any coverage in which the employee was automatically enrolled.

## CONCLUSION

Health care reform is here.

Although legal challenges and repeal efforts loom ahead, and many provisions do not actually take effect for years, employers face a multitude of changes that must be addressed in coming months. Small employers may find compliance burdens especially challenging due to provisions that deepen the complexities of an already difficult-to-administer law.

For more on health care reform, including detail about application of the law's grandfather rules, plus a timetable and an in-depth analysis of the law, [click here](#).

*The observations, comments and suggestions we have made in this publication are advisory and are not intended nor should they be taken as legal advice. Please contact your own legal adviser for an analysis of your specific facts and circumstances.*



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