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Flex Contributions and Opt-Out Payments Under ACA

Traditionally, employers have used flex contributions and/or opt-out payments to provide employees with additional benefits under a cafeteria plan or to offer a benefit to employees who do not take the employer's group health plan coverage. Today, employers that offer flex contributions and/or opt-out payments face some unique issues in determining if the health coverage they offer to employees is affordable under the ACA's shared responsibility rules. Depending on how the program is structured, these contributions and payments can adversely affect affordability. This *FYI In-Depth* examines guidance issued by the IRS that would impact employers offering flex contributions or opt-out payments. As appropriate, you should be aware of the issues and may want to review your plan's contribution design to avoid unexpected results.

Background

The affordability of employer-sponsored coverage plays an important role under the Affordable Care Act (ACA) for the following purposes:

- **Individual mandate exemption**. Individuals who fail to enroll in medical coverage may be exempt from the individual mandate if they are eligible for employer-sponsored coverage that is not affordable. For 2016, employer-sponsored coverage is considered affordable only if the required employee contribution for self-only or family coverage (as applicable) does not exceed 8.13% of adjusted household income (8.16% for 2017).
- **Premium tax credit eligibility**. Individuals who decline employer-sponsored coverage and enroll in coverage through a public marketplace may be eligible for a premium tax credit if the employer-sponsored coverage is not affordable. For 2016, employer-sponsored coverage is considered affordable only if the required employee contribution for the lowest cost self-only option does not exceed 9.66% of adjusted household income (9.69% for 2017).

- **Shared responsibility assessments**. An applicable large employer can avoid a shared responsibility assessment if its coverage satisfies one of three affordability safe harbors, even if a full-time employee receives a premium tax credit because the employer's coverage is considered unaffordable. (See sidebar below.) Although the method for determining affordability for each purpose differs slightly, there is one common element — each method is based on the employee's required contribution for the employer health coverage.

When an employee is given the choice between receiving his or her compensation and reducing that compensation to purchase employer-sponsored health coverage, the required employee contribution is easy to determine — it's the amount by which the employee's compensation would be reduced to pay for the coverage (e.g., the salary reduction amount). The determination is not as straightforward when the employer offers flex contributions or opt-out payments. Flex contributions are employer contributions offered through a cafeteria plan that an employee can apply towards the cost of qualified benefits, such as group health plan coverage — or in some cases, take as cash. Opt-out payments allow an employer to provide a taxable benefit to employees who don't take the employer's "core" benefits like group health plan coverage. While not always the case, an employer offering an opt-out payment might require the employee to show that he or she has other coverage before the opt-out payment is provided. How employer flex contributions and opt-out payments factored into determinations of affordability under the ACA was never very clear.

The IRS has issued guidance on when flex contributions and opt-out payments may affect the determination of the required employee contribution for affordability purposes. Regulations addressing the individual mandate exemption discuss the affordability determination and when flex contributions are taken into account for purposes of that calculation. Notice 2015-87 addresses both flex contributions and opt-out payments and makes clear that the same general principles for determining the amount of the required employee contribution for individual mandate purposes also apply for both premium tax credit eligibility and employer shared responsibility purposes. Recently, the IRS issued proposed regulations addressing ACA's premium tax credit and the individual shared responsibility penalty provisions that discuss opt-out payments in more detail.

Employer Mandate: Affordability

Employers may use affordability safe harbors if the coverage is offered to full-time employees and their dependent children and meets minimum value. For 2016, employer-sponsored coverage generally is considered affordable if the required employee contribution for the lowest cost self-only option does not exceed 9.66% of one of the following:

- The employee's wages for the calendar year reported on the Form W-2 (W-2 safe harbor)
- An amount equal to 130 hours multiplied by the lower of the employee's hourly rate of pay as of the first day of the coverage period or an employee's lowest hourly rate of pay during the calendar year (rate of pay safe harbor for hourly employees)
- An amount equal to the federal poverty line for a single individual for the applicable calendar year, divided by 12 (FPL safe harbor)

The percentage increases to 9.69% for 2017. For more about the employer mandate and the affordability safe harbors, see our **April 17, 2014** *FYI.*

Flex Contributions and Opt-Out Payments

In Notice 2015-87, the IRS expressed its view that for affordability purposes, the appropriate measure of an employee's required contribution is the compensation that the employee must forgo to obtain coverage under the employer's group health plan or that the employee could apply to something other than health-related expenses.

Thus, depending on the contribution structure, the required contribution for affordability purposes may be more or less than the actual "price tag."

Flex Contributions

In Q/A 8 of the notice, the IRS applies this principle to employer flex contributions. In doing so, it distinguishes between "health flex contributions," which will reduce the employee's required contribution, and "non-health flex contributions," which will not.

Health flex contributions. A health flex contribution is a flex contribution under which the employee meets all of these conditions:

- May not opt to receive as a taxable benefit or cash
- May use to pay for minimum essential coverage
- Must use exclusively to pay for medical care within the meaning of Section 213 of the Internal Revenue Code

The IRS explains that because the health flex contributions can only be used to pay for health coverage and health-related expenses, the employee does not have to forgo any compensation or non-health benefit(s) by enrolling in the employer coverage. For that reason, the required contribution is equal to the amount the employee is required to pay for the employer coverage less the amount of the health flex contributions — i.e., the health flex contributions reduce the employee's required contribution. This is the case even if the employee does not enroll in the employer health coverage. Health flex contributions are treated as if they are made ratably for each month of the period to which they relate.

In contrast, flex contributions that do not qualify as health contributions (because they can be used for non-health benefits or received as cash or other taxable benefits) cannot be used to reduce the amount of the required employee contribution. The IRS explains this is because an employee who wants to apply them towards the cost of employer health coverage would have to give up non-health benefits or the opportunity to receive cash. Note these non-health flex contributions do not affect the amount of the required employee contribution — they don't reduce it, but don't increase it either.

Transition relief. The notice offers transition relief for employers providing flex contributions that can be used for health coverage but do not qualify as health flex contributions because they also can be used for non-health benefit and/or received in cash. This relief provides that for plan years beginning before 2017, these non-health flex contributions will be treated as reducing the employee's required contribution for shared responsibility information reporting purposes (Form 1095-C). This relief is not available to flex contribution arrangements adopted after December 16, 2015, or if the flex contribution amount was substantially increased after that date.

Note that this transition relief does not apply to individuals. So, for purposes of determining if the person is exempt from the individual mandate or whether coverage is affordable (to ascertain if a premium

"Adopted" for purposes of the Notice 2015-87 transition rules

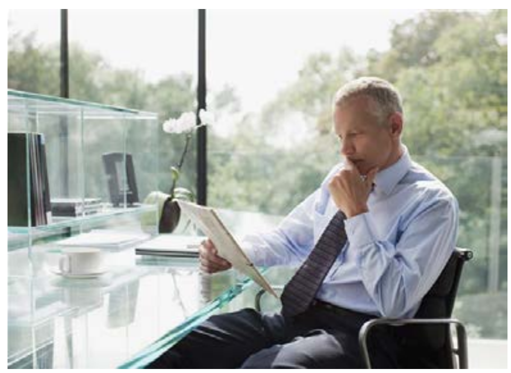
A flex contribution arrangement or an opt-out arrangement will be treated as adopted after December 16, 2015, unless (1) the employer offered the arrangement (or a substantially similar one) for a plan year including December 16, 2015; (2) a board, committee or similar body or an authorized officer of the employer specifically adopted the arrangement before December 16, 2015; or (3) the employer-provided written communications to employees on or before December 16, 2015, indicating that the arrangement would be offered to employees at some future time.

tax credit is appropriate), non-health flex contributions will not reduce the amount of an employee's required contribution. The individual can qualify for a premium tax credit, but, in this instance, the employer will not be exposed to a shared responsibility assessment.

> **Comment**. Although transition relief is available, the IRS "encourages" employers not to reduce the amount of the employee's required contribution by the amount of a non-health flex contribution on Line 15 of the Form 1095-C because it could affect the employee's eligibility for the premium tax credit. It notes that if the employer is subsequently contacted by the IRS about a potential shared responsibility assessment because the employee qualified for the premium tax credit, the employer can show at that time it was entitled to the relief provided in the notice.

Pulling it together. Suppose an employer provides employees with flex contributions of $40 per month (totaling $480 for the year).Under the plan, the flex contributions can be applied toward the cost of the employer's group health plan coverage ($200 per month) or contributed to a health FSA. In this example, the $480 employer flex contribution is a health flex contribution that reduces the employee's required contribution for purposes of determining affordability of the employer's health coverage, even if the employee elects to use the flex contributions for health FSA coverage. For employer shared responsibility purposes and related reporting under Section 6056 (Form 1095-C), the employee's required contribution for the group health plan coverage is $160 ($200 minus $40) per month.

Now suppose the employer provides employees with flex contributions of $40 per month (totaling $480 for the year), but the flex contributions can be applied toward the cost of the employer's group health plan coverage ($200 per month), contributed to a health FSA or received in cash. In this example, while the $480 is a flex contribution, it is not a health flex contribution and does not reduce the employee's required contribution in determining affordability (except to the extent permitted under applicable transition relief) because it can be received in cash. The employee's required contribution for the group health plan coverage is $200 per month. Note that the availability of the cashout does not convert the flex contribution to an opt-out payment because the employee is not required to waive employer coverage in order to receive it. Also, because the flex contribution is allowed to be cashed out (e.g., there is a choice between cash and a nontaxable benefit), any portion allocated to a health FSA will count toward the employee's limit ($2,550 for 2016) on annual health FSA salary reductions.



Assume the same facts, but employees can use the employer's flex contribution($40 per month) toward the cost of the employer's comprehensive group health plan coverage or for any other benefit provided under the cafeteria plan (including non-health benefits). The $480 employer flex contribution is not a health flex contribution and does not reduce the employee's required contribution in determining affordability (except to the extent permitted under applicable transition relief). For employer shared responsibility purposes and related reporting under Section 6056 (Form 1095-C), the employee's required contribution for the group health plan coverage is $200 per month.

Opt-Out Payments

In Q/A 9 of Notice 2015-87, the IRS discusses how opt-out payments may affect the amount of an employee's required contribution for affordability. For this purpose, an opt-out payment is an amount offered by the employer that an employee cannot use to pay for the employer's health coverage and is available only if he or she declines (or waives) that coverage. In the notice, the IRS distinguishes between arrangements where the only condition an employee has to meet to receive the payment is to decline employer health coverage (unconditional opt-out arrangement) and arrangements where an employee must also satisfy other "meaningful" requirements, such as showing proof of other coverage in order to receive payment (conditional opt-out arrangement). The notice provides that unconditional opt-out arrangements would be treated as salary reductions for purposes of determining affordability because the employee must forgo the additional compensation — the opt-out payment — in order to have employer health coverage. The IRS also stated that it would issue proposed regulations that would reflect this rule and would address the treatment of conditional opt-out arrangements.

The IRS' recently issued proposed regulations, effective for plan years beginning on or after January 1, 2017, discuss opt-out arrangements and how the amounts might impact affordability of employer-provided health coverage for an individual. Generally, unless an opt-out arrangement qualifies as an "eligible opt-out arrangement," as described below, the amount of the opt-out payment will be taken into account in determining the amount of the employee's required contribution (e.g., added to the amount that the employee is deemed to pay for employer health coverage).

Eligible opt-out arrangements. The proposed regulations provide a limited exception to this general rule for "eligible opt-out arrangements." Payments made under an eligible opt-out arrangement are available only to employees who both:

- Decline employer-sponsored coverage
- Provide reasonable evidence annually that they (and tax dependents) have or will have minimum essential coverage, other than individual market coverage (whether obtained through the public marketplace or not), during the plan year or other period covered by the opt-out arrangement

An opt-out payment conditioned on an employee obtaining individual market coverage may be treated as an employer payment plan that reimburses the employee's premium for that individual coverage. Employer payment plans are considered group health plans, which is problematic under the ACA's market mandates. See our **April 7, 2015** *FYI*.

Reasonable evidence of alternative coverage. Under the proposed regulations, reasonable evidence of alternative coverage can include an attestation that the employee and all other members of the "employee's expected tax family" have or will have minimum essential coverage (other than coverage in the individual market, whether or not obtained through the marketplace) for the relevant period. The arrangement must require the employee to provide such evidence at least once per plan year. The evidence must be provided within a reasonable time prior to the start of the period to which the opt-out arrangement relates, such as during open enrollment. Further, an opt-out payment may not be made if the employer knows or has reason to know that the employee or any other member of the employee's expected tax family does not have or will not have the alternative coverage.

> **Comment.** The preamble in the proposed regulation discusses what would be considered "reasonable evidence of alternative coverage." Prior to providing the opt-out payment, it would be reasonable for an employer to require an employee to give written or electronic attestation or certification that he or she (and

tax dependents) has appropriate coverage. Currently, some employers might require employees to show proof of other coverage, such as copies of insurance cards, before the opt-out payment is provided. This also appears to be a reasonable practice if the other coverage is not individual coverage (even if obtained in the public marketplace).

If the reasonable evidence requirement is met, the amount of a payment made available under an eligible opt-out arrangement is excluded from the employee's required contribution for the remainder of the period of coverage to which the opt-out payment originally applied. The opt-out payment may continue to be excluded even if the alternative coverage subsequently is terminated for the employee or any other member of the expected tax family, regardless of whether the opt-out payment is required to be adjusted or terminated due to the loss of alternative coverage, and regardless of whether the employee is required to provide notice of the loss of alternative coverage to the employer. Essentially the eligible opt-out payment does not impact the cost of the coverage. This is useful for ACA reporting purposes, as the reported amount on Line 15 of Form 1095-C would not change under these circumstances.

Transition relief. Notice 2015-87 provided some transition relief for opt-out arrangements adopted before December 16, 2015 (e.g., an ineligible opt-out arrangement where proof of other coverage is not required). This relief provides that for plan years beginning before 2017, employers need not increase an employee's required contribution by amounts made available under these arrangements for shared responsibility information reporting purposes (Form 1095-C).

The proposed regulations retain this relief and expand it to opt-out arrangements maintained pursuant to a collective bargaining agreement. For purposes of shared responsibility assessments and information reporting, an unconditional opt-out arrangement required under the terms of a collective bargaining agreement in effect before December 16, 2015, will be treated as having been adopted prior to December 16, 2015. In addition, until the later of (1) the beginning of the first plan year that begins following the expiration of the collective bargaining agreement in effect before December 16, 2015 (disregarding any extensions on or after that date), or (2) the applicability date of the regulations with respect to shared responsibility and reporting, employers participating in the collective bargaining agreement are not required to increase the amount of an employee's required contribution by amounts made available under such an opt-out arrangement for purposes of Sections 4980H(b) or 6056 (Form 1095-C). This treatment will apply to any successor employer adopting the opt-out arrangement before the expiration of the collective bargaining agreement in effect before December 16, 2015 (disregarding any extensions on or after December 16, 2015).

Note this transition relief does not apply to individuals. This means that in determining affordability for premium tax credit or individual mandate purposes, unconditional opt-out payments will increase the amount of the employee's required contribution. In addition, for periods before the final regulations are applicable and, if later, through the end of the most recent plan year beginning before January 1, 2017, an employee who can demonstrate that he or she meets a condition (in addition to declining the employer's health coverage) that must be satisfied to receive an opt-out payment (such as demonstrating proof of coverage under a spouse's group health plan) may treat the opt-out payment as increasing the required contribution.

Pulling it together. Suppose an employer offers employees who decline coverage under the group health plan an additional $100 per month of compensation (taxable opt-out payment). Employees who elect coverage under the employer's group health plan coverage pay $200 per month. Disregarding the transition relief, the offer of the $100 per month opt-out payment increases the required employee contribution to $300 ($200 + $100) per month. This is because employees who elect the coverage must forgo the $100 per month in compensation in addition to contributing $200 per month. For employer shared responsibility purposes and related reporting under Section 6056 (Form 1095-C), the employee's required contribution for the group health plan coverage is $300 per month.

Suppose the employer offers employees who decline coverage under the group health plan an additional $100 per month of compensation (taxable opt-out payment). During open enrollment, employees who choose this opt-out payment must attest that they (and all other expected tax dependents) are or will be enrolled in minimum essential coverage through a source other than the individual market. Employees who enroll in the employer's comprehensive group health plan pay $200 per month. Under the proposed regulations, this is an eligible opt-out arrangement. The $100 per month opt-out payment does not increase the employee's required contribution. For employer shared responsibility purposes and related reporting under Section 6056 (Form 1095-C), the employee's required contribution for the group health plan coverage is $200 per month.

Flex Contributions, Opt-Out Payments and Overtime Pay

Benefit payments that result in cash or can be cashed out might also impact an employee's rate of overtime pay (e.g., increase an employee's take-home pay) under the Fair Labor Standards Act (FLSA), which in turn could have ramifications beyond the calculation of compensation. Recently in *Flores v. City of San Gabriel*, the 9th Circuit Court of Appeals held that payment of unused benefits as cash must be included in the employee's regular rate of pay, and thus in the calculation of the overtime rate under the FLSA. The court found that "cash-in-lieu of benefits payments" had the effect of increasing the employee's take-home pay by increasing overtime pay. An appeal is likely. Increased overtime pay also could impact ACA safe harbors for calculating employee income and affordability of health coverage.

> **Comment.** Employers, particularly those in Alaska, Arizona, California, Hawaii, Washington, Montana, Idaho and Nevada (e.g., the area of the ninth circuit), that offer flex contributions and/or opt-out payments, should talk with legal counsel and consider evaluating their pay practices in light of this ruling — not only for overtime pay requirements but also the impact such payments might have on shared responsibility reporting and assessments. (For more on the FLSA, see out July 14, 2016 *For Your Information*.)

In Closing

In general, employer contributions towards the cost of health coverage will reduce employees' required contributions so long as they can be used exclusively for medical expenses (including coverage under an employer-sponsored health plan) — but not if they can be received as taxable benefits or used to purchase non-health benefits. Cash incentives offered to employees for opting out of the employer's health coverage, without any restrictions (i.e., annual attestation that the employee and his or her tax family has, or will have, coverage other than individual coverage), will increase the cost of coverage for purposes of affordability under the ACA. Employers that wish to maintain an "eligible opt-out arrangement" must make administrative changes to obtain reasonable evidence of alternative coverage on an annual basis. Flex contributions that are dedicated to (e.g., can be used only to purchase) employer-provided health coverage can decrease the cost of coverage. Employers offering flex contributions and opt-out payments should consider the ramifications on affordability and shared responsibility reporting (as well as any impact on overtime pay).

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