McGriff EMPLOYEE BENEFIT SOLUTIONS

COMPLIANCE Q&A

Affordability Safe Harbors

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Question: I am an Applicable Large Employer (ALE) sponsoring a calendar year health insurance plan. I don't know how much I should contribute to the cost of my employees' health care. I want to avoid "pay-or-play" penalties, but I can't afford to contribute more than the minimum required amount. What IRS affordability "safe harbor" works best for me?

Summary:

The IRS provides three optional affordability safe harbors that allow an ALE to calculate affordability of its health coverage without requiring information on an employee's household income: the federal poverty level (FPL), the W-2, or the rate of pay. There are advantages and disadvantages to each of these safe harbors. The best affordability safe harbor for an ALE is a fact-specific determination based on that ALE's employee benefits strategy and employee population. We *strongly* recommend that an ALE use one of these IRS approved safe harbors to determine affordability. If the IRS issues a penalty letter in the form of a Letter 226J, the ALE will have an easier argument that coverage is affordable if there is a safe harbor to reference.

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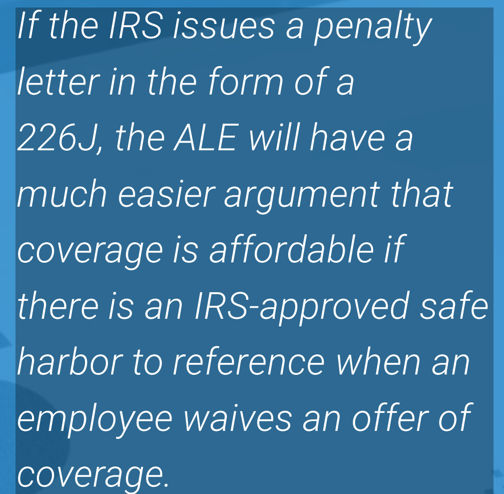

Detail:

Under the employer shared responsibility provisions of the Affordable Care Act (ACA), an ALE is required to offer health insurance coverage that is "affordable" and provides "minimum value" to full-time employees (and their dependents), or risk an employer shared responsibility penalty (pay or play).[1] Coverage is considered affordable if the employee's portion of the self-only premium for the employer's lowest-cost plan providing minimum value does not exceed 9.5% of the employee's household income for the tax year.[2] The affordability contribution percentage is adjusted annually for inflation – 8.39% for 2024.[3] This is a substantial decrease in this percentage (down from 9.12% in 2023).

An employer is not required to make every health insurance plan affordable. If an employer offers multiple health care coverage plan options, the affordability test applies to the lowest-cost option that also meets minimum value. Affordability is based on employee-only (i.e., self-only) coverage, regardless of how many family members are covered under the plan or how much the employer charges to cover a spouse or dependent children.

Obviously, employers do not have the benefit of knowing what the household income of each employee will be (i.e., the income levels of other family members in the employee's household or additional income from other employment ventures). Therefore, the IRS provides three optional affordability safe harbors that allow an ALE to calculate affordability of its health coverage without requiring information on an employee's household income: the federal poverty level (FPL) safe harbor, the W-2 safe harbor, or the rate of pay safe harbor.[4] There are advantages and disadvantages to each of these safe harbors.

An ALE can use different affordability safe harbors for different bona fide business classifications of employees. For example, it is acceptable to use a W-2 for all salaried employees and rate of pay for all hourly employees. While these safe harbors are optional, we strongly recommend that an ALE use a safe harbor to determine affordability. If the IRS issues a penalty letter in the form of a Letter 226J, the ALE will have a much easier argument that coverage is affordable if there is an IRS-approved safe harbor to reference when an employee waives an offer of coverage.

A. Federal Poverty Level (FPL) Safe Harbor

The FPL safe harbor measures affordability based on IRS federal poverty guidelines for a single individual. In order to meet the FPL safe harbor, the employer must show that the employee's share of the monthly cost for self-only coverage on the lowest-cost plan providing minimum value does not exceed the FPL multiplied by 8.39% and divided by 12. As long as the employee's monthly contribution is less than or equal to this amount, the FPL safe harbor is met.

In order to provide employers with adequate time to establish premium amounts in advance of the plan's open enrollment, the IRS allows an employer to use federal poverty guidelines in effect within six months before the first day of the plan year. Because the Department of Health and Human Services (HHS) does not typically release the FPL for the year until late January, an employer with a calendar year plan must use the prior year's FPL. Accordingly, the 2023 FPL, which

was $14,580, must be used for calendar year plans beginning January 1, 2024. To be at or lower than the 8.39% threshold for 2024, monthly employee premium contributions must be $101.93 or less for calendar year plans. For any 2024 non-calendar year plan, the 2024 FPL can be used. The 2024 FPL is unknown at the date of this publication and is generally released in mid-January.

As an example, Anne works for McGriff. She is a full-time employee and earns $9.50 an hour. McGriff offers two calendar year health insurance plans – a PPO and an HDHP. The employee monthly contribution for self-only coverage on the PPO is $200 while employee monthly contribution for self-only coverage on the HDHP is $100. McGriff can use the FPL affordability safe harbor because the employee contribution for self-only coverage on the lowest-cost plan providing minimum value – the HDHP plan – is less than $101.93.

Advantages: The FPL is the only true “safe” harbor available because the amount isn’t affected by the employee’s hourly rate, number of hours worked, or total income at the end of the year. No matter what an ALE pays its employees or how much the employees work, the ALE will never be penalized for unaffordability.

The FPL safe harbor also allows an ALE to use simplified reporting on the 1095-C forms that must be provided to all full-time employees.[5]

Disadvantages: As expected, the FPL safe harbor is the most expensive for employers. It may not be economically viable for the company to have such low employee contribution amounts.

B. Rate of Pay Safe Harbor

The rate of pay safe harbor eliminates the need for an ALE to analyze each individual employee’s wages and hours during the year. For hourly employees, it allows an ALE to take the lower of the hourly employee’s rate of pay as of the first day of the coverage period (generally, the first day of the plan year) or the employee’s lowest hourly rate of pay during the calendar month, and multiply that rate by 130 hours per month. Affordability for the calendar month is based on the resulting monthly wage amount. Specifically, the employee’s monthly contribution amount for the self-only coverage is affordable if it is equal to or lower than 8.39% of the computed monthly wages (the hourly rate of pay multiplied by 130 hours).

Generally, an employer will use the hourly rate of the lowest paid hourly employee to set contribution rates for the entire employee base. Sometimes, employers will set a tiered structure with higher employer contributions for lower paid employees.

As an example, Stephanie is a non-exempt employee earning $9.50 an hour who frequently works overtime. McGriff offers an HDHP with an employee monthly contribution for self-only coverage of $125.00. This would not be affordable under the rate of pay safe harbor because the monthly contribution is more than $103.61 ($9.50 hourly rate X 130 hours X 8.39% = $103.61).

Advantages: The rate of pay safe harbor is fairly predictable. Regardless of the numbers of hours worked by the individual employee, the affordability calculation is always based on the hourly pay rate multiplied by 130 hours.

Disadvantages: Because the affordability calculation is always based on an employee's hourly pay rate multiplied by 130 hours, the rate of pay safe harbor may not allow for the highest employee premium contributions. An ALE cannot take advantage of accumulated employee income when the employee population regularly works more than 30 hours per week (as in the above example).

C. W-2 Safe Harbor

Under the W-2 safe harbor, an ALE may determine the affordability of its health coverage based solely on the employee's yearly wages from that ALE. An ALE satisfies the W-2 safe harbor with respect to an employee if the employee's required contribution for the calendar year for the ALE's lowest-cost self-only coverage providing minimum value during the entire calendar year does not exceed 8.39% of that employee's Form W–2 wages from the employer for the calendar year.

For this purpose, "wages" is defined as the amount reported in Box 1 of the employee's Form W-2 for the current year. Box 1 shows total taxable wages, tips and other compensation, but it does not include elective deferrals to retirement plans or pretax benefits.

To be eligible for the W-2 safe harbor, the employee's required contribution must remain a consistent amount or percentage of all Form W–2 wages during the calendar year (or during the plan year for plans not based on the calendar year). Because an ALE has to use the Box 1 W-2 earnings

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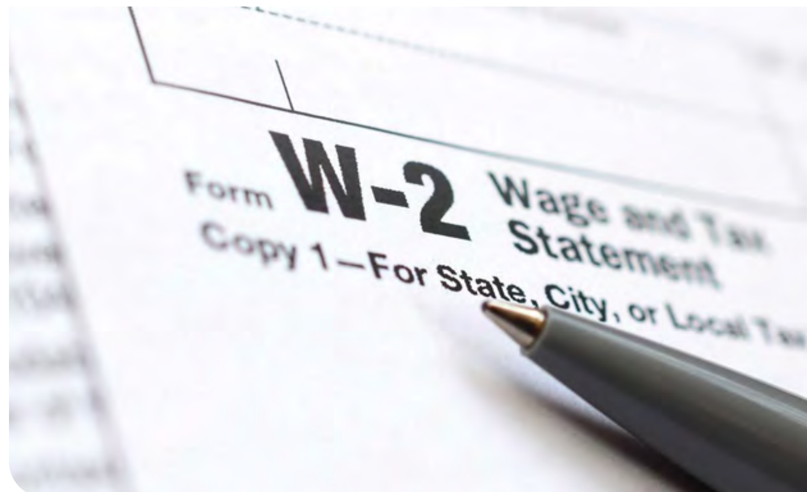
for the current year, it could be a very risky decision to assume that an employee earning $10 per hour would have at least $20,800 in their Box 1 earnings for the year. That would mean the employee would have to work 40 hours per week, 52 weeks per year, and not contribute to a retirement plan or pay for any benefits on a pretax basis.

As an example, Chris is paid an annual salary of $30,000. McGriff offers a PPO at a monthly cost of $200 to the employee for self-only coverage. At first glance, it appears this would be affordable under the W-2 safe harbor because the monthly contribution in the example is less than $209.75 ($30,000 X 8.39% / 12 = $209.75). However, if Chris chooses to contribute 10% of his earnings to his 401(k) account, his Box 1 W-2 earnings will be reduced by $3,000, and the coverage will not be affordable based on the W-2 safe harbor ($27,000 X 8.39% / 12 = $188.77).

Advantages: Because the employer is able to base affordability on the employee's Box 1 W-2 earnings, this method often permits the employer to charge employees a higher monthly premium, particularly when employees regularly work more than 30 hours per week. By using this method, an employer can consider all hours worked by an employee and the employee's annual taxable income, rather than being limited to a flat 130 hours per month (rate of pay safe harbor) or to the federal poverty line threshold (FPL safe harbor). This method works well if the company has



an employee population with several years of employment, which provides an established salary history to rely on.

Disadvantages: An ALE cannot be sure the cost of coverage will be affordable until after the reporting year is over. If an employee goes out on unpaid leave or works erratic hours such that the employee's W-2 pay is less than expected, the pre-calculated monthly premiums could turn out to be unaffordable under the W-2 safe harbor. For these reasons, the W-2 safe harbor is unpredictable. In addition, ALEs often forget that the safe harbor is based on Box 1 earnings, which does not include compensation deducted on a pre-tax basis or 401(k) plan contributions.

Conclusion:

This isn't a one-size-fits-all determination! The best safe harbor for an ALE is based on that ALE's employee benefits strategy and employee population. It is very important for an ALE to determine which affordability safe harbor it wants to use when determining employee contributions for the plan year because this determination can protect the ALE from potential IRS tax penalties.

References

1 - If an employer has at least 50 full-time employees, including full-time equivalent employees, on average during the prior year, the employer is an ALE for the current calendar year, and is therefore subject to the employer shared responsibility mandate and ACA's Section 6056 reporting requirements. Treas. Reg. § 54.4980H(b).

2 - Each year the affordability contribution percentage is adjusted for inflation: 2015 = 9.56%; 2016 = 9.66%; 2017 = 9.69%; 2018 = 9.56%; 2019 = 9.86%; 2020 = 9.78%; 2021 = 9.83%; 2022 = 9.61%; 2023 = 9.12%; 2024 = 8.39%.

3 - All examples provided in this Compliance Q&A are calculated using the 2023 affordability percentage of 8.39%.

4 - There are several additional nuances to consider when determining affordability that are beyond the scope of this Compliance Q&A, such as opt-out payments and wellness program incentives. For more information about these affordability considerations, please ask your McGriff Benefits Consultant for guidance.

5 - 26 CFR § 301.6056-1.

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