
IRS issues final ACA employer shared responsibility regulations: Employers that misclassify workers may face significant exposure

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In brief

The Internal Revenue Service (IRS) recently issued final regulations providing guidance to employers regarding the implementation of the employer shared responsibility payment enacted as part of the Affordable Care Act (ACA). For large employers that fail to provide healthcare coverage to full-time employees, a significant excise tax under Section 4980H of the Internal Revenue Code could be assessed for each full-time employee performing services for those employers.

While the employer shared responsibility provisions will generally apply for large employers starting in 2015, small to midsize employers with at least 50 but fewer than 100 full-time employees will be provided transition relief until 2016. In addition, employers with more than 100 full-time employees will only have to offer coverage to 70% of their full-time employees in 2015, rather than 95% beginning in 2016.

Since enactment of ACA, some commentators have raised concerns over the possible impact worker misclassification may have on an employer's potential liability under Section 4980H. Specifically, employers already facing substantial exposure for employment tax liabilities may also be subject to significant excise tax assessments under ACA for misclassification. In addition, the final regulations clarify that employers that currently rely on relief provisions under Section 530 of the Revenue Act of 1978 for employment tax purposes will not be able to obtain similar relief with respect to the Section 4980H excise tax. Accordingly, the Section 4980H excise tax presents a challenge for all employers with independent contractors that are susceptible to reclassification by the IRS.

In detail

Employer shared responsibility under Section 4980H

Section 4980H generally provides that employers with at least 50 full-time employees (applicable large employer) will be subject to an excise tax if they fail to

offer minimum affordable health coverage to their full-time employees (and their dependents) and at least one of their full-time employees receives a premium tax credit for purchasing individual coverage on one of the new insurance exchanges. The penalty is 1/12 of \$2,000 times the number of full-time

employees, less 30, for any month in which any full-time employee obtains subsidized coverage on the exchange. If the employer offers coverage, but it is not minimum affordable coverage, and any full-time employee obtains subsidized coverage on the exchange, the penalty is 1/12 of \$3,000 for each employee

that obtains subsidized coverage for that month.

For these purposes, a full-time employee is defined as one who works an average of at least 30 hours per week. The final regulations also provide clarifications regarding whether certain types of employees or individuals, including volunteers, students, teachers, adjunct faculty members, and seasonal employees, employed in certain types of occupations are considered full-time. Consistent with the proposed regulations, the new rules define an employee for purposes of Section 4980H as an individual who is an employee under the common law standard. Consequently, determining whether an individual meets the common law definition becomes critical in assessing whether the ACA penalty may apply.

Determining worker classification status

Whether a worker should be classified as an independent contractor or an employee can be a difficult question. There is no bright-line test. Instead, the applicable common law standard requires an examination of the facts and circumstances surrounding the relationship between the service recipient and service provider to assess whether the service recipient has the right to direct and control the performance of services.

As a result, businesses that are not certain whether a group of workers are properly classified as independent contractors should consider the potential consequences under Section 4980H. Specifically, if a worker was not treated as an employee by the business and was not offered health coverage, but is subsequently reclassified as an employee due to an IRS employment tax examination, such reclassification could impact

whether the Section 4980H excise tax may be imposed against the employer.

Example 1: Consider a company that employs 1,000 full-time employees who are entitled to participate in the company's health care plan. The company also engages 100 independent contractors (each of whom works in excess of 30 hours per week) who do not participate in these plans. If all of the contractors are reclassified by the IRS as a result of the examination, then the company will fail the 95% coverage test ($1,100 \times 95\% = 1,045$), resulting in an excise tax assessment of \$2.14 million ($((1,100 - 30) \times \$2,000)$ if one of the individuals receives a premium tax credit.

Example 2: Similarly, consider an employer with 40 full-time employees and 15 independent contractors. If the employer does not provide health coverage to its employees and all of the independent contractors are reclassified as full-time employees, then beginning in 2016, the company would be assessed a penalty of \$50,000 ($((55-30) \times \$2,000)$.

Accordingly, in order to mitigate the exposure associated with worker misclassification, businesses that use independent contractors should review their current arrangements to determine if those workers have been properly classified.

Interaction of Section 4980H excise tax and Section 530 relief

Section 530 of the Revenue Act of 1978 provides a safe harbor for employers that have historically treated a class of workers as independent contractors. Section 530 has three substantive requirements: reporting consistency, substantive consistency and a reasonable basis for treating the individuals as contractors. If the requirements of Section 530 are met, an employer that misclassifies

employees as independent contractors (1) is not liable for the employment taxes associated with misclassifying the employees as independent contractors and (2) may continue to treat the employees as independent contractors prospectively.

Since passage of ACA, uncertainty has existed as to whether Section 530 will apply to relieve employers of the potential liabilities under Section 4980H. However, the final regulations clarify that Section 530 relief will apply only to employment taxes and will not protect against the Section 4980H excise tax. The US Department of the Treasury and the IRS believe that allowing Section 530 relief to apply to the Section 4980H excise tax would serve to increase the potential for worker misclassification. Consequently, an employer entitled to relief under Section 530 may be immune from employment taxes but could be subject to a large excise tax for failing to offer affordable health insurance coverage to the employees it treats as independent contractors. Therefore, it is critical for employers relying on Section 530 to consider how the excise tax might apply and begin to take steps to avoid having the excise tax imposed inadvertently.

Currently, IRS auditors must consider the application of Section 530 relief before examining whether independent contractors are misclassified under the common law test. If the IRS determines that a business is entitled to Section 530 relief, the IRS will not proceed with the determination as to whether an individual is properly treated as an independent contractor or an employee. With passage of Section 4980H, however, the IRS now has an independent basis to examine whether workers are classified properly even in cases where it has determined that Section 530 relief is appropriate.

The takeaway

The Section 4980H excise tax presents serious challenges for large employers that use independent contractors and especially for those

relying on Section 530. Understanding the difference between an employee and an independent contractor is critical because if an employer fails the 95% coverage test

due to misclassification and a single misclassified worker purchases subsidized insurance on an exchange, the excise tax may be applied to all full-time employees.

Let's talk

If you have any questions regarding the new reporting obligations or the impact of worker classification on the employer shared responsibility provisions, please contact:

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