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Pushing back on proposed ACA penalties - Part 1 - by Michael Duffy

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A significant number of 226-J Letters sent to large employers contain material errors. Don't cut the IRS a check unless you're sure the ESRP penalty being proposed is actually due.

What is a 226-J Letter? As part of the Affordable Care Act (ACA), large employers are required to offer at least 95% of their full-time employees the opportunity to enroll in an employer-sponsored healthcare plan that provides standardized coverage at an affordable price. Failure to offer sufficient coverage to enough full-time employees can expose an employer to the ACA's Employer Shared Responsibility Payment (ESRP) penalties. The IRS is tasked with monitoring whether employers are in compliance with the ACA and whether an ESRP penalty is due.

The IRS requires that taxpayers annually file Forms 1095-C and 1094-C in order to self-report the total number of full-time employees they retain during the year. Individual employees are given statements concerning whether or not they were enrolled or offered the opportunity to enroll in an employer-sponsored ACA-compliant healthcare plan. The IRS began requesting this data from employers in 2015, and since late 2017 it began analyzing the employer data in order to identify errors and compliance gaps.

If the IRS identifies a possible ACA deficiency, it sends out a Letter 226-J to employers. What usually generates most of the calls to CPAs and attorneys is that Letter 226-J usually proposes a six-figure penalty and is drafted to look like a formal IRS tax assessment.

What is the ESRP Penalty? The ESRP penalties are supposed to coerce employers into sponsoring a healthcare plan for the benefit of essentially all of their employees. The coercion is accomplished by assessing large employers with an annual ESRP offer penalty that can equal $2,000 per full-time employee (1) if coverage is not offered to a large enough pool of employees. In the 2015 transition year, employers were required to offer coverage to 70% of their full-time employees, but for all subsequent years the percentage is 95%. Consequently, the penalty can easily reach hundreds of thousands of dollars. In the event an employer-sponsored healthcare plan is in place and offered to enough full-time employees, but the monthly plan costs payable by employees are too high relative to their earnings, a different ESRP may be imposed. The ESRP offer penalty tends to be the biggest risk for large employers.

What is important to remember is that the ESRP offer penalty is imposed on an employer who does not offer coverage to at least 95% of their full-time employees, regardless of the number of employees that may have been offered coverage, and regardless of the number of employees that actually enroll in whatever employer-sponsored healthcare plan is being offered. For example, if an employer offers coverage to 94% of its full-time employees, the ESRP penalty counts the total number of the employer’s full-time employees, as opposed to just the employees not offered coverage. This fact comes as a surprise for employers that offer reasonably strong benefits, but fail to meet the 95% threshold through inadvertence. Conversely, if coverage is offered to all full-time employees, but for whatever reason no employee actually enrolls, no ESRP offer penalty is due. Actual enrollment in the plan being offered is not relevant for the purposes of the ESRP penalties.

Whether adequate coverage is offered to employees is only half of the requirement of either ESRP penalty, however. In order for the IRS to be able to assess an ESRP penalty, it must also show during the same period that at least one full-time employee enrolled in an “Obamacare” plan that was, at least in part, subsidized.(2) If a large employer fails to offer any sort of employer-sponsored healthcare plan options, but none of the employees actually get subsidized healthcare through a public option, then the IRS is unable to assess either ESRP penalty.

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1. This number is increased upwards each year with inflation.

2. An employee that is eligible to participate in an employer-sponsored healthcare plan can always elect to go to an ACA exchange and obtain Obamacare coverage. But, if a valid employer-sponsored plan is available to the employee already, then the employee’s coverage is not eligible for any government subsidies. In almost all cases, the employer-sponsored plan will be cheaper than unsubsidized coverage available through Obamacare.