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The Affordable Care Act—Countdown to Compliance for Employers, Week 23: The Impact of Employment Contract Terms on Variable Hour Employee Status

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For **applicable large employers** (i.e., employers who employed at least 50 full-time and full-time equivalent employees on business days during the preceding calendar year) endeavoring to comply with the **Affordable Care Act's employer shared responsibility rules**, determining an **employee's status as "full-time"** is critically important. Final regulations implementing the Act's employer shared responsibility requirements establish two methods—(1) the monthly measurement method and (2) the look-back measurement method—for making that call. The latter, the look-back measurement method, further classifies newly-hired employees as full-time, variable hour, seasonal or part-time. Of these, what constitutes a "new variable hour employee" has proved to be far and away the most confusing.

A recently published set of Questions & Answers made available by the American Bar Association's Section of Taxation, Employee Benefits Committee, provides some helpful insights into the IRS's view of which employees may be properly classified as "variable hour." The Q&As are based on a presentation made by IRS and Treasury officials at the Tax Section's Employee Benefits Committee May 2014 meeting in Washington, D.C. The Q&As reflect the unofficial, individual views of the government participants, which do not necessarily represent formal agency policy. Thus, they may not be relied on as precedent. They are, nevertheless, useful in gaining an understanding of how the regulators think the rules ought to work. One particular Q&A (Q&A 25), entitled "Determining Whether a New Employee is a Variable Hour Employee," deals with the effect of the terms of an employment contract on variable hour status. The IRS response also elucidates other important aspects of the rules governing variable hour employees.

Background

For purposes of the Act's employer shared responsibility rules, an employee is a "full-time employee" if he or she averages at least 30 hours of service per week or 130 hours of service in a calendar month. Under the "monthly measurement method" an employer determines each employee's status as a full-time employee by counting the employee's hours of service for each month. The problem with this method is, of course, that one might not know until after the month is over whether a particular employee is or is not full-time. Recognizing the inherent limitation of the

monthly measurement method, the final rules also provide for a “look-back measurement” method. Under the look-back measurement method, an employer determines the status of an employee as a full-time employee during a future period (referred to as the “stability period”), based upon the hours of service of the employee in a prior period (referred to as the “measurement period”).

The final regulations prescribe two sets of measurement periods, an “initial measurement period,” which generally begins on date-of-hire or the first day of the month following date-of hire, and a “standard measurement period,” which is a fixed period of at least three but not more than twelve consecutive months (e.g., the calendar year) selected by the employer. Each measurement period is followed by a corresponding “stability period,” which is a period selected by the employer that “immediately follows, and is associated with, a standard measurement period or an initial measurement period.” An employer is permitted to interpose an “administrative period” of up to three months between the measurement and stability period.

When applying the look-back measurement method, a newly hired employee must be classified as full-time, variable hour, seasonal, or part-time.

- *Full-time employee*

A “full-time employee” is an employee “who is reasonably expected at the employee’s start date to be a full-time employee (and is not a seasonal employee).”

- *Variable hour employee*

An employee is a “variable hour employee” if, based on the facts and circumstances at the employee’s start date, the employer cannot determine whether the employee is reasonably expected to be employed on average at least 30 hours of service per week during the initial measurement period because the employee’s hours are variable or otherwise uncertain. The final regulations prescribe a series of factors to be applied in making this call. (We explained these factors at length in our April 14, 2014 post.)

- *Seasonal employee*

A “seasonal employee” is an employee who is hired into a position for which the customary annual employment is six months or less.

- *Part-time employee*

A “part-time employee” means a new employee who the employer reasonably expects to be employed on average less than 30 hours of service per week during the initial measurement period, “based on the facts and circumstances at the employee’s start date.” As is the case with variable hour employee determinations, the final regulations prescribe a series of factors to be applied.

Once an employee has been employed for a full standard measurement period, he or she sheds his or her status as full-time, variable hour, seasonal, or part-time, and instead becomes (and is tested as) an “ongoing” employee. Special rules apply governing the transition from a newly hired employee to an ongoing employee.

The attractiveness of the look-back measurement method is that the employer is not penalized for failing to offer group health plan coverage to newly hired variable hour, seasonal, or part-time

employees during their initial measurement period. But if the variable hour, seasonal, or part-time employee is determined to work on average 30 hours or more per week during the initial measurement period, he or she must be offered coverage during the corresponding stability period, despite that he or she no longer works on average 30 hours or more per week, so long as he or she remains employed. A similar approach applies to ongoing employees.

According to the final regulations, for purposes of determining whether an employee is a variable hour employee, an employer "may not take into account the likelihood that the employee may terminate employment . . . before the end of the initial measurement period." This requirement appears, at least at first blush, to contradict one or more of the factors that must be applied in order to establish variable hour status. For purposes of this post, the factor of greatest interest is—

> "[W]hether the job was advertised, or otherwise communicated to the new employee or otherwise documented (for example, *through a contract* or job description) as requiring hours of service that would average at least 30 hours of service per week, less than 30 hours of service per week, or may vary above and below an average of 30 hours of service per week. (Emphasis added.)

This particular factor invites the question (excerpted from Q&A 25 referred to above):

> "If the terms of the employment contract provide for termination before the end of the initial measurement period, can the employer 'take into account that the employee may terminate employment before the end of the initial measurement period?' What if there is some other restriction (such as the expiration of a work visa) that will make it impossible for the employee's employment to continue through the end of the initial measurement period?"

Variable Hour Determinations—Terms of an Employment Contract

The lead up to the proposed response to Q&A 25 picks up on the apparent contradiction noted above. On the one hand, the factors include the terms of an employment contract or job description, which are known in advance; on the other hand, the regulations also state that "the employer may not take into account the likelihood that the employee may terminate employment before the end of the initial measurement period." The proposed response concludes that the "employer can take into account the provisions of an employment agreement—including the term of the employment agreement—in determining whether an employee is a variable hour employee." The IRS disagrees.

Before examining the IRS's response, it's worthwhile to examine the reasoning of the proposed response. It notes that:

> "The purpose of the prohibition on taking into account the likelihood of termination of employment is to avoid making assumptions about employees in positions with high turnover, which would penalize employees who are working full-time hours throughout the initial measurement period. This concern is not present when the employment is of a fixed duration, either by agreement or by operation of law."

This is a compelling, though admittedly narrow, reading of the rule. If the purpose of the variable hour rules was so limited, that is, if the sole purpose of the variable hour rules is to avoid making assumptions about employees in positions with high turnover, then the proposed response would be viable. But the regulators do not read the rule this way. Here's how they see it:

> "The terms of an employment contract can be relevant in terms of how many hours a week does the employer expect the employee to work while employed, whatever period that is. If the employer does not know if the hours worked are going to be above 130 hours a month or not then the employer can treat them as variable. *If an employer hires an employee who is going to work 40 hours a week, but the employer only expects the employee to be employed for six months, so it is going to come out to 20 hours a week for the first year, an employer cannot treat the employee as part time.*" (Emphasis added.)

Simply put, whether a new employee is a variable hour employee is based on whether he or she is expected to work on average 30 hours of service per week or 130 hours of service per calendar month, not whether he or she is expected as of his or her date of hire to work 1,560 hours in a year. The 1,560 hour test is applied at the end of the initial measurement period to determine whether the employer must extend an offer of coverage during the corresponding stability period, and not at the beginning of the initial measurement period to determine whether the employee is variable hour.

Q&A 25 separately offers the following, welcome clarification relating to seasonal employees.

> "An example of a seasonal employee is a life guard or a ski instructor, but it does not have to be someone whose job is affected by the weather directly. It can just be someone who is peak season working in a hotel or something like that or a summer associate at a law firm for that matter."

Where a newly hired employee is properly determined to be a seasonal employee, then the employer may use the initial measurement period for determining if he or she is full-time. But if the employee is simply on a short-term contract, the employer cannot do that. On this last point, the Service representative helpfully adds that an employer "always has until the beginning of the fourth month to get employee into the plan." Thus, if the employee is only going to be employed for, say, two months, then the employer will not have to make an offer of coverage to the employee under its group health plan.

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