



COMPLIANCE BULLETIN

Key strategies for avoiding ACA pay-or-play penalties

The Affordable Care Act (ACA) requires applicable large employers (ALEs) to offer affordable, minimum-value health coverage to their full-time employees (and dependents) or potentially pay a penalty to the IRS. This employer mandate is also known as the pay-or-play rules. Small employers who aren't ALEs are not subject to the ACA's pay-or-play rules.

An ALE may be subject to a pay-or-play penalty if at least one full-time employee receives a premium tax credit for purchasing individual health coverage through an ACA exchange, and the ALE:

- ✓ Didn't offer health plan coverage to at least 95% of full-time employees and their dependents.
- ✓ Offered health plan coverage to at least 95% of full-time employees, but not to the specific full-time employee receiving the credit.
- ✓ Offered health plan coverage to full-time employees that was unaffordable or didn't provide minimum value.

This compliance overview outlines strategies for ALEs to use to help avoid penalties under the ACA's pay-or-play rules.

LINKS AND RESOURCES

- ✓ IRS [final regulations](#) on the ACA's pay-or-play rules
- ✓ IRS [Revenue Procedure 2025-25](#), containing the affordability percentage for 2026 plan years
- ✓ Forms [1094-C](#) and [1095-C](#) (and related [instructions](#)) for ACA reporting by ALEs

HIGHLIGHTS

Key strategies ALEs should consider the following strategies for avoiding pay-or-play penalties:

- Accurately track employees' full-time status.
- Apply the adjusted affordability percentage.
- Utilize an appropriate affordability safe harbor.
- Timely and accurately complete ACA reporting.
- Promptly respond to IRS Letter 226-J.

AFFORDABILITY PERCENTAGE

The adjusted affordability percentage is:

- 9.02% for 2025 plan years.
- 9.96% for 2026 plan years.
- Not released yet for 2027 plan years.

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STRATEGY:

Accurately track employees' full-time status

Accurately tracking employees' full-time status is central to the ACA's pay-or-play rules. To avoid penalties, ALEs must offer affordable, minimum-value health coverage to their full-time employees. A full-time employee is an employee who has, on average, at least **30 hours of service per week**, or at least 130 hours per calendar month. Even if ALEs have a different definition of what's considered full-time for purposes of payroll or other company policies, they must offer coverage to employees meeting the IRS' definition to avoid potential pay-or-play penalties.

Because ALEs must report coverage to the IRS for each calendar month, January through December, it's important to keep track of their employees' status throughout the year. There are two methods for identifying full-time employees for purposes of offering health coverage:

- 1** *The **look-back measurement method** involves counting an employee's hours of service during one period (called a measurement period) to determine their full-time status for a future period (called a stability period). The details of this method are complex and vary based on whether the employees are ongoing or new, and whether new employees are expected to work full-time or are variable, seasonal, or part-time employees. This method can provide predictability for companies with employees who have varying hours or work schedules.*
- 2** *The **monthly measurement method** involves a month-to-month analysis, where full-time employees are identified based on their hours of service for each calendar month. This method works best for employers with mostly full-time employees who have consistent hours or work schedules.*

Inaccurately tracking full-time employee status can result in failures to offer coverage and, ultimately, possible assessment of pay-or-play penalties.

STRATEGY:

Apply the adjusted percentage to determine affordability

The affordability of health coverage is a key point in determining whether an ALE may be subject to a pay-or-play penalty. An ALE's health coverage is considered affordable if the employee's required contribution to the plan doesn't exceed 9.5% (as adjusted annually) of the employee's household income for the taxable year. This percentage is adjusted each year based on health plan premium growth rates in relation to income growth rates. For plan years beginning in 2026, the adjusted affordability percentage is 9.96% (up from 9.02% for plan years beginning in 2025). The IRS hasn't yet announced the adjusted affordability percentage for plan years beginning in 2027.

For purposes of the pay-or-play rules, the affordability test applies only to the employee portion of the annual premiums for **self-only coverage** and doesn't include any additional cost for family coverage. Also, if an employer offers multiple health coverage options, the affordability test applies to the **lowest-cost option** that provides minimum value. The extent to which an employer may increase or decrease employee contributions for the upcoming plan year while still meeting the ACA's affordability percentage depends on how the affordability percentage is adjusted for that year.

Before the start of each plan year, ALEs should confirm that at least one health plan option offered to full-time employees will satisfy the applicable affordability percentage using one or more of the safe harbors discussed below.



Even if ALEs have a different definition of what's considered full-time for purposes of payroll or other company policies, they must offer coverage to employees meeting the IRS' definition to avoid potential pay-or-play penalties.

STRATEGY:

Utilize an appropriate affordability safe harbor

Because an employer generally doesn't know an employee's household income, the IRS has provided three optional affordability safe harbors which ALEs may use to determine affordability based on information that's available to them: **the Form W-2 safe harbor**, the **rate-of-pay safe harbor**, and the **federal poverty level (FPL) safe harbor**. These safe harbors can protect an employer from pay-or-play penalties, even if an employee receives a premium tax credit for purchasing health insurance through an ACA exchange.

An ALE may choose to use one or more safe harbors for all its employees or for any reasonable category of employees, provided it does so on a uniform and consistent basis for all employees in a category. To select a safe harbor for its employees (or for a reasonable category of employees), an ALE should review how each one works. This includes assessing each safe harbor's level of predictability and ability to maximize employee contributions. Certain safe harbors may be more appropriate than others, depending on an ALE's workforce.

The following table provides a quick overview of the three affordability safe harbors and identifies the types of employers who may benefit the most from each.

Safe harbor	Quick overview	Pros and cons
Form W-2	An ALE determines the affordability of its health coverage for each employee by looking at the employee's wages reported in Box 1 of their Form W-2 after the end of the year.	<i>This safe harbor is the least predictable method for determining affordability because it's based on the actual amount of each employee's W-2 wages, which isn't known until after the end of the year. Due to this uncertainty, it works best for employees whose annual compensation can be predicted with accuracy before the start of the year. If employers are comfortable with this risk, this safe harbor potentially allows them to maximize employee contributions toward the cost of health coverage based on actual compensation.</i>
Rate-of-pay	An ALE determines the affordability of its health coverage for each employee by looking at the employee's hourly rate multiplied by 130 hours (regardless of the number of hours worked). Monthly salary is used for salaried employees instead of the hourly rate.	<i>This safe harbor provides a more predictable, design-based method for determining affordability. It's especially useful for ALEs with a significant number of hourly employees since it uses an assumed rate of 130 hours per calendar month, regardless of the actual number of hours worked by the employee. However, this safe harbor may not maximize employee contributions toward the cost of health coverage if hourly employees regularly work more than 130 hours per month.</i>
FPL	An ALE determines the affordability of its health coverage for all employees by looking at the FPL for a single individual.	<i>This safe harbor provides the most predictable, design-based method for determining affordability. It gives ALEs a predetermined maximum amount of employee contribution that, in all cases, will result in the coverage being deemed affordable. It's relatively easy to apply because it doesn't require any employee-specific data. However, it often requires the largest employer contribution toward the cost of health coverage.</i>

STRATEGY:

Timely and accurately complete ACA reporting

Each year, ALEs are required to report to the IRS about their compliance with the ACA's pay-or-play rules and the health coverage they have (or haven't) offered by filing Forms [1094-C](#) (a transmittal) and [1095-C](#) (an information return). The reporting deadline is generally **March 31** of each year, although ALEs may request an automatic 30-day extension by filing [Form 8809](#) by the due date.

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The IRS' determination of whether an ALE may be liable for a pay-or-play penalty and the amount of the proposed penalty are based on information from Forms 1094-C and 1095-C filed by the ALE and the individual income tax returns filed by the ALE's employees.

In addition to accurately tracking employees' full-time status, ALEs should ensure they correctly report offers of coverage on Form 1095-C. Form 1095-C contains the bulk of the information ALEs need to gather to correctly report, so understanding the complexities of this form (particularly the indicator codes on lines 14–16) is essential. For ALEs with fully insured plans, one form must be completed for each full-time employee (even if an ALE doesn't offer coverage to any full-time employees). For ALEs with self-funded plans, one form must be completed for anyone who was covered, not just full-time employees.

STRATEGY: Promptly respond to IRS Letter 226-J

The IRS issues [Letter 226-J](#) to an ALE if it determines that, for at least one month in the year, one or more of the ALE's full-time employees enrolled in health coverage through an ACA exchange and received a premium tax credit. Letter 226-J is only an initial notification that an ALE may be liable for a pay-or-play penalty and not a tax bill; however, ALEs that receive these letters should take them seriously and start preparing a response to help minimize their penalty exposure.

The response to Letter 226-J is due by the deadline shown on the first page of the letter, which generally will be 90 days from the date of the letter. ALEs must respond to Letter 226-J, either agreeing with the proposed penalty or disagreeing with part or all of the proposed amount. If the ALE doesn't respond by the response deadline, the IRS will send a notice and demand for the penalty that was proposed and assessed.

To determine if a pay-or-play penalty is actually owed, ALEs should review the health coverage offered to full-time employees for the tax year covered by Letter 226-J. ALEs should have their Forms 1094-C and 1095-C that they filed with the IRS for the applicable tax year to review the IRS' proposed penalty assessment. If the information reported on a full-time employee's Form 1095-C was inaccurate or incomplete, an ALE should promptly submit changes using the applicable indicator codes for lines 14–16 that are described in the [Instructions for Forms 1094-C and 1095-C](#).



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