This is Part II of our two-Alert package on the IRS's proposed regulations regarding the "play or pay" mandate on employers. The play or pay mandate requires larger employers to offer coverage (or risk penalties) to their "full-time" employees, meaning employees who average at least 30 hours per week or 130 hours per month. The employer excludes independent contractors, leased employees, employees with inadequate U.S.-source income, partners and more than two percent shareholders in subchapter S corporations.

Employers subject to the mandate may wish to categorize employees as either regular (non-seasonal) full-time, or seasonal/variable hour. Employers with large hourly populations and thin margins will want to put as many employees as possible in the seasonal/variable hour bucket, because the employer may take up to a 12-month look at these employees before considering them "full-time."

Employers must generally count all hours for which an employee is paid (including paid time off). For non-hourly employees, employers must count hours, or credit the employee with either eight hours per day, or 40 hours per week, for each day or week in which the employee is paid for at least one hour.

The proposed regulations would impose somewhat cumbersome "break in service" rules when a seasonal or variable hour employee terminates, is laid off or is on unpaid leave, but then returns to the employer.

The proposed regulations supply special rules for staffing agencies and educational institutions, and offer accommodation under non-calendar year Section 125 cafeteria plans for employers desiring to allow employees to make coverage changes during the 2013-14 fiscal year, without regard to life events or other qualifying events.

On the last business day of 2012, the IRS issued 144 pages of proposed regulations addressing the employer "play or pay" mandate under 2010's federal health reform law, the Patient Protection and Affordable Care Act (PPACA).
We dealt with half of the regulatory package in Part I of our two-part Alert package on the proposed regulations (click here for our Part I). In this Part II we address: how the IRS proposes larger employers count hours of service, for determining "full-time employees" under the play or pay mandate; how hours for some employees may be averaged over extended periods; and other related matters.

**Background**

As noted in Part I, the play or pay mandate applies to employers who employed an average of at least 50 full-time/full-time equivalent employees on the previous calendar year's business days.

For employers subject to the mandate, the notion of "full-time employee" is important because the employer has a two-tiered obligation with respect to such employees.

*The Two-Tiered "Play or Pay" Obligation*

First, the employer must offer nearly all its full-time employees and their children (to age 26) at least "minimum essential coverage" or risk penalties.

Employers who satisfy Tier 1 by deciding to "play" rather than "pay" must then negotiate Tier 2. The employer's coverage offer -- at least to the full-time employee -- should satisfy a "minimum value" standard and be "affordable" to the employee, or the employer risks a different, contingent penalty. The penalty is contingent on whether the employee declines the employer's coverage offer and instead buys health insurance in a public health insurance exchange, and obtains federal subsidies to do so.

Under Tier 2, coverage has "minimum value" if it has at least a 60 percent actuarial value, and it's "affordable" if the employee pays no more than 9.5 percent of household income for employee-only coverage (see Part I for safe harbors the IRS has proposed, to permit the employer to satisfy the affordability requirement).

Under the PPACA, full-time employees are those that average at least 30 hours per week. The proposed regulations would treat 130 hours per month as the equivalent of 30 hours per week. The 130-hours-per-month equivalency is permissive, but if used it must be used reasonably and on a consistent basis.

"*Who Are These Guys?*"

In defining "full-time employees" the proposed regulations largely mirror earlier guidance, in IRS Notice 2012-58, published just before Labor Day (see our September 10, 2012, Alert by clicking here). There is one set of proposed requirements for regular (i.e., non-seasonal), full-time employees, and a second set for seasonal and variable hour employees.

If finalized, the proposed regulations would require larger employers to offer coverage to new, regular (i.e., non-seasonal) full-time employees within three full calendar months of hire, or risk penalties.

The regulations would permit employers to average the hours worked by seasonal and variable hour employees over a "measurement period" of up to 12 months to see who averaged at least 30 hours per week (or 130 hours per month). The employer would then have a brief period of time -- an "administrative period"-- to identify these employees and get them an offer of
coverage. The employer would have to treat them as full-time for a "stability period" that lasts at least six months or, if longer, the length of the measurement period.

**Lockton Comment:** It's easy to confuse the PPACA's prohibition on waiting periods that exceed 90 days with the requirement to offer a new regular (non-seasonal) full-time employee health insurance within three full calendar months or risk penalties. The waiting period rule does not require an employer to offer coverage, nor does it impose penalties if the employer fails to do so. The rule merely says that if an employer sponsors a health plan, once an employee is considered eligible for that coverage the coverage must begin within 90 days.¹

*Who These Guys Are Not*

Under the play or pay mandate, employers are only required to deal with their common law employees, except those who don't have adequate U.S.-source income. Common law employees are those, generally speaking, who are subject to the will and control of the employer, not only with respect to what shall be done, but also how it shall be done.

The employer has no obligation with respect to true independent contractors, partners, and more than two percent shareholders in a subchapter S corporation. Similarly, the employer has no play or pay obligation with respect to leased employees (i.e., employees leased from a staffing company, where the staffing company is the employer). Employees placed by a professional employer organization (PEO) appear, based on legislative history to the PPACA, to be the responsibility of the client, not the PEO. However, the IRS has not yet announced its position on the matter.

**In Which Bucket Does a New Employee Begin?**

The proposed regulations would, in essence, require an employer to classify new employees as either (i) regular (non-seasonal) full-time, or (ii) seasonal or variable hour. The bucket in which an employee is placed affects whether and when the employer must offer coverage in order to avoid potential penalties.

**Regular (i.e., Non-Seasonal) Full-Time Employees**

As noted above, newly hired regular full-time employees must receive an offer of coverage within three full calendar months after their start date, or the employer risks penalties. Of course, if a plan states that regular full-time employees are eligible for coverage, generally coverage would have to begin within 90 days, to satisfy the PPACA's separate waiting period rule.

Generally, employers should include in the "regular full-time" bucket those non-seasonal employees who are hired to work full-time hours even for a temporary engagement (e.g., employees hired to work full-time hours for a discrete, seven-month project). Special rules, described below, apply to employees of staffing agencies. The proposed regulations suggest the IRS wants these temporary full-time employees placed in the "regular, full-time employee" bucket, at least for periods after 2014. Of course, if their term of full-time employment is three months or less, nothing under the PPACA requires the employer to offer them coverage.

**Seasonal and Variable Hour Employees**
An employer has more leeway with seasonal employees (even if working full-time hours), and variable hour employees. As noted above, it is these employees with respect to whom the employer may claim up to a 12-month measurement period, over which it may average the employee's hours to determine "full-time" status. The concepts of measurement periods, and their related administrative and stability periods, were addressed in our September 10 Alert, and are again discussed briefly below.

**Lockton Comment:** Many employers, particularly those in the retail, restaurant and hospitality/entertainment sectors, will want to put as many employees as possible in the "seasonal or variable hour" bucket, to buy themselves that 12-month look at the employees.

The proposed regulations don't define "seasonal" employees. For the time being, the IRS encourages employers to make the determination in good faith. IRS officials have said informally that seasonal employees mean employees hired for legitimate seasonal work, such as lifeguards, ski instructors, retail clerks hired for a holiday season, etc. Under the proposed regulations, an educational institution may *not* treat a full-time employee as seasonal simply because the employee works only during the portion of the year when the academic term is in session.

Variable hour employees are:

- Employees whose hours are expected to vary such that, on an employee's start date, the employer can't reasonably conclude the employee will average at least 30 hours per week/130 hours per month over a measurement period of up to 12 months; and
- Employees whose hours, at least initially, are expected to be at least 30 hours per week/130 hours per month, but whose hours thereafter will vary, so that the employer similarly cannot reasonable determine, on the start date, whether the employee will average at least 30 hours per week/130 hours per month over the employee's initial measurement period.

**Lockton Comment:** In which bucket does an employer drop an employee who is non-seasonal, and who is expected to work full-time hours for the duration of his or her employment, but that duration is expected to be relatively brief...so brief that it is expected to end prior to the end of the employee's initial measurement period?

Earlier guidance seemed to suggest the employer could put the employee in the "variable hour" bucket because it would not be clear, on the employee's start date, that she would average at least 30 hours per week over the 12-month measurement period. But the proposed regulations clarify that the IRS wants the employee in the "regular, full-time" bucket, at least for periods after 2014 (the IRS is willing to be flexible for 2014). The result is different, though, for staffing agency employees whose placements may be intermittent, even though some may be full-time engagements. See the discussion below regarding staffing agencies.

**Employees Who Switch to Regular, Full-Time During Their Initial Measurement Period**

The proposed regulations supply a twist for new variable hour employees who, during their initial months of employment are moved into regular, full-time status by the employer. They should be treated as "full-time," for purposes of the play or pay mandate, not later than the first day of the
fourth month following the change in employment status. If the change in status occurs late in their initial measurement period, however, and they average at least 30 hours per week over that period, the employer might need to treat them as "full-time" a bit earlier.

**Which "Hours" Does an Employer Count?**

The proposed regulations would require an employer, in determining an employee's status as full-time for purposes of the play or pay mandate, to count all hours for which the employee is *paid*, whether or not the employee works those hours (e.g., paid vacation, paid leave, etc.).

For employees not paid on an hourly basis, the proposed regulations would give little help to the employer. The employer would have just three options: (1) find a way to count hours; (2) credit an employee with eight hours for every day the employee works at least one hour; or (3) credit an employee with 40 hours for every week the employee works at least one hour. However, the equivalencies in (2) and (3) are not permitted if the result would be to *understate* an employee's hours.

An employer would be allowed to use different equivalencies for different groups of non-hourly employees, as long as the classifications are reasonable and consistently applied. An employer may change the method annually.

Notwithstanding the limited equivalencies for non-hourly employees, the IRS says it continues to study the issue, and appears willing to permit -- until further guidance is issued -- employers of commission-based employees, adjunct faculty members, employees whose hours are limited by federal law (e.g., airline pilots) and employees whose work hours or method of compensation pose similar issues, to count hours using "a reasonable method" that is consistent with the play or pay rules and does not understate hours.

An employer may ignore hours for which an employee is paid from sources outside the US, regardless of the employee's citizenship.

**Measurement, Administrative and Stability Periods for New Seasonal and Variable Hour Employees**

*Initial Measurement Periods*

The proposed regulations largely mirror IRS Notice 2012-58, and our September 10, 2012 Alert regarding that Notice, by permitting an employer to designate an initial measurement period of between three and 12 months for new seasonal and variable hour employees. Only if the new employee averages at least 30 hours per week/130 hours per month over the measurement period would the employer be required to offer health insurance or risk penalties.

Although the proposed regulations are a bit contradictory about this, it appears the initial measurement period may run on the basis of *months*, not just calendar months. A "month" is a period that begins on one day of a calendar month (say, the 15th) and ends on the preceding day of the following calendar month (i.e., the 14th). A *calendar* month is one of the named months.

*Initial Administrative Periods*

An employer may delay the commencement of an initial measurement period a short while, after
a new employee's start date. For example, the employer might wait to begin counting hours until
the first day of the ensuing payroll period, or first day of the ensuing month. This short-term
delay is called an "administrative period."

As described in our September 10 Alert, the employer may designate a second administrative
period after the close of an employee's initial measurement period, to allow the employer time to
determine if the employee emerged from her initial measurement period as "full-time," and if she
did, offer her coverage before her initial stability period begins (stability periods are described
below).

There are limits on the combined length of these administrative periods. They may not exceed
90 days in the aggregate, and may not be so long that the initial measurement and
administrative periods extend beyond the last day of the first calendar month that begins on or
after the one-year anniversary of the employee's start date. This allows an initial measurement
period and administrative periods that, combined, amount to up to 13 months and a fraction of
another month. For example, if an employee's start date is June 15, 2014, his or her initial
measurement and administrative periods may not extend beyond July 31, 2015.

**Initial Stability Periods**

After the measurement period and any ensuing administrative period would come the new
employee's "stability period," the prospective period during which an employee is treated as full-
time or part-time, depending on his or her average hours per week or month during the
measurement period. Of course, if an employee is considered "full-time" for a stability period, the
employer must make the employee and her children an offer of coverage, or risk penalties.

The stability period must run on calendar months. It must be at least six calendar months, but
can't be shorter than the measurement period. For an employer emerging from his initial
measurement period as part-time, the employee's status must be re-evaluated as of the end of
the standard measurement period (discussed below) that overlaps the employee's initial
measurement period. Our September 10 Alert included a chart illustrating the overlapping nature
of these periods.

**Measurement, Administrative and Stability Periods for Ongoing Employees**

**Standard Measurement Periods**

Every newly hired seasonal and variable hour employee has a unique initial measurement period
(in terms of when it starts), related to his or her start date, and therefore a related and equally
unique initial stability period. But hours-per-week determinations for ongoing employees are
made on the basis of a standard measurement period that is the same for each ongoing
employee. An ongoing employee is one who has been employed for at least one entire standard
measurement period.

The standard measurement period, like the initial measurement period, must be between three
and 12 months (not necessarily calendar months).

Where an employer pays its employees weekly, bi-weekly or semi-monthly, its payroll periods
likely won't line up with the beginning and ending of the applicable standard measurement
period. To facilitate the collection of hours by payroll period, the proposed regulations would
permit the employer to begin counting hours on the first day of the payroll period that begins just before the beginning of the standard measurement period. The employer may then cease counting the hours as of the end of the payroll period that ends just before the end of the measurement period.

Alternatively, the employer may begin counting hours with the first day of the payroll period that begins just after the beginning of the measurement period, as long as it counts hours through the end of the payroll period that ends just after the close of the measurement period.

**Standard Administrative Periods**

Standard measurement periods may be followed by an administrative period of up to 90 days.

*Lockton Comment:* Watch out here. The administrative period is limited to 90 days, not three months. Employers will need an administrative period to identify employees emerging from the standard measurement period as full-time, offer them them coverage in time to elect it, and for coverage to begin by the end of the administrative period.

**Standard Stability Periods**

The standard administrative period is followed by a standard stability period that must be the same duration as a new seasonal or variable hour employee's *initial* stability period. In any event, these periods may not be shorter, and as a practical matter can't be longer, than the accompanying standard measurement periods.

Many employers who will use measurement periods to gauge full-time status for seasonal and variable hour employees will want to use the maximum 12-month measurement periods, which means they'll be using 12-month stability periods. For purposes of stability periods beginning in 2014, however, the IRS will allow employers to use a shorter measurement period of at least six months, as long as the measurement period begins by July 1, 2013, and ends no earlier than 90 days before the 2014 stability period.

Why? If an employer with a calendar year plan, for example, wanted to declare a 12-month stability period beginning January 1, 2014, it would otherwise need to declare a 12-month measurement period beginning in late 2012, to allow the full measurement period to run, and allow also for a subsequent administrative period, all prior to January 1, 2014. This special accommodation allows the employer to begin a short measurement period later in 2013, but still utilize a full 12-month stability period beginning in 2014.

**Different Standard Measurement, Administrative and Stability Periods**

The proposed regulations would allow an employer to use different standard measurement, administrative and stability periods for different, select groups of employees. Differences would be permitted between:

- Employees in different bargaining units, operating under different bargaining agreements;
- Bargaining unit and non-bargaining unit employees;
- Salaried and hourly employees;
- Employees whose primary places of employment are in different states; and
- Employees employed under different employer identification numbers (EINs).

While not entirely clear from the proposed regulations, we assume an employer may also designate different initial measurement, administrative and stability periods for employees in the different classifications listed above.

**Lockton Comment:** Employers looking to minimize the number of employees they must treat as "full-time" for health reform purposes may endeavor to do so by managing the hours worked by some employees (so they don't exceed 30 hours per week), and by application of measurement, administrative and stability periods for seasonal and variable hour employees.

Employers intending to manage hours should be prudent about this. While it's not clear that an employee may bring -- much less win -- a claim against an employer for reducing the employee's hours simply to avoid risking a play or pay penalty, someone will try. Any workforce management strategy should be discussed with employment law counsel, because the employer's actions may have implications under other state and federal laws, such as age discrimination laws, wage and hour rules, etc. Counsel can discuss with the employer how to categorize employees in employment policies, handbooks and contracts to minimize the risk of a problem.

Employers looking to cram as many employees as possible into the seasonal and variable hour bucket, to avail themselves of the measurement period concept, must take care not to categorize as "seasonal" those employees who truly are not, or to categorize as "variable hour" those employees who best belong in the "full-time" bucket.

**As If All This Were Not Complex Enough...Breaks in Service, Rehires, Recalls and Unpaid Leave**

Earlier guidance on measurement, administrative and stability periods was provocatively silent on an important issue: What happens if a seasonal or variable hour employee is terminated, laid off or begins a period of unpaid leave, but is then recalled, rehired, or returns from leave during a measurement period or stability period?

The proposed regulations would apply several complex and administratively cumbersome rules here; if finalized quickly, these new rules might apply for 2014, but are more likely to apply for 2015.

When an employee is rehired or recalled or returns to service after a 26-week or longer break during which the employee was credited with no paid hours, the employer would be permitted to treat the employee as a new hire. Alternatively, if the employee's break in service (i.e., no paid hours) is at least four weeks and longer than the period he or she was credited with paid hours prior to the break, the employer may treat the employee as a new hire.

If the break is shorter than that, the employee would step back into the shoes she left behind. For example, if an employee were to return during the same measurement period, the employer would have to aggregate her paid hours during her intermittent periods of employment, when determining her average hours for the measurement period. Similarly, if she had been considered "full-time" when she left and had elected coverage, and she were to return in the same stability
period, she would have to be offered coverage upon her return, or as soon as practicable thereafter.

When averaging a seasonal or variable hour employee's hours over a measurement period, the employer may generally credit the employee with zero hours for days and weeks for which the employee was on unpaid leave. But the proposed regulations would make several exceptions.

For unpaid FMLA, USERRA and jury duty leave, the employer would be required to cut the period of unpaid leave out of the measurement period -- literally, shrink the measurement period -- or credit the employee with deemed hours during the unpaid leave. However, this special FMLA/USERRA/jury duty rule would only apply where an employee returns from such unpaid leave under circumstances where the employer may not treat the employee as a new hire.

**Offering Coverage**

Generally, when an employer determines an employee is "full-time" for purposes of the play or pay mandate, the employer must offer the employee and his or her children under age 26 at least "minimum essential coverage," or risk penalties.

For regular (i.e., non-seasonal) full-time employees, the offer should come prior to the end of the employee's initial three full calendar months of employment, and perhaps earlier, if the PPACA's 90-day waiting period limit rule applies. For seasonal and variable hour employees, the offer should come during the administrative period following the relevant measurement period.

As an anti-abuse rule, the IRS will not treat an employer as having offered coverage for a calendar month unless it offers coverage for the entire calendar month. Because stability periods run on calendar months, this should not be an issue in most cases.

The offer need only come once during the plan year, in order for the employer to be treated as having made an "offer" of coverage. If the employee declines the offer, the employer has nevertheless satisfied its obligation. If an employee terminates during a month, the employer will be deemed to have offered coverage for the entire month if the employee would have had the offer for the entire month, but for his termination.

If a full-time employee has elected coverage for a stability period and then stops paying for it, the employer may terminate the coverage for the remainder of the plan's coverage period (usually the plan year). The employer won't risk a play or pay penalty for terminating coverage. However, the proposed regulations would require the employer to give the employee notice and opportunity to cure an underpayment of premium, if the underpayment is insignificant. "Insignificant" means the underpayment is not greater than $50 or, if smaller, 10 percent of the premium due.

**Staffing Agencies**

The proposed regulations give a nod to the unique characteristics of temporary staffing agencies. The IRS declined a request from the staffing industry to allow staffing agencies to presumptively drop all their staffing employees into the "variable hour" bucket. But examples in the regulations make clear that the vast majority of staffing agency employees may be placed there anyway.
For example, the proposed regulations would allow a staffing agency to treat an employee as "variable hour" where the agency, upon the employee's start date, intends to place the employee in various assignments over time, with gaps in assignments, and where the assignments may vary in average hours of work per week -- some will exceed 30 hours per week, and some won't - - so that on the employee's start date the staffing agency can't reasonably tell whether the employee will average 30 or more hours per week over his entire initial measurement period.

The IRS does, however, expect staffing agencies to consider each employee individually. In some cases, for example, the staffing agency might conclude upon an employee's start date that the employee will be placed in a position or positions such that he or she will average at least 30 hours per week on an indefinite basis. Or the agency might hire an employee for a discrete or unique assignment for full-time hours. In those cases the IRS appears to expect the agency to place the employee in the "full-time" bucket. But the vast majority of staffing agency hires would be described in the immediately preceding paragraph.

Oh, and the IRS is watching staffing agencies to ensure they don't engage in abusive practices, such as forming two staffing companies, one that places an employee with a client for 20 hours a week, and another that then places the same employee, with the same client, for another 20 hours per week. In those cases, the IRS will treat the employee as a full-time employee of the client.

**Special Rules for Educational Institutions**

The IRS also proposes special rules for educational institutions. The rules appear designed to require these institutions to treat as "full-time" some employees who might not otherwise have been considered full-time, where the academic calendar encompasses only a part of a 12-month period.

Under the proposed regulations, an educational institution would not be allowed to treat an employee as "seasonal" simply because he works only during the academic portion of the year. In addition, the IRS proposes to require educational institutions to apply the special FMLA/USERRA/jury duty rule to all breaks in service of at least four consecutive weeks that arise out of the institution's non-working portion of its academic calendar. This special rule would apply to employees who, upon return, may not be treated as new hires.

The institution is not required to credit more than 501 deemed hours, or even paid hours, for periods when an employee is not working, disregarding deemed hours awarded under the special FMLA/USERRA/jury duty rule.

**Cafeteria Plan Issues**

The vast majority of employees enrolled in employer-based health coverage pay for that coverage on a pre-tax basis under a Tax Code section 125 "cafeteria plan." When an employee makes a coverage election under a cafeteria plan, she is typically locked in to that election for the balance of the plan year, unless she experiences one of several life or similar events that justify an election change, under IRS regulations.

The IRS recognizes that for cafeteria plans operating on a non-calendar year basis, some employees who are buying coverage from an employer in 2013 might want to drop that coverage mid-year, to leap into a health insurance exchange on January 1, 2014. Other employees who
decline to enroll in coverage through an employer might want to enroll, effective January 1, 2014, to satisfy the PPACA's individual mandate.

To address these issues, the IRS proposes to permit -- but not require -- an employer to amend its non-calendar year cafeteria plan to allow for a one-time election change for employees in the 2013-14 cafeteria plan year. The employer may permit employees to drop or change health coverage, or to enroll in health coverage, without any life change or similar event. The flexibility appears to apply to health flexible spending accounts as well as more robust healthcare plans. The accommodation applies to employers subject to the play or pay mandate; whether it applies to smaller employers is unclear.

Employers wishing to take advantage of this accommodation must amend their plans retroactively, by December 31, 2014, to reflect the accommodation.

**Reliance**

Employers are permitted to rely upon the proposed regulations, if they care to do so. To the extent they don't, employers may rely upon the IRS's earlier guidance regarding measurement, administrative and stability periods, at least for 2014. That guidance is described in our September 10 Alert.

The IRS will finalize the proposed regulations later this year. We don't know yet whether the Service will require compliance (for 2014) with final rules governing counting hours, breaks in service, and other matters not addressed in earlier guidance. Whether they will likely depends on how quickly the IRS can finalize the proposed regulations. So stay tuned, and stay flexible.

**Ed Fensholt, J.D.**

*Health Reform Advisory Practice*

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1The play or pay mandate, for its part, does not literally require the employer to offer coverage at all, or to treat any particular employee as eligible for coverage. It therefore does not impose a literal waiting period of any kind. It simply says that if the employer *fails* to offer at least some coverage to a new, regular full-time employee within three full calendar months (different than 90 days), the employer risks penalties.

In some cases, the waiting period rule will win out. For example, if *the health plan* says that regular (non-seasonal) employees are in a class eligible for coverage, the plan cannot require a new regular, full-time employee to wait more than 90 days for that coverage to begin. If the plan does *not* offer coverage to the employee, the employee is considered "full-time" for purposes of the play or pay mandate at the end of the third full calendar month of employment. After that date, the employer may become subject to penalties for not having made the offer.

In other cases, the play or pay mandate rule might trump the waiting period rule. For example, an employer might require regular, full-time employees to work 500 hours in a quarter, in order to be considered eligible for coverage. Coverage for regular, full-time employees who satisfy that standard must begin within 90 days after the end of the quarter, to satisfy the prohibition on waiting periods that exceed 90 days. But under the play or pay mandate, once the regular, full-time employee has been employed for three full calendar months, the employer becomes exposed to penalties for not offering at least minimum essential coverage to the employee by the end of that third month.

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