EMPLOYEE BENEFITS

PPACA UPDATE: UPCOMING EMPLOYER RESPONSIBILITY TO HANDLE MLR REBATES FOR GROUP HEALTH INSURANCE

by Cynthia A. Moore
April 2012

Under the medical loss ratio or "MLR" provisions of the Patient Protection and Affordable Care Act of 2010 ("PPACA"), health insurance insurers who spend more than a specified percentage of premium dollars on categories of spending other than clinical services and activities designed to improve the quality of health care are required to rebate a portion of the premiums to enrollees. The medical loss ratio is 80% in the small group market and 85% in the large group market. This requirement first applied to insurers in 2011 and, to the extent rebates are required, will be paid in August 2012.

MLR rebates are potentially significant. A study by The Commonwealth Fund released in April 2012 found that if the MLR rules had been in effect in 2010, insurers would have issued an estimated $2 billion in rebates, about half of which was attributable to the group market.

Under interim final rules issued by the Department of Health and Human Services ("HHS") in December 2010, the insurer of a group health insurance policy was required to issue rebate checks to the employer and the employees covered by the policy in amounts proportionate to the amount of premiums each paid. The insurer was permitted to enter into an agreement with the employer by which the employer would distribute the rebates on behalf of the insurer if the employer agreed to distribute it proportionately and provide detailed documentation regarding the distribution to each employee. However, the insurer remained liable for complying with the distribution and for maintaining records demonstrating that rebates were provided accurately to individual employees. Comments on the interim final rule raised concerns about the logistical and tax problems inherent in this distribution methodology. For example, insurers often do not know the proportionate amount of premiums paid by each of the employer and the employees. Further, the distribution of a cash rebate may be taxable income to the employee, which could have made the insurer responsible for withholding obligations. In response to these comments, revisions to the interim final rules were issued in December 2011, under which the insurer is now required to issue the rebate to the policyholder. In the group context, this is typically the employer.

So, what is the employer required to do when it receives the rebate check from the insurer? The Department of Labor ("DOL") has issued Technical Release 2011-4 which provides guidance for ERISA-governed group health plans. In addition, HHS issued interim final regulations which direct how non-Federal governmental group health plans must distribute the MLR rebate to employees.

ERISA Plans. Importantly, an employer should not assume that it can simply deposit the rebate in its general checking account. If the participants contribute to the cost of insurance, and in the absence of any plan provision to the contrary, the DOL will generally take the position that a portion of the rebate attributable to the share of the premiums paid by the employees constitutes "plan assets" and must be used for the exclusive benefit of participants and beneficiaries. In this situation, if the employer retained the rebate, it will have engaged in a prohibited transaction and be subject to fines and penalties and the possibility of a lawsuit by participants.

In determining how to allocate the rebate, the initial inquiry is to determine who paid the premiums for the health insurance policy.

- If the premiums were paid from a trust, the rebate should be deposited in the trust and used in accordance with the trust agreement.
- If the premiums were paid 100% by the employer, the employer can retain 100% of the rebate.
- If the premiums were paid 100% by the employees, the employees should receive 100% of the rebate.
- If the premiums were paid partly by the employer and partly by the employees, the rebate must be split between the employer and the employees.

If the employees made premium contributions, and the employer receives a rebate check, the employer must determine (1) what portion of the rebate is attributable to participant contributions and (2) how the participants' share of the rebate will be used for their benefit. The portion of the rebate attributable to participant contributions is usually based on the share or percentage of premiums paid by the employees. For example, if employees pay 25% of the premium cost and the employer receives a rebate of $4000, $1000 (25% x $4000) is deemed to be attributable to participant contributions and must be used for the benefit of the participants.

Once the employer has determined the portion of the rebate that is attributable to participant contributions, it must then decide how to use the participants' share of the rebate. The DOL considers this amount to be a "plan asset" and any use must be made under ERISA's general standards of fiduciary conduct.

There are three ways that rebates can be applied.

- The rebate can be paid to the participants, under a fair and equitable allocation method. For example, the employer could "weight" the rebate so that an employee with family coverage who paid a larger share of premiums would get a larger share of the rebate. The employer may conclude that only current participants are allowed to share in the rebate. Each employee who received a share of the rebate would recognize additional taxable income.

- The employer can apply the rebate toward future participant premium payments (i.e., give participants a "premium holiday").

- The employer could use the rebate to provide enhanced benefits for the participants.

The DOL suggests in the Technical Release that the second and third options should be used only if distributing payments to participants is not cost effective - for example, if the payments to participants are *de minimis* or if they would give rise to tax consequences to the participants.

Under DOL guidelines, to avoid being forced to establish a trust to hold the rebate, the employer should apply the rebate as a distribution, premium credit or benefit enhancement within three months after receipt of the rebate.

If the employer is receiving a rebate from multiple policies, it must be careful to allocate the rebate related to a particular policy only to participants who were covered by the policy. According to the DOL, using the rebate generated by one plan to benefit the participants of another plan is a breach of the duty of loyalty to a plan's participants.

Under the interim final rule, the insurer is required to issue a notice to the employer and to the employees on or before August 1, 2012, providing a description of the MLR rules and indicating that it is paying a rebate to the employer. Employees who participate in an ERISA-governed plan are asked to direct any questions about the rebate to their employers. Therefore, an employer should have an action plan in place and be prepared to respond to questions from employees in advance of August 1, 2012.

The guidelines set out in the Technical Release will sound familiar to employers who received demutualization proceeds from insurers in the past. The Technical Release may also be a signal that, as in the case of the use of demutualization proceeds, the DOL will not hesitate to pursue enforcement action against an employer who does not apply rebates in accordance with the fiduciary guidelines set out in the Technical Release.

Non-Federal Governmental Group Health Plans. At its option, the governmental entity must use the amount of the rebate that is proportionate to the total amount of premium paid by all employees, for the benefit of the employees in one of the following ways:

- To reduce employees' premium payments for the subsequent policy year for all employees covered under any option offered under the group health plan at the time the rebate is received by the governmental entity;

- To reduce employees' premium payments for the subsequent policy year for those employees who are covered, at the time the rebate is received, under the group health plan option for which the insurer is providing a rebate; or

- Provide a cash refund to employees enrolled in the group health plan option, at the time the rebate is received, for which the insurer is providing a rebate.

At the governmental entity's option, the premium reductions or cash refund may be divided evenly among the employees (i.e., divided "per capita"); divided based on each employee's actual contributions to premium; or apportioned in a manner that reasonably reflects each subscriber's contribution to premiums (e.g., weighted based on single vs. family coverage.) Further, the portion of the rebate based upon former employees' contributions to premium must be aggregated and used for the benefit of current employees in the group health plan in any of the above three methods.

Tax Implications. On April 2, 2012, the IRS posted FAQs addressing the income tax implications of providing MLR rebates to employees. The key question in determining the income tax effect of the MLR rebate is whether employee premium contributions were paid on an after-tax basis or a pre-tax basis.

If employees made premium contributions on an *after-tax* basis, in general, the rebate will not be taxable income to the employee or be subject to federal employment taxes. This is the case whether the employer applies the rebate toward current year premium contributions or pays the rebate to the employees in cash. If the employee deducted the premium payments on his or her prior year Form 1040 and received a tax benefit for the deduction, the employee may have to include a portion or all of the rebate in his or her current year taxable income. The IRS does not indicate in the FAQs whether the employer has any obligation to report the MLR rebate on Form W-2 even though it is not taxable income to the employee.

If employees make premium contributions on a *pre-tax* basis under a Section 125 cafeteria plan, in general, the rebate will be taxable income in the current year and will be wages subject to federal employment taxes. This is the case whether the employer applies the rebate toward current year premium contributions or pays the rebate to the employees in cash. If the rebate is used to reduce the employee's premium that would otherwise be paid through a salary reduction contribution for the pay period, then the employee would have a corresponding increase in his or her taxable salary for that period. In this situation, the rebate should be reported as taxable income on the employee's Form W-2. The IRS does not state whether it is permissible to reduce an employee's salary reductions mid-year under the Section 125 "status change" rules; presumably this would be allowed if the Section 125 plan document provided for automatic cost adjustments to reflect an increase or decrease in the cost of a qualified benefit.

Action Steps

Following are suggested action steps for an employer who provides group health insurance to employees and who reasonably anticipates receiving an MLR rebate:

- Determine whether an insurer expects to issue a rebate with respect to a group health insurance policy. Insurers are required to file reports in June 2012 so the insurer may be able to advise employers on or after June 2012 whether a rebate will be paid.
- If the employer expects to receive a rebate, determine who is entitled to all or a share of the rebate (a trust, the employer, or the employees).
- If employees are entitled to a share of rebate, determine the portion attributable to participant contributions and how the rebate will be applied (as a distribution to participants, as a premium holiday or as a benefit enhancement). Consider the tax implications to employees and appropriate communication to them.
- If the plan is governed by ERISA, remember that these are fiduciary decisions that must be made in the interests of the participants and beneficiaries. If the employer decides on the distribution method or the premium holiday method, discuss and document the distribution methodology which should be reasonable, fair and objective and does not benefit the employer.
- Use the rebate for the benefit of the participants within 3 months after receipt, if at all possible.

FOR MORE INFORMATION CONTACT:

Cynthia A. Moore, is a member and practice department mananger in Dickinson Wright's Troy office. She can be reached at 248.433.7295 or cmoore@dickinsonwright.com.

Deborah L. Grace, is a member in Dickinson Wright's Troy office. She can be reached at 248.433.7217 or dgrace@dickinsonwright.com.