PRYOR CASHMAN LLP

LEGAL UPDATE

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# DISCRIMINATORY HEALTH PLANS WILL BE SUBJECT TO SIGNIFICANT PENALTY TAXES

## SUMMARY

The Health Reform Acts[1] enacted earlier this year impose a **$100 per day per participant** penalty tax on group health plans discriminating in favor of "highly compensated individuals." These penalties apply with respect to plan years commencing on or after September 23, 2010. Many group health plans use the calendar year as their plan year and for such plans these penalties would begin to apply for the calendar/plan year commencing on January 1, 2011.

## BACKGROUND

Historically, the taxation of reimbursement of employee medical expenses by group health plans has taken a two pronged approach. Insured group health plans (plans where the benefits are provided under a policy of accident or health insurance) were not subject to anti-discrimination rules. In contrast, if self-insured group health plans (plans where employers bear the cost of the benefits) discriminated in favor of "highly compensated employees" then reimbursements to the highly compensated individuals potentially became includible in the income of such employees and thus became taxable. For these purposes, a "highly compensated individual"[2] is:

- an employee who is one of the five highest paid officers of the employer,
- a shareholder holding more than 10 percent of the stock of the employer, or
- an employee who is among the highest paid 25 percent of all employees of the employer.

## HEALTH REFORM ACTS

The Health Reform Acts extend these non-discrimination rules to insured group health plans, but rather than causing the "highly compensated individuals" to be subject to a penalty (as they are for self-insured health plans), the Health Reform Acts impose significant excise taxes on insured group health plans themselves which discriminate in favor of the "highly compensated individuals." These requirements are effective for plan years beginning on or after September 23, 2010.

Insured group health plans which violate these new rules are subject to a penalty tax of **$100 per day per non-highly compensated individual** for each day that the insured group health plan does not comply with the law. In the case of a group health plan covering 2,000 non-highly compensated individuals, the excise tax would amount to **$200,000 per day** and **$7.3 million per year**. In addition, the Health Reform Acts amend the Employee Retirement Income Security Act of 1974, as amended ("ERISA") to permit civil actions against group health plans to compel such plans to provide nondiscriminatory benefits.

## WHEN IS A GROUP HEALTH PLAN DISCRIMINATORY?

The discrimination rules provide that a plan cannot discriminate in favor of highly compensated individuals as to

- eligibility to participate and

[1] The Patient Protection and Affordable Care Act, which was enacted on March 23, 2010, and the Health Care and Education Reconciliation Act, which was enacted on March 30, 2010 are collectively referred to herein as the "Health Reform Acts."

[2] The term "highly compensated individual" should not be confused with "highly compensated employee" which is used in anti-discrimination testing on qualified plans, such as 401(k) plans.

- the benefits provided under the plan.

In order to satisfy the eligibility requirements either

- at least 70% of all employees must participate in the plan or
- at least 70% of all employees must be eligible to participate in the plan and at least 80% of all eligible employees must participate in the plan.

In order to satisfy the non-discrimination rules as to benefits all the benefits provided for participants who are highly compensated individuals must be provided for all other employees who are participants and all the benefits available for dependents of highly compensated individuals must also be available on the same basis for the dependents of all other employees who are participants.

The rules described above are the non-discrimination rules applied to self-insured plans which have been broadly extended to insured group health plans. The Internal Revenue Service and the Department of the Treasury are considering issuing further guidance specifically related to the changes promulgated by the Health Reform Acts.

## EXCEPTIONS

### SMALL EMPLOYERS

The non-discrimination penalty tax does not apply to small employers (employers who have 50 or less employees) which provide health insurance coverage solely through a contract with a health insurance issuer.[3]

### GRANDFATHERED PLANS

The non-discrimination requirements also do not apply to "grandfathered" plans. Many of the new rules and requirements of the Health Reform Acts, including the rule prohibiting insured group health plans from discriminating in favor of highly compensated individuals, do not apply to grandfathered plans. Generally, a grandfathered plan is an insured group health plan in which an individual was enrolled on March 23, 2010. Furthermore, a grandfathered plan does not lose its grandfathered status merely because individuals covered on March 23, 2010 cease to be covered, or new individuals become covered under the grandfathered plan after March 23, 2010. However, if an employer enters into a new policy or insurance contract after March 23, 2010, that policy is not a grandfathered plan. Various other changes, such as the elimination of certain benefits, increases in co-pays and premiums, etc. also will result in the loss of grandfathered status. As a result, it seems unlikely that a group health plan will be able to maintain grandfathered status for any significant length of time.

Employers need to exercise care when considering plan changes, as relatively small modifications to plan benefits or cost sharing arrangements may result in the loss of a plan's grandfathered status. If grandfathered status is lost, the insured group health plan will need to implement all of the rules and requirements of the Health Reform Acts. In many cases, these will significantly increase plan expenses.

Finally, in order to maintain grandfathered status, a group health plan must disclose to plan participants and beneficiaries the fact that it believes it is a grandfathered health plan. This disclosure must be included within all plan materials that describe the benefits provided under the plan.[4]

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[3] For new employers, whether such employer qualifies as a small employer depends on the number of employees the employer reasonably expects to employ.

[4] The following model language can be used to satisfy this disclosure requirement: "This [group health plan or health insurance issuer] believes this [plan or coverage] is a `grandfathered health plan' under the Patient Protection and Affordable Care Act (the Affordable Care Act). As permitted by the Affordable Care Act, a grandfathered health plan can preserve certain basic health coverage that was already in effect when that law was enacted. Being a grandfathered health plan means that your [plan or policy] may not include certain consumer protections of the Affordable Care Act that apply to other plans, for example, the requirement for the provision of preventive health services without any cost sharing. However, grandfathered health plans must comply with certain other consumer protections in the Affordable Care Act, for example, the elimination of lifetime limits on benefits.

Questions regarding which protections apply and which protections do not apply to a grandfathered health plan and what might cause a plan to change from grandfathered health plan status can be directed to the plan administrator at [insert contact information]. [For

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*The foregoing is merely a discussion of the new non-discrimination rules imposed by the Health Reform Acts on insured group health plans and is not intended to provide legal advice. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Edward J. Rayner at 212-326-0110 or erayner@pryorcashman.com, Christopher J. Sues at 212-326-0428 or csues@pryorcashman.com, or Matthew O. Young at 212-326-0179 or myoung@pryorcashman.com.*

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ERISA plans, insert: You may also contact the Employee Benefits Security Administration, U.S. Department of Labor at 1-866-444-3272 or www.dol.gov/ebsa/healthreform. This website has a table summarizing which protections do and do not apply to grandfathered health plans.] [For individual market policies and nonfederal governmental plans, insert: You may also contact the U.S. Department of Health and Human Services at www.healthreform.gov.]"

## About the Authors

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Edward J. Rayner is a Partner and is Chairman of the Executive Compensation, ERISA and Employee Benefits Group. Ed's practice encompasses all aspects of executive compensation, employment and severance arrangements, pension plan investments and employee benefits.

Ed has extensive experience negotiating, designing and implementing employment agreements and severance agreements for CEOs, chairpersons and senior executives of public and private corporations, both domestic and foreign. Ed has represented a large number of clients in leveraged and management buyouts, including many of the most prominent buyout firms, as well as management teams and individual senior executives. As a result of these transactions, Ed has acquired exceptional expertise dealing with the issues arising from using stock in privately-held companies in connection with compensation arrangements.

In addition, Ed also regularly represents financial professionals, such as bankers, asset managers, hedge funds and various other professionals in connection with employment, severance, partnership and other compensation arrangements.

Ed is a nationally recognized expert on the issues relating to managing pension plan assets and dealing with counterparties that are subject to ERISA. He has regularly advised clients on all aspects of ERISA's fiduciary responsibility rules and has a great deal of experience advising both financial institutions, such as banks and insurance companies, as well as various hedge and private equity funds on these rules. Ed's experience in this area includes the following matters:

- Advising financial institutions on ISDA transactions and various other transactions with pension plans and other entities subject to ERISA
- Setting up "plan asset" funds and establishing investment procedures for such funds to comply with ERISA's fiduciary obligations
- Structuring funds and other vehicles to avoid plan asset status by remaining below the 25% threshold
- Using the Venture Capital Operating Company/Real Estate Operating Company exemptions under the plan asset regulation and structuring the prospective investments by funds to comply with those exemptions
- Structuring certain corporate and structured finance vehicles to comply with ERISA's requirements
- Representing both borrowers and lenders, including banks and insurance companies, with respect to ERISA provisions in credit and other lending arrangements

Ed has also represented clients in all kinds of acquisitions and divestitures in connection with ERISA and executive compensation, including mergers, sales of assets, tender offers, spinoffs, split-offs, reorganizations and other transactions. Many of these transactions were large multi-billion dollar transactions.

Ed has been named by *The Best Lawyers in America* as one of the leading lawyers in Employee Benefits Law (2008, 2009, 2010 and 2011 editions) . He has also been named as a "Super Lawyer" in Employee Benefits Law by *New York Super Lawyers* (2007, 2008, 2009 and 2010 editions).

Ed is a frequent ERISA speaker at prominent conferences, including PLI, NYSBA, Institutional Investor and West Legalworks.

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