Health Care Reform
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How Health Care Reform Adversely Impacts Executive Health Care and COBRA Subsidy Arrangements

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Background

Employer-provided COBRA,[1] other medical subsidies, and perquisites affecting medical care are common components of many executive employment and severance agreements. However, as discussed more fully below, many of these arrangements will not comply with the nondiscrimination requirements under the Patient Protection and Affordable Care Act ("Health Care Reform").

Prior to Health Care Reform, only *self-insured* medical plans were subject to nondiscrimination rules. These rules prohibit medical plans from discriminating, with respect to both eligibility and benefits, in favor of highly compensated individuals (HCIs).[2] If a self-insured medical plan is found to have discriminated in favor of HCIs, a portion of medical benefits (e.g., plan reimbursements for surgery) received by the HCIs under the plan become taxable to the HCIs. The employer paying the benefits, however, is not penalized. Since the value of plan reimbursements is usually far greater than the cost of the premiums, self-insured medical plans routinely avoided the application of these rules by treating the premium cost as taxable income to the executive.

Discussion

Health Care Reform extends these nondiscrimination rules to *fully-insured* medical plans, generally effective January 1, 2011 (though some plans may have an earlier or later effective date). Thus, any COBRA subsidy or other pre-tax payments of medical costs provided to a former employee under an insured plan may be discriminatory under Health Care Reform if:

- The terminated employee is receiving the COBRA subsidy after the health care reform effective date;
- The terminated employee is considered an HCI;
- This subsidy is not offered to all terminated employees; and
- The plan is not "grandfathered" (some plans do not need to meet the new nondiscrimination requirement so long as no significant changes have been made to the plan since March 23, 2010).

If an arrangement is not otherwise exempt from Health Care Reform, there is also an argument that a standalone arrangement with one individual may be exempt since a health plan covering a single individual is generally exempt from Health Care Reform. In addition, a retiree medical arrangement may also be exempt to the extent the same only covers a single former employee. Many questions remain in this area, such as whether a series of similar executive contracts will be deemed separate or aggregated together, and whether changes to an underlying insured group health plan will adversely affect possible grandfathered status for an executive arrangement. Unfortunately, the federal agencies charged with promulgating rules around Health Care Reform have not addressed these issues in any specific guidance.

Although there is limited guidance as to how Health Care Reform will be applied to executive arrangements, we know that the potential penalties for noncompliance are steep. If an insured group health plan is found to be discriminatory, the plan or plan sponsor is subject to an excise tax or civil money penalty of $100 per day per individual *discriminated against* (i.e., all non-highly compensated individuals), and the plan is subject to a civil action to compel it to provide nondiscriminatory benefits.

Although the Internal Revenue Service has not been aggressive about auditing self-insured arrangements in the recent past, Health Care Reform has renewed the focus on these issues, and we anticipate that enforcement will increase in the near future. Because of the public disclosure and reporting rules, it seems public companies are most at risk, at least initially.

Action Steps

Employers and executives should begin an immediate review of any employment, severance, and other executive arrangements to determine if possible offending subsidies or perquisites exist and consult counsel with respect to correcting any noncompliant arrangements. If an arrangement is found not to comply with Health Care Reform, remedial action such as eliminating a subsidy must be taken before Health Care Reform takes effect (generally, by year-end).

Endnotes

1 COBRA refers to the health care continuation requirements under §4980 of the Internal Revenue Code of 1986, as amended (the "Code"), and its corollary provisions under the Employee Retirement Security Act of 1974, as amended.

2 Note the definition of "highly compensated individual" (HCIs) and "highly compensated employee" under the qualified retirement plan provisions of the Code differ significantly. HCIs include the five highest paid officers, shareholders with more than a 10% interest in the employer, and the top 25% of employees ranked on the basis of compensation.

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