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BENEFITS BRIEF

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Authors: Jon W. Breyfogle, Elizabeth T. Dold, Christine L. Keller and Mark C. Nielsen

If you have questions, please contact your regular Groom attorney or any of the Health and Welfare attorneys listed below:

Jon W. Breyfogle
jbreyfogle@groom.com
(202) 861-6641

Elizabeth T. Dold
edold@groom.com
(202) 861-5406

Thomas F. Fitzgerald
tfitzgerald@groom.com
(202) 861-6617

Cheryl Risley Hughes
chughes@groom.com
(202) 861-0167

Christine L. Keller
ckeller@groom.com
(202) 861-9371

Tamara S. Killion
tkillion@groom.com
(202) 861-6328

Mark C. Nielsen
mnielsen@groom.com
(202) 861-5429

William F. Sweetnam, Jr.
bsweetnam@groom.com
(202) 861-5427

Christy A. Tinnes
ctinnes@groom.com
(202) 861-6603

Vivian Hunter Turner
vturner@groom.com
(202) 861-6324

Brigen L. Winters
bwinters@groom.com
(202) 861-6618

Medical Loss Rebates—Fiduciary and Tax Implications

Over the next several weeks, health insurers will be issuing rebate checks in accordance with the medical loss ratio ("MLR") rules under the Patient Protection and Affordable Care Act (the "ACA"). Those receiving rebates will likely have many questions, such as what the money can be used for, and whether it is taxable. Fortunately, DOL and IRS guidance addresses many of these questions. That guidance is summarized briefly, below.

Background

The ACA establishes a MLR requirement that applies to health insurers. Generally, the MLR rule requires an insurer to provide policyholders with "rebates" if the insurer's MLR ratio falls below 85 percent for the large group market, and 80 percent for the small group and individual market. The MLR is calculated based on the ratio of the insurer's (a) claims and quality improvement expenses to (2) total premium dollars earned (minus federal and state taxes and licensing and regulatory fees). In 2010, HHS released an interim final rule (the "IFR") that governed the manner in which insurers must calculate and report MLR, and how any MLR rebates must be distributed. *See* 75 Fed. Reg. 74865, 74866 (December 1, 2010).

The IFR provided that insurers in the large and small group markets must allocate any MLR rebates between the policyholder (usually the employer) and each enrollee covered by the policy at issue (i.e., employees) "in amounts proportionate to the amount of premium paid." This requirement caused difficulties for insurers and employers, however, given that insurers generally do not have information about the employer/employee split of premium costs, and would have required employers to provide insurers with significant information about the premium split and factors that could cause an employee's share of the premium to vary during the course of a year (e.g., a change in job classification, participation in a wellness program, etc.).

Responding to insurer and employer concerns about the rebate allocation rules, HHS significantly revised the IFR. 76 Fed. Reg. 76574 (Dec. 7, 2011), 76 Fed. Reg. 76596 (Dec. 7, 2011). Rather than requiring insurers to allocate rebates between group policyholders and enrollees, HHS's final regulation now directs insurers to remit the entirety of any MLR rebate directly to the *group* policyholder (*e.g.*, the employer). 45 CFR § 158.242(b). A separate regulation also provides guidance as to how such rebates must be used by non-ERISA plans, such as plans sponsored by state and local governments, and church plans. 76 Fed. Reg. 76596 (Dec. 7, 2011). On the same date, the Department of Labor ("DOL") issued Technical Release 2011-4, which provides guidance regarding how such rebates must be used by the sponsors of ERISA-covered plans.

On April 2, 2012 (and revised on April 19th), the IRS issued FAQ's that provide information on the federal tax consequences to the health insurance issuer that pays a MLR rebate and the employee or individual policyholder that receives the MLR rebate. http://www.irs.gov/newsroom/article/0,,id=256167,00.html. These FAQs are divided into four sections—Insurance Company, Policies Purchased on the Individual Market, Group Policies Paid with After-Tax Employee Premiums, and Group Policies Paid with Pre-Tax Employee Premiums.

How Can the Sponsor of an ERISA Group Health Plan Use the Rebate?

A threshold issue for ERISA plans is whether MLR rebates are "plan assets" that are subject to ERISA's strict rules of fiduciary conduct. The Technical Release provides that MLR rebates are considered "plan assets" under ERISA if "under ordinary notions of property rights . . . a plan has a beneficial interest in the distribution." The guidance then discusses DOL's views as to how to determine whether an MLR rebate is a plan asset, which requires close attention to the terms of the insurance contract and governing plan documents. The Technical Release provides that where the plan itself (or its trust, such as VEBA) is the policyholder, any rebates attributable to such policy will be considered "plan assets," in the absence of any plan or policy language to the contrary. Where, however, the employer is the policyholder, and the insurance policy, together with other instruments governing the plan, can fairly be ready to provide that some part or all of the MLR rebate belongs to the employer, then that language will generally govern, and the employer may retain the rebate.

In the absence of direct evidence as to whether the plan or the employer has a beneficial interest in the MLR rebate, the DOL will look to the source of premium payments for the policy:

- If the premium is paid entirely out of trust assets, DOL views "the entire amount received from the insurer" as a plan asset;
- If participants paid the entire cost of plan premiums, the entire amount of the MLR rebate is considered a plan asset;
- If the employer pays the entire cost of insurance coverage, then the rebate is *not* considered a plan asset, and may be retained by the employer;
- If the employer and enrollees contribute a percentage of the premium, the MLR rebate is a plan asset to the extent attributable of participant contributions and the balance is not a plan asset and may be retained by the employer.

The DOL's Technical Release goes on to provide that where MLR rebates are considered plan assets, the plan fiduciary generally must:

- Distribute rebate amounts to participants;
- Enhance benefits; or
- Reduce future participant premiums.

In deciding on how to apply the rebates, the DOL guidance notes that a plan "may properly weigh the costs to the plan and the ultimate plan benefit as well as the competing interests of participants or classes of participants provided such method is reasonable, fair and objective." The guidance goes on to provide some helpful examples of reasonable methods for allocating MLR rebates that are plan assets, which plans and their sponsors should consult in deciding how to allocate and apply MLR rebates that are plan assets.

For plans that are exempt from ERISA's trust and annual audit rules (i.e., unfunded group health plans that are insured), DOL allows such plans to receive MLR rebates and remain exempt from ERISA's trust, annual audit and reporting requirements, but only if certain conditions are satisfied. Specifically, to remain exempt from ERISA's trust, auditing, and reporting requirements, the policyholder receiving an MLR rebate that is a plan asset must – within 3 months of receiving the rebate:

- Distribute the rebate amounts to participants, or
- Reduce the participants' share of premiums.

It is not clear from the guidance whether a plan fiduciary could apply such amounts to the subsequent year's premium, if the next year's premium is paid after the 3-month period.

How Can the Sponsor of a Non-Federal Governmental Plan Use the Rebate?

HHS also released an interim final rule addressing the use of MLR rebates in connection with non-federal governmental plans (e.g., plans sponsored by state or municipal governments for their employees). 76 Fed. Reg. 76596 (Dec. 7, 2011). This interim final rule requires that the portion of any MLR rebates attributable to participant contributions be used to:

- Reduce the participants' portion of the annual premium for the subsequent policy year for participants in any group health policy offered by the plan;
- Reduce the enrollees' portion of the annual premium for the subsequent policy year for participants covered by the group health policy for which the rebate was based; or
- Be distributed as a cash refund to participants that were covered by the group health policy for which the refund was based.

How Can the Sponsor of a Non-ERISA, Non-Governmental Plans, Such as a "Church Plan" use the Rebate?

With respect to non-ERISA and non-governmental plans, such as "church plans," the HHS guidance provides MLR rebates may be paid directly to the group policyholder, but only if the insurer receives written assurance from the policyholder that the rebate will be used for the benefit of current subscribers using one of the three non-federal governmental plans options listed above. Otherwise, the rebate must be paid directly to the policyholder's subscribers.

Are Insurers Required to Send a Notice Regarding the Rebate?

Yes. The HHS final rule imposes a new notice requirement upon insurers. Specifically, insurers that distribute MLR rebates must provide written notices to group policyholders – and their subscribers – regarding the rebate. The notice must include information regarding:

- The purpose of the MLR requirement imposed by the ACA;
- The applicable MLR standard;
- The issuer's actual MLR for the reporting year at issue and its adjusted aggregate premium revenue;

- The rebate being provided; and
- If applicable, an explanation that the rebate is being provided to the policyholder. For ERISA plans, this explanation must state that policyholders may have obligations under ERISA with respect to the handling of the rebate amount, and the contact information for the ERISA covered plan. For other group health plans (such as non-federal governmental plans), the explanation must explain how the policyholders will use the rebate to benefit subscribers.

What are the Tax and Reporting Obligations of Insurers Who Pay Rebates?

The MLR rebates reduce the Insurance Company's taxable income. Cash rebates paid to individual policyholders generally do not need to be reported on Form 1099-MISC. And rebates paid to group policyholders (e.g., employers) are also generally not reported as (1) there is no reporting requirement to corporations and tax exempt organizations, and (2) the income must be fixed and determinable, which would require knowledge of the policyholder's tax positions.

Is a Rebate on a Policy Purchased on the Individual Market Taxable?

IRS FAQs state that the policy owner is taxed on the rebate only to the extent that he or she received a tax benefit from deducting the premiums. However, the FAQs are silent concerning the tax consequences of receiving a rebate for an individual policy that is purchased with pre-tax dollars, such as through an employer's cafeteria plan, or an employer's health reimbursement arrangement. Presumably, the individual would need to report the amount of the rebate on his/her Form 1040 as "other income." It does not appear that the insurer or employer is subject to any reporting requirements in this circumstance (e.g., Form 1099 or Form W-2).

Is a Rebate on a Policy Purchased on the Group Market with Employee After-tax Premium Payments Taxable?

The employee is taxed on the rebate (either cash or premium reduction) only to the extent that he or she received a tax benefit from deducting the premiums. Therefore, the employee has no income if he or she did not deduct the premiums on his or her tax return. And regardless of any prior deduction of premiums, no taxable income results (although any deduction for current year premiums is reduced) if the employer provides the rebate to all current employees participating in the health plan, without regard to who participated in the year the rebate relates. Importantly, in no event is the rebate subject to employment taxes.

Is a Rebate on a Policy Purchased on the Group Market with Employee Pre-Tax Premium Payments (e.g., 125 Plans) Taxable?

If the rebate is distributed as a premium reduction for the employee, then the amount paid for the coverage is less, resulting in increased taxable wages. If the rebate is distributed in cash, then the rebate is treated as taxable wages, subject to income and employment taxes.