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Employers face penalties with new nondiscrimination rules

By Frank Palmieri

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Self-insured health plans have previously been subject to Section 105(h) of the Internal Revenue Code, prohibiting discrimination with regard to eligibility or benefits in favor of highly compensated employees.

The consequence to self-insured plans failing to meet the nondiscrimination requirements is taxation for highly compensated individuals.

For example, assume a highly compensated employee was promised benefits for life under a self-insured health plan following a termination of employment. The employee incurs $100,000 of medical expenses in connection with an illness.

Under these facts, the employee may generally have $100,000 of income under Section 105(h). For this reason, attorneys caution clients with self-insured plans not to establish special eligibility rules only for senior executives in connection with retirements or terminations of employment.

The Patient Protection and Affordable Care Act now extends these nondiscrimination rules to insured health plans for plan years beginning on or after Sept. 23. To the extent that a plan is in existence on March 23, 2010, it will be a "grandfathered" plan and not subject to the new rules, unless the grandfathered status is lost.

PPACA made this change by including the nondiscrimination rules in the Public Health Service Act, as well as in ERISA. The rules are also included in the Code, but only in the excise tax provisions and not the income tax provisions.

Thus, the consequences of failing to meet the nondiscrimination requirements for insured health plans will be different than taxation to employees, as under self-insured plans. For both insured and self-insured plans, an employer will be prohibited from discriminating.

However, if an insured plan violates the nondiscrimination rules there will be no adverse tax consequence for the highly compensated employee. The employer sponsoring the insured health plan will be subject to an excise tax in the amount of $100 per day per participant.

Who qualifies

Under Section 105(h), highly compensated individuals are those who are: (a) among the five highest paid officers; (b) shareholders owning more than 10% of the employer; and (c) the highest paid 25% of employees.

The purpose of the PPACA change was probably to minimize the existence of executive medical plans. For example, some employers maintain medical programs for all employees with supplemental insured executive medical plans.

These programs permitted employers to provide additional benefits to senior executives in a discriminatory manner since such programs were insured, rather than self-insured.

Given the new health care mandates, Cadillac plan rules, and related issues, the existence of such programs may reasonably be regulated or eliminated.

The Section 105(h) rules and the extension of the nondiscrimination rules to insured medical plans are straight forward and do not initially create a significant hardship for employers. However, consider a common situation.

An employer with a self-insured health plan entered into an employment agreement with an executive in 2009.

As part of the employment agreement, the employer agreed to provide the employee with three years (36 months) of medical coverage following a separation from service in connection with an involuntary termination of employment or a change in control.

The employer understood it could subsidize the cost of COBRA for 18 months, and anticipated purchasing an individual insured medical policy for the second 18-month period, to provide a total of 36 months of coverage.

The executive terminates employment in April 2010. The first 18 months of COBRA coverage may be subsidized by the employer starting in May 2010 and does not result in any harm (ignoring the loss of the federal COBRA subsidy).

However, effective Nov. 1, 2011, when the second 18-month period begins and the employer purchases an individual policy, the new nondiscrimination rules will apply and the individual insurance policy will be considered to be discriminatory in nature.

At that time, the employer will be subject to the $100 per day excise tax, resulting in an annual penalty of $36,500 (365 days per year x $100).

One alternative to avoid this result is to argue that the fully insured plan was provided in connection with a "contractual obligation" in existence prior to March 23, 2010, and should receive grandfathered status for at least a reasonable period of time.

However, until guidance is issued on the actions necessary to establish and/or lose grandfathered status, no clear answer will exist for this issue.

Revisit your documentation

The extension of the Section 105(h) nondiscrimination rules to insured health plans will require all employers to revisit employment agreements, offer letters and other documents providing for extended health coverage for senior executives (i.e., highly compensated employees.)

Under the above scenario, the employee has a contractual right to receive health coverage and the employer has a contractual obligation to provide it. Since the excise tax is on the employer, and not the employee, some executives may be unwilling to renegotiate agreements to avoid the excise tax.

Many employers completed their review of employment and other senior executive agreements prior to Dec. 31, 2008 to comply with section 409A of the Code.

Given the substantial effort by employers to ensure that senior executive arrangements didn't result in a deferral of compensation, and that they satisfied the election and documentary requirements under section 409A, many will be reluctant to reopen negotiations.

However, since IRS Notice 2010-6 allows employers to "fix" section 409A errors before Dec. 31, 2010, most employers would nevertheless benefit from a review of all executive agreements to ensure they are in compliance with section 409A and to address the potential new excise tax under PPACA.

Long-term care implications

Long-term care benefits must also be considered. It's not uncommon for C Corporations to purchase LTC policies for senior executives when they are close to retirement. Providing a LTC policy is a tax-free benefit to an executive and a corporation receives a deduction for the payment of an LTC policy.

However, a LTC policy is considered a health plan. Accordingly, providing a fully insured LTC policy for only one senior executive will once again result in discrimination and the excise tax will be imposed on the employer.

Assuming the LTC policy requires payments for a 10-year period in order to purchase benefits, it would appear that the policy would be discriminatory for a 10-year period, resulting in significant excise taxes to an employer.

Employers must become familiar with the health care legislation and drill down on specific issues, such as the extension of Section 105(h), part-time employees and other issues relevant to each employer. By considering each component of the laws as it applies to an employer, business decisions may be made and penalties minimized.

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