Making Sense of the Medical Loss Ratio Rebate Guidance

Health insurance issuers were required to provide rebates to policyholders, including most large employers, by August 1, 2012.

Rebates owed to plan participants must be distributed within three months of an employer’s receipt of the rebate to avoid additional requirements, so affected employers must decide what to do and quickly. However, while guidance has been issued regarding the distribution of rebate payments, employers still face outstanding issues with respect to the appropriate process for making distributions.

The Patient Protection and Affordable Care Act (PPACA) provides for the creation of medical loss ratio (MLR) standards for health insurance issuers. If an issuer spends less than 85% of premiums on clinical services and health care quality improvements in the large group market (or less than 80% in the individual and small group markets), the issuer must rebate the portion of the premium that exceeded these limits to the policyholder.

WHERE CAN EMPLOYERS FIND APPLICABLE GUIDANCE?

Three federal government agencies issued regulations and guidance with respect to the allocation and distribution of MLR rebates. The Department of Health and Human Services issued regulations primarily of interest to insurance companies. The following two agencies issued guidance of interest to employers:

1. Department of Labor: The Department of Labor (DOL) issued guidance relating to the distribution of rebates to plan participants. Since MLR rebates issued for ERISA-covered health plans may be considered “plan assets” under the Employee Retirement Income Security Act of 1974 (ERISA), the DOL’s guidance sets forth the fiduciary duties of employers responsible for distribution of the MLR rebates.

2. Internal Revenue Service: Because rebates are applied against premiums that have been paid with either pre-tax or post-tax dollars, the Internal Revenue Service (IRS) issued guidance with respect to the federal tax treatment of rebate distributions by employers electing to issue cash rebates.

ARE ALL HEALTH PLANS ELIGIBLE TO RECEIVE MLR REBATES?

No. Self-insured plans are not subject to the MLR requirements. In most cases, insured plans are required to comply with the MLR regulations whether or not grandfathered under the PPACA.
IS THE REBATE CONSIDERED A “PLAN ASSET” UNDER ERISA?

The DOL guidance sets forth a method plan fiduciaries may use to determine whether or not the MLR rebate is considered a “plan asset.”

First, if the plan is the policyholder, the policy is a plan asset and the employer has no interest in the distribution (absent specific plan language to the contrary). Typically, however, the employer is the policyholder, not the plan.

If the employer is the policyholder, the employer must review the plan documents to determine whether any portion of the rebate belongs to the employer.

Absent plan language, the DOL looks to the sources of the insurance policy’s premium payments, reasoning that the portion of the rebate attributable to participant contributions would be considered plan assets, as follows:

- **100% employer-paid premiums:** if the employer paid the entire cost of the insurance coverage, then none of the rebate is considered a plan asset.
- **100% participant-paid premiums:** if the participants paid the entire cost of the insurance coverage, the full rebate is considered a plan asset.
- **Shared costs, based on percentage of premiums:** if the participants and the employer paid a fixed percentage of the cost, the proportional percentage of the rebate is considered a plan asset.

**Shared costs, based on fixed dollar amounts:** if the employer paid a fixed dollar amount and the participants paid the remainder, the amount of the rebate up to the amount of the participant’s total contributions is a plan asset. If the participants paid a fixed dollar amount and the employer paid the remainder, the amount of the rebate equal to the amount paid by the employer is not a plan asset, and any excess rebate amount is a plan asset.

WHAT ARE THE EMPLOYER’S FIDUCIARY RESPONSIBILITIES TO PLAN PARTICIPANTS?

To the extent MLR rebates constitute plan assets under ERISA:

- All distributions must be made within three months of receipt of the rebate by the employer, in order to qualify for the DOL’s trust relief and related reporting exemptions; and
- All decisions regarding the distribution of the rebate must be made by a plan fiduciary consistent with the fiduciary rules under ERISA, meaning the plan fiduciary must: act prudently; solely in the interest of plan participants and beneficiaries; and in accordance with the terms of the plan.

WHAT ARE THE EMPLOYER’S OPTIONS FOR DISTRIBUTING THE MLR REBATE?

Employers must distribute rebates during the MLR reporting year on which the rebate is based. Employers may distribute the rebate in the form of a cash payment; a credit towards future premium payments, sometimes referred to as a “premium holiday;” or to enhance benefit options.

The allocation method does not have to reflect the premium activity of each participant. Also, a fiduciary may properly consider the costs to the plan, the ultimate plan benefit and the competing interests of participants (or classes of participants) in selecting an allocation method.

Under ERISA, plan assets must generally be held in trust, unless subject to the trust relief and exemptions under applicable DOL regulations. This relief is available to employers so long as the rebates are distributed within three months from the receipt of the rebate by the employer. Since the rebate must be allocated prior to the start of the calendar year to avoid the trust requirement, this three month window may make it difficult to use the rebate for new benefit enhancements or towards credit premiums for the following plan year.
IS THE EMPLOYER REQUIRED TO MAKE DISTRIBUTIONS TO FORMER PARTICIPANTS AND COBRA PARTICIPANTS?

There is no bright line test provided to determine whether former employees should share in the rebate, including current COBRA participants. If the cost of distributing shares of a rebate to former plan participants approximates the amount of the rebate payment, the fiduciary may decide to allocate these rebate payments to current participants. A similar analysis may be used in determining whether to provide rebates to COBRA participants. Types of costs that may be taken into account include costs associated with locating missing former plan participants, changing systems to ensure proper tax reporting and related administrative (including legal) costs.

In all cases, the method of making this determination must be reasonable, fair and objective. Plan fiduciaries should consider documenting the process adopted by the fiduciary (or fiduciary committee) to make allocation determinations, including a record that the distribution of rebate payments was within the three month window, if applicable.

WHAT TAX CONSIDERATIONS SHOULD EMPLOYERS BE AWARE OF?

The IRS provided guidance with respect to the federal tax consequences associated with MLR rebates distributed to plan participants in the form of cash. The IRS generally views the 2012 cash payments as a return of the participant’s 2011 premiums. The tax effect is as follows:

Pre-Tax Premium Payments
To the extent the employee paid premiums pre-tax, such as through a cafeteria plan, the rebate is taxable as 2012 compensation (i.e., taxable wages) and will be subject to withholding and applicable payroll taxes.

Income Tax: while there is no specific reference to the withholding rate, the IRS guidance calls these amounts “wages,” so the regular withholding rate applicable to the employee should be used.

Employment Taxes: the rebate is subject to employment taxes (e.g., FICA).

After-Tax Premium Payments
To the extent the employee paid premiums on an after-tax basis, then the rebate is not taxable with respect to either income taxes or employment taxes, unless the employee deducted the premium payment on his or her 2011 Form 1040, any cash rebate would be taxable income in 2012.

In this case, the rebate is not subject to employment tax, only federal income tax.

In each case, because cash payments are characterized as “wages,” other deductions, such as 401(k) deferrals, may also be required.

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