



Legal Alert: Health Insurance for Terminating Executives

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Self-insured health plans have long been subject to nondiscrimination rules under Section 105(h) of the Internal Revenue Code. Those rules prohibit the plan from discriminating in favor of highly-compensated employees regarding both eligibility to participate in the plan and the benefits to which a participant is entitled. Failure to comply with these nondiscrimination rules results in taxability of the benefits paid to highly compensated individuals. For example, a self-insured plan covering executives only would be discriminatory, and the benefits that are received by the covered executives would be taxable income to them. The Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act (the "Act") applies these nondiscrimination rules to insured health plans as well, effective for plan years beginning on or after Sept. 23, 2010. ("Grandfathered" plans, however, are not subject to many of the new requirements, including these new nondiscrimination rules, unless "grandfathered" status is lost. See our Legal Alert dated June 23, 2010 regarding "grandfathered" plans, which can be found at <http://www.fordharrison.com/shownews.aspx?Show=6300> .) However, even though the new application of the nondiscrimination rules is contained in the Code, it is contained only in the excise tax provisions – not the income tax provisions. As a result, if an insured plan violates the nondiscrimination rules there are no adverse income tax consequence to the covered highly compensated employees. Instead, the employer maintaining the plan is subjected to an excise tax penalty in the amount of \$100 per day per participant. For this purpose, highly-compensated employees are defined in the same way as for purposes of the nondiscrimination rules for self-insured plans – i.e., (a) the employer's five highest paid officers; (b) more-than-10% shareholders of the employer; and (c) the highest-paid 25% of all employees. In addition to effectively eliminating executive-only supplemental plans, this may very well shut down the fairly common practice of providing post-severance health benefits (beyond COBRA) to terminating executives. For example, suppose that an employment agreement provides that the employer will (i) subsidize COBRA coverage, and (ii) continue the executive's health coverage for 12 months following the COBRA continuation period (i.e., a total of 30 months of coverage following separation). Assuming that the plan is grandfathered, the employer can subsidize the cost of the COBRA coverage. But when the COBRA period ends, if the employer purchases an individual medical policy for the executive (or the executive and his or her family) for the remaining 12 months of its obligation, the new nondiscrimination rules will apply and the individual policy will be discriminatory. The executive will not be taxed on the insurance benefits, which would be the case under a self-insured plan, but the employer will be subject to the new excise tax penalty, resulting in a

penalty of \$36,500 (365 days @ \$100 per day). This additional cost to the employer will certainly affect the economics of the arrangement, and will likely make it unworkable.

Bottom Line: If you have not already done so, now that nondiscrimination rules apply to insured health plans, you should revisit employment agreements and other documents in which you may have agreed to provide health benefits for executives (or other "highly compensated employees"). However, since the excise tax is only imposed on the employer, an executive may have to be provided an incentive to revise or renegotiate his or her agreement. If you have any questions regarding this Alert, or would like additional details concerning health care reform, you can contact the author of this Alert, Jeffrey S. Ashendorf, 212-453-5926, jashendorf@fordharrison.com, any member of Ford & Harrison's Employee Benefits practice group, or the Ford & Harrison attorney with whom you usually work.

You may also visit the health care reform tab of the Ford & Harrison website, <http://www.fordharrison.com/HealthcareReform.aspx>, for more helpful resources and tools on health care reform.