Nondiscrimination Rules Now Extend to Insured Health Plans

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Buried in the provisions of health care reform are critical new rules that come into play when current or former executives have employer-provided health care coverage or benefits not generally available to the entire workforce or former employees. Providing more favorable coverage or benefits to even one current or former executive -- "executive," for this purpose generally means anyone in the top 25% of the workforce, by pay -- can create huge problems. Further, the issue arises whether the more favorable coverage or benefits are provided or promised under a health plan or simply in an employment or severance agreement..

Discriminatory coverage and benefits have always been problematic when the coverage is provided through a self-funded health care plan. But discriminatory coverage through an insured plan has never been prohibited -- until now. Under health care reform provisions, insured coverage and benefits for executives (or former executives) not made available to non-executive employees (or former employees) have been targeted for severe penalties.

Some Examples of Potential Discrimination

Below are some common examples of potentially discriminatory coverage or benefits:

- **Scenario One:** As a recruiting tool, the company begins health insurance coverage for its new VP on her first day of employment instead of 60 days later, as called for in the plan and applied to other new employees.
- **Scenario Two:** Salaried workers are immediately eligible for health benefits while hourly workers must wait 90 days.
- **Scenario Three:** A severance agreement with a manager provides, among other things, that the company will pay all or a portion of the manager's COBRA premiums for 12 months if his employment is involuntarily terminated. The company charges full COBRA premiums for other former employees.
- **Scenario Four:** An employment agreement with an executive says the executive will be able to continue coverage in the company’s health plan until age 65 at the executive's expense. Other employees do not have access to this coverage.

- **Scenario Five:** Headquarters employees pay a premium contribution of $100 per pay period for family health insurance coverage while employees at the company's production plant are charged $125 per pay period.

Whether or not these examples are actually discriminatory may depend on the demographics of the employer and the application of numerical testing. Although it is too early to tell, it is also possible that some of these examples will not be considered discriminatory under IRS regulations.

As soon as the new health care reform law applies to you (for many this will be January 1, 2011), your company will be subject to an excise tax penalty of $100 per day per each employee who does not receive the discriminatory coverage or benefit. The amount will be capped at the lesser of $500,000 or 10% of the employer's prior year's health plan costs. Moreover, the employer has an affirmative obligation to report this tax liability on Form 8928. This is quite different from a discriminatory *self-insured* plan where the penalty is additional income tax payable by the highly compensated individuals.

An IRS attorney recently said: *"If you have 500 employees and you're providing discriminatory benefits to the three highest paid people in your company, the $100 a day is going to apply to the 497 non-highly compensated employees. Obviously, you aren't going to design your plan so that you are paying the IRS $49,700 a day for 500 employees."*

Because of the drastic effect of this nondiscrimination provision and its impact on existing programs and contracts, we had expected that its effective date might be delayed, that existing contracts might be grandfathered or that the rules might be softened somewhat by future IRS guidance. However, the IRS recently issued a notice that appears to indicate there will be no relief. Unless the IRS has a change of heart, this means that every company with an insured health plan or program providing discriminatory coverage or benefits -- even if pursuant to a binding contract with an individual executive -- may have to change the discriminatory nature of the arrangement or eliminate it, potentially very quickly.

The Exceptions

There are some situations that won't be subject to these rules. They include:

- **Grandfathered Plans:** This nondiscrimination provision will not apply until your plan loses grandfathered status under health care reform. Existing plans that are designed to favor highly compensated employees may want to make the effort to retain grandfather status as long as possible. If your arrangements are not grandfathered, these new rules will apply as soon as the next plan year starts. Further, if you lose grandfathered status at some point in the future, these rules will then apply immediately or even retroactively to the start of the plan year. So, steps should be taken promptly to recheck your grandfathered status and identify and potentially modify the affected executive arrangements or provisions. This may require negotiation with affected executives.

- **Retiree-only Plans:** This nondiscrimination provision does not apply to stand-alone insured retiree-only health plans that do not cover any active employees. However, determining whether you truly have a stand-alone retiree-only plan can be difficult, and the stakes are high.

What To Do

Where plan design gives discriminatory benefits to a certain group, the best approach may be to equalize the terms under which the coverage is offered for all groups.

Where discriminatory benefits are offered only to a select group of executives, the best approach may simply be to replace this health coverage benefit with a cash payment or stream of payments that the executives can use to purchase their own health care coverage. Such payments will be taxable to the recipients, however, so recipients may demand that the amount also cover the tax liability.

Even if there is a formula or inflation factor built into that promise, this approach shifts to the executive the risk that medical inflation will outpace the amount payable. Further, any such promise of future payments will likely be deferred compensation subject to Section 409A of the Internal Revenue Code, which will make it difficult to modify the obligation in the future.

Another option is to replace insured health plan benefits with self-funded benefits and require those receiving discriminatory benefits to pay the fair-market value of this coverage on an after-tax basis.

Since executives are not penalized, they will have no direct incentive to agree to any modification of the company's obligations. That may prove troublesome if you cannot unilaterally modify these arrangements.

There are additional complications not discussed here. If you have any plan provision, arrangement or contract that might trigger these rules, the matter should be reviewed as soon as possible. If you have questions, please contact Anthony Kolenic (616.752.2412 or akolenic@wnj.com), Sue Conway (616.752.2153 or sconway@wnj.com) or any member of the Health Care Reform Task Force at Warner Norcross & Judd.