New Non-discrimination Rules Could Impact Your Executive Employment and Severance Agreements

Health Care Reform includes new non-discrimination rules for insured health care plans. Under these new rules, employers may not discriminate in favor of “highly compensated individuals”. The new rules can apply where an employer provides supplemental health insurance, such as long term care insurance, for executives or pays a greater portion of health care premiums, such as COBRA premiums or retiree health premiums, for a former executive than it does for other employees.

In many executive employment and severance agreements, employers agree to provide group health plan benefits under the employer's group health plan that is in excess of the level provided to other active or former employees or to provide extended continuation coverage under COBRA. Sometimes the employer will pay the premiums for this coverage on a tax-free basis for a longer time or at a level greater than what is provided to other employees.

These practices have historically created a potential discrimination problem for self-insured group health plans. They did not, however, affect fully insured group health plans, which were unregulated in this area. That is no longer the case. Now, the enactment of the Health Care Reform Law creates an issue that previously didn’t exist for employers offering fully insured group health plan coverage as part of their executive compensation or severance practices.

The Old Self Insured Health Plan Discrimination Rules

Historically discrimination rules applied to self-insured group health plans and under Section 105(h) of the Internal Revenue Code and it generally prohibited a group health plan from discriminating in favor of “highly compensated individuals”.

If a self-insured plan provides discriminatory benefits, the value of the actual benefits paid by the employer to a highly compensated individual (whether active or retired) are considered “excess reimbursements” and the dollar value or some fraction of the dollar value of such excess reimbursements must be included in the highly compensated individual's income.

Approaches used by Self-Insured Health Plans

Discrimination problems that involve the employer paying a greater portion of a highly compensated individual's premiums under a self-insured group health plan can usually be solved by the employer requiring that the highly compensated individual pay the same amount of premiums as non-highly compensated individuals, and then the employer provides a taxable reimbursement to the executive or former executive for all or a portion of this amount.

As a more elaborate solution, if the highly compensated individual is a retiree, an employer may pay all or a portion of an executive's premium payments (including COBRA premiums) if it has a self-insured retiree-only plan. A self-insured retiree-only plan will not violate code Section 105(h) if the benefits are provided to highly compensated retirees on a more favorable basis than to retirees generally. This is because Section 105(h) generally does not apply to stand-alone retiree medical plans (whether fully insured or self-insured) if, on the first day of the plan year, the group health plan had fewer than two participants who were current employees.

The New Fully Insured Health Plan Discrimination Rules

The Health Care Reform Law provides that, effective for plan years beginning on or after Sept. 23, 2010, rules similar to the nondiscrimination rules of code Section 105(h)(2) will apply to fully insured group health plans, unless the plan is "grandfathered." The extent to which these rules differ for a self-insured plan versus a fully insured plan has not been clarified.

If a fully insured group health plan does not meet the requirements of code Section 105(h), an excise tax will be imposed on the employer equal to $100 per day during the period of noncompliance with respect to each participant who is discriminated against. The maximum penalty for unintentional failures which are due to reasonable cause and not willful neglect is the lesser of: (i) 10 percent of the aggregate amount paid or incurred by the employer during the preceding taxable year for group health plans or (ii) $500,000.

There is an exception for fully insured small employers. A "small employer" is an employer who employs an average of at least two employees but not more than 50 employees during the preceding calendar year. To determine whether an employer who was not in existence in the preceding year is a small employer, the test is based on the average number of employees that the employer expects to employ in the current calendar year.

Implementation of the New Rules

Notice 2010-63, 2010 issued on September 20, 2010, requested public comments on guidance needed by employers . Comments raised fundamental concerns about plans' ability to comply without regulatory guidance, including, in particular, guidance regarding the meaning of provides that "[r]ules similar to the rules contained in paragraphs (3), (4) and (8) of section 105(h) of such Code shall apply" to insured plans. The reference to rules "similar to" means that guidance must specify in what respects insured plans are subject to the same statutory provisions that apply to self-insured plans and in what respects insured plans are subject to rules reflecting a different (although "similar") application of those statutory provisions. Because regulatory guidance is essential to the operation of the statutory provisions, the Treasury Department and the IRS, as well as the Departments of Labor and Health and Human Services (collectively, the Departments), have determined that compliance should not be

required (and thus, any sanctions for failure to comply do not apply) until after regulations or other administrative guidance has been issued. In order to provide insured group health plans time to implement any changes required as a result of the regulations or other guidance, the Departments anticipate that the guidance will not apply until plan years beginning a specified period after issuance.

Potential Approaches for Fully Insured Health Coverage

One solution for a fully insured group health plan that fails discrimination testing is to preserve its grandfathered status so as to avoid application of the Section 105(h) rules. Discriminatory benefits may be provided to current and former executives under a grandfathered, fully insured group health plan, regardless of the reason for the discrimination, and without penalty.

As with self-insured group health plans, there may be solutions available where the arrangement is discriminatory because the employer is paying a greater portion of a highly compensated individual's premiums under the fully insured group health plan. These solutions might include:

The employer may charge the highly compensated individual the same premium as non-highly compensated individuals and then reimburse all or a portion of the highly compensated individual's premiums on a taxable basis in the same manner as described above for self-insured group health plans.

The employer might be able to pay all or a portion of a former executive's premium payments if it has a fully insured retiree-only group health plan under which former executives receive such benefits. A fully insured retiree-only group health plan appears to be able to take advantage of the same rules as described above for self- insured retiree-only group health plans.

Until regulatory guidance is given there is some uncertainty about the feasibility of these approaches.

Employers Should Review Existing Arrangements

The new Health Care Reform Law's discrimination rules affecting fully insured group health plans may catch employers by surprise. The Health Care Reform Law does not create an exemption for existing arrangements. If an existing employment or severance agreement provides for discriminatory fully insured group health plan benefits to a highly compensated individual, the new penalties will begin after the effective date of the promised guidance (unless the plan is grandfathered).

Employers should have their existing employment and severance agreements reviewed by legal counsel to make sure that the employer has not promised group health plan benefits that it will be unable to deliver or, if delivered, will create significant penalties. And new employment or severance agreements s should be structured in a manner that complies with, or is exempt from, Section 105(h).