A Timely Analysis of Legal Developments

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April 2012

Once Bitten, Twice Shy: COBRA Excise Tax Audits May Add to COBRA's Bite

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The advent of Health Care Reform has not lessened the importance of complying with existing Employee Retirement Income Security Act (ERISA) and Internal Revenue Code requirements for employer-provided group health plans, such as COBRA, which requires covered health plans to provide certain notices and the opportunity to elect continued coverage to covered persons (qualified beneficiaries) who would otherwise lose coverage because of certain "qualifying events" such as termination of employment, loss of dependent status, and others.

IRS Updated COBRA Audit Guidelines

In 1994, the IRS prepared audit guidelines for COBRA compliance, but never released them publicly. Now, after a 10-year task force study, the IRS has published revised audit guidelines (the "Guidelines") for COBRA compliance. The stated purpose of revising the COBRA audit guidelines was to incorporate changes to account for new laws that have affected COBRA since the 1994 Guidelines, such as the Health Insurance Portability and Accountability Act (HIPAA) and the Family and Medical Leave Act (FMLA). The updated Guidelines apparently herald a new COBRA compliance audit effort by the Service.

The Guidelines provide a general overview of the requirements of COBRA and the excise tax associated with COBRA non-compliance, including limitations and exceptions. In some cases, the Guidelines lend some insight into the IRS's approach to COBRA enforcement. For example, the IRS will examine the issue of whether an employee was ineligible for COBRA rights because he or she was terminated for "gross misconduct" by determining whether the employee was granted or denied unemployment benefits, and may interview other employees with knowledge of the circumstances of the employee's termination, or, in the case of a collective bargaining agreement, review any arbitration proceedings if the termination was grieved.

The Guidelines provide an advance look at the extensive nature of future COBRA audits, including the list of documents reviewing agents will call for, which in turn suggests that employers and administrators will want to have those documents and procedures as part of their compliance arsenal. This document list includes:

- COBRA compliance procedures manual;
- COBRA form letters and notices;

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- Internal audit procedures for COBRA continuation coverage;
- All group health care plan documents; and
- Documentation of any past or pending lawsuits claiming COBRA violations.

The Guidelines suggest methods the IRS examiners may use to "probe" for noncompliance. For example, the Guidelines instruct IRS agents to compare the list of covered individuals under the plan on the first and last day of the plan year to identify those dropped from coverage during the year and then check that list against records of COBRA notices and elections, or to make a similar comparison of succeeding years' state and federal employment tax returns. Auditors are also advised to examine personnel records for dates of qualifying events such as termination of employment or death, dates COBRA notices were provided, type of coverage received, notices to insurers or COBRA administrators, reasons for termination of COBRA coverage and reasons for employment termination. Based on a reading of the Guidelines, COBRA audits conducted under them can be expected to be rigorous.

The COBRA Excise Tax

The excise tax for COBRA violations is computed as follows:

1. The number of days in the "noncompliance period," multiplied by
2. The number of qualified beneficiaries for which a failure occurred, multiplied by
3. $100.

The $100 figure in item 3 will be not more than $200 where a failure occurs with respect to a qualifying event that affects more than one qualified beneficiary, such as where the employee dies, and the COBRA administrator fails to provide the COBRA notice of qualifying event to the employee's four covered dependents.

The noncompliance period begins on the day of the failure, and ends on the date the failure is corrected, or, if earlier, six months after the last day of the applicable maximum COBRA continuation coverage period. However, in the example cited in the preceding paragraph, the noncompliance period could be up to 3½ years (36 months plus six months). Such an occurrence could yield a COBRA excise tax of over $250,000.

Minimum and Maximum COBRA Excise Tax

If the COBRA failure was not corrected before the date a notice of IRS examination was sent to the taxpayer (usually the employer), and the failure continued during the examination, the minimum amount of excise tax will be $2,500 for each qualified beneficiary for whom one or more failures occurred if the failures were "de minimis" – $15,000 for each qualified beneficiary if the failures are more than de minimis.

For COBRA failures which are discovered during an IRS audit, the Service may impose a maximum COBRA excise tax for failures in any one taxable year of up to $500,000, or, if less, 10% of the employer's total expenditures on the group health plan (or in the case of a third party administrator such as an insurer, $2 million).

This makes COBRA compliance a critical issue for health plan sponsors as the IRS moves toward a new COBRA audit effort. Employers who experience an audit by the U.S. Department of Labor's (DOL) Employee Benefits Security Administration (EBSA) may now find an IRS audit following closely on its heels. Therefore, it is critical that employers initiate COBRA compliance self-audits to root out possible COBRA violations before the IRS shows up.

Implementation of effective written COBRA procedures, training responsible employees on those procedures, and use of competent professional advice can help mitigate COBRA excise taxes. Monitoring compliance by third party administrators and insurance carriers, and making sure that service contracts do not shift potential penalties to the employer, will also be very important.

Inadvertent Failures and the 30-Day Grace Period

COBRA provides that if a failure is inadvertent, the "noncompliance period" will not begin until the responsible person (the employer or COBRA

administrator) knew or should have known of the failure. Further, if a COBRA failure is due to reasonable cause and not willful neglect, the excise tax will not apply if the failure is corrected within 30 days of the date on which the responsible person discovered it, or could have discovered it through reasonable diligence. In the case of a failure that is due to reasonable cause and not willful neglect, the Secretary of the Treasury (effectively, the Commissioner of the IRS) is authorized to waive any part or all of the excise tax, to the extent the Commissioner determines that the tax would be unreasonably burdensome, based on the seriousness of the failure.

If the employer has effective COBRA procedures in place and follows them, it will be much easier to argue that any COBRA failures were due to reasonable cause and not willful neglect. Also, the IRS will take into account the taxpayer's efforts to comply with COBRA in determining whether it will be appropriate to waive the excise tax in any given situation, by examining its COBRA compliance procedures, the training of personnel on those procedures, and the extent of the taxpayer's use of competent professional counsel such as legal counsel and, where appropriate, actuarial advice, and the extent to which the COBRA program is updated to maintain compliance with current requirements.

COBRA in General

COBRA Coverage Requirements Generally. By now most employers are familiar with COBRA and its requirements, if not its fine detail. COBRA applies to employers who sponsor group health plans except for an employer with fewer than 20 employees on a typical business day for the preceding calendar year, among a few other exemptions.

Where COBRA applies, generally, an employee who loses coverage because of termination of employment (except for gross misconduct, if the plan provides), or reduction of hours to below the threshold for eligibility, is entitled to elect to continue coverage for up to 18 months. Covered dependents who lose coverage because of their age, the covered employee's death, termination of the covered employee's employment or reduction of hours, divorce or legal separation, or because of loss of eligible dependent status for any other reason, may elect to continue coverage for up to 36 months. In the case of certain retiree medical plans, eligibility of the former covered employee for Medicare which causes the former covered employee to lose eligibility is a qualifying event as to the former employee's covered dependents. COBRA is also available to certain individuals who lose retiree medical coverage on account of (or in anticipation of) the employer's reorganization in bankruptcy.

Disability Extension. If the former employee is disabled during the first 60 days of COBRA coverage and provides the administrator with evidence of the Social Security Administration's disability determination within the 18-month coverage period, the COBRA coverage period may be extended to a total of 29 months, and the cost of coverage may be increased to 150% of the applicable premium after the initial 18-month period.

Termination of COBRA Coverage. COBRA coverage may be terminated at the expiration of the maximum required coverage period, or for nonpayment of the required premium or other cost of coverage, or for any reason that would support termination of coverage with respect to a similarly situated covered employee, such as failure to elect coverage during an annual or open enrollment period.

Notice Rights. COBRA requires that covered individuals receive an initial notice of rights when they first become eligible to participate in the COBRA-covered group health plan, and again when a qualifying event occurs, along with the opportunity to elect continuation coverage. These notices must be provided within strict time limits.

For example, in the case of the qualifying event of termination of employment, the employer must provide the plan administrator with notice of the qualifying event within 30 days, and the plan administrator in turn must provide notice of the qualifying event and opportunity to elect to all affected qualified beneficiaries within 14 days of receiving the notice from the employer. If the employer and plan administrator are one and the same person, the regulations provide that the employer has 44 days to provide the notice to qualified beneficiaries. In the case of some qualifying events, such as divorce, the employer will not directly know that the event occurred. In such a case, the covered employee or qualified beneficiary has a duty to provide notice to the plan administrator within 60 days of the event. If the employee or qualified beneficiary does not provide this notice within the 60-day time period, then COBRA rights are extinguished (but some courts have held that if the initial notice is not provided to the participant, or if it is provided only to the participant but not the spouse, this 60-day notice requirement cannot be enforced).

There is even a requirement to provide a "notice of no COBRA rights" if COBRA will be denied to a former employee and his or her covered dependents because the employee was terminated for gross misconduct or for any other reason.

It is usually these notice requirements that trip up employers and administrators in COBRA administration. Failures to provide timely COBRA notices create most of the COBRA issues we see in our practice. The COBRA notice requirements therefore should be the focal point for employer compliance efforts.

Independent Right to Elect COBRA Coverage. Each qualified beneficiary who has experienced a qualifying event has an independent right to notice of the qualifying event and the opportunity to elect COBRA continuation coverage. However, a single notice may be sent to multiple qualifying beneficiaries known to reside at a single address although they each have separate COBRA election rights so long as the notice is adequate to apprise all the qualified beneficiaries of their rights and obligations.

Cost of COBRA Coverage. The plan may charge the employee for the cost of providing the coverage required under COBRA. The maximum amount the plan may charge a qualified beneficiary for the cost of COBRA coverage is generally 102% of the total premium or other cost of coverage – that is, both the employer's and employee's portion of the cost of coverage that applies to similarly situated covered employees and their covered dependents. Specific rules and grace periods apply for payment of the COBRA cost of coverage, and for determination of the cost of coverage for a self-funded plan.

COBRA Penalties for Noncompliance

COBRA's rules are complex and detailed, and the penalties for noncompliance can be severe. In this regard, the excise tax described above is only one of the penalties. In addition, under ERISA's civil enforcement provisions, each qualified beneficiary who is aggrieved by a COBRA notice violation may recover civil penalties of up to $110 per day in federal district court for each day a COBRA notification failure continues, in addition to attorneys' fees. This is in addition to any potential recovery for benefits if the individual should have had – but was not provided – the opportunity to elect continued medical coverage due to the COBRA failure. Under recent Supreme Court authority, this could result in the qualified beneficiary being reinstated to plan participation retroactively, or recovering medical benefits that should have been provided under an equitable theory called "surcharge" or the court could order reformation, in the case of an inaccurate notice.[1]

COBRA applies to both private employer group health plans as well as public employers through parallel provisions in the Public Health Services Act, but neither the excise tax nor the ERISA notice penalty applies to governmental employers.

Since the enactment of COBRA in 1986, most compliance audits have been conducted by the DOL's Employee Benefits Security Administration, often in response to a complaint by a former employee. Even though the IRS and DOL routinely refer examinations to each other or coordinate duplicative examinations under an IRS/DOL Coordination Agreement, in recent years audits by the IRS for COBRA compliance have been relatively rare. We expect the publication of the Guidelines to initiate a new compliance audit initiative in conjunction with other IRS audits of employers.

What You Should Do Now

Every employer who is subject to the COBRA excise tax should review their plan documentation to ensure it is current with applicable requirements, and establish or review their COBRA compliance procedures. They should train all personnel responsible for COBRA compliance on those procedures, and make sure that all aspects of their COBRA compliance program has been reviewed by counsel, that their COBRA premiums charged are supported by insurance premium data or actuarial calculations, and that they can support a good faith effort to comply with COBRA.

Finally, employers should conduct periodic COBRA compliance audits using a well-designed COBRA audit manual or using the IRS Guidelines to monitor their COBRA compliance efforts.

Littler's Employee Benefits Practice Group has substantial experience in representing employers in connection with IRS and DOL COBRA audits, as well as designing, drafting and assisting in the implementation of COBRA programs and compliance documents. We also can assist employers with compliance self-audits as to any aspect of their ERISA and employee benefits programs.

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[1] *See generally, CIGNA Corp. v. Amara*, 131 S. Ct. 1866, 1879-1882 (2011) (plaintiffs showing actual harm from inaccurate SPD may be entitled to recover through reformation or surcharge).