A Timely Analysis of Legal Developments

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Employers with Insured Health Plans Must Take Care in Providing Healthcare Subsidies to Departing Executives

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Many executives have employment agreements that provide for specified payments in the event of termination. In instances where employees do not have employment agreements, employers often seek to provide terminating employees, generally executives, with some type of severance payment in exchange for a release of claims. In addition to a cash payment or salary continuation for a period of time following termination, many employment agreements and severance arrangements include some sort of post-termination subsidy of the cost of healthcare coverage. The Patient Protection and Affordable Care Act (ACA), the healthcare reform law, creates new issues for employers to deal with and may eventually prohibit certain long-standing practices that had been undertaken by employers that maintain insured health plans.

Post-termination healthcare subsidies are generally handled in one of two ways. First, where permissible under the terms of the health insurance plan or insurance policy, an employer may continue to cover the former employee under the employer's health insurance plan, as though he or she were an active employee, for a number of months or years, generally equivalent to the length of time that the former employee is receiving severance pay. At the expiration of this post-termination healthcare coverage, the employee is eligible to elect COBRA continuation coverage. As a second approach, where continuing an employee as active under the employer's health insurance plan is either not desirable or not permissible under the employer's insurance policy, employers often agree to subsidize COBRA coverage for a period of months during the COBRA period, usually by directly paying the COBRA premiums to the insurance company. This ASAP will review certain "nondiscrimination" rules that may be violated by these post-employment health care coverage arrangements and provide guidance to help avoid running afoul of these rules.

Self-Insured Health Plans: Currently Subject to Nondiscrimination Rules

Historically, under a "self-insured" health plan, employers had to be careful not to provide terms of eligibility or benefits that discriminated in favor of highly compensated employees. Under section 105(h) of the Internal Revenue Code, a highly compensated employee is defined as: (1) in the top 25% highest paid employees; (2) one of the five highest paid officers; or (3) a shareholder who owns more than 10% of company stock.

One example of how an employer could potentially violate the nondiscrimination rules is by paying a top executive's COBRA premiums for the full 18 months of COBRA, while paying a clerical employee's COBRA premiums only for a month or not at all. If a self-insured plan is found to have discriminated in favor of providing additional benefits to a highly compensated employee that are not provided to non-highly compensated employees, the highly compensated employee could be taxed on both the amount of premiums paid on his or her behalf and on the value of the entire healthcare benefits provided to the former employee. To avoid that result, in cases where the healthcare subsidy would likely be found discriminatory, an employer may instead pay the departing highly compensated employee a sum of money that might be used to pay for all or a portion of his or her COBRA premiums, but need not be used for COBRA. This additional amount need not be provided to non-highly compensated employees. Because such additional payment will be taxable to the employee, often employers will "gross up" such amounts for taxes, although that is not legally required.

Non-Grandfathered Insured Plans: Nondiscrimination Rules Enacted; Awaiting Further Guidance and Implementation Date

In the past, nondiscrimination rules did not apply to "insured" healthcare plans. Thus, it was permissible for an employer with an insured (as opposed to a "self-insured") healthcare plan to provide an executive with post-employment insured health coverage, either by continuing such executive on the employer's insurance plan where permissible, or by paying the executive's COBRA premiums for a period of time. However, the ACA extended healthcare nondiscrimination rules to "non-grandfathered" insured group arrangements. For clarification, "grandfathered" health plans are those healthcare plans that were in existence on March 23, 2010, and have not been altered in certain defined ways since prior to March 23, 2010. "Non-grandfathered" health plans are either: (a) plans that were not in existence on March 23, 2010; or (b) plans that were in existence on March 23, 2010, but were altered in ways that caused the loss of "grandfathered" status. Note, however, the nondiscrimination rules applicable to insured plans are not effective yet, as discussed below.

Where the nondiscrimination rules are found to have been violated in the case of an employer with a self-insured healthcare plan, the penalty is solely on the highly compensated employee. Conversely, where the nondiscrimination rules are found to have been violated in the case of an employer with a non-grandfathered insured healthcare plan, the penalty is on the employer and quite steep. In general, an employer can be fined an amount equal to $100 per day of noncompliance multiplied by the number of employees who are the subject of discrimination (*i.e.*, the non-highly compensated employees who do not receive the enhanced benefits), up to the lesser of: (i) $500,000; or (ii) 10% of the employer's aggregate healthcare costs for group health plans during the preceding taxable year. Note, however, that there are some circumstances in which the penalty is not applicable: (1) where the rules are violated due to reasonable cause and not willful neglect, and the violation is corrected within a specified time period; and/or (2) where the employer qualifies for the "small employer exception" to the penalty (the employer employs an average of 2-50 employees during the preceding calendar year and employs at least two employees on the first day of the applicable plan year).

Although these nondiscrimination rules for non-grandfathered insured healthcare plans originally were initially to have been effective on January 1, 2011, for most group health plans, the Internal Revenue Service (IRS) postponed the implementation date until the first day of the plan year following the year in which the IRS issues regulations. To date, the IRS has not yet issued regulations, and thus these rules are not currently in effect for non-grandfathered insured healthcare plans. If the IRS issues regulations during 2012, the nondiscrimination rules will be effective January 1, 2013; if the IRS does not issue regulations until 2013, the nondiscrimination rules for non-grandfathered insured healthcare plans will not be effective until January 1, 2014.

In addition to affecting the insured healthcare benefits that employers can offer to highly compensated employees during their employment, these rules will also likely affect agreements that provide for non-grandfathered employee subsidies of post-employment COBRA or healthcare coverage. Since regulations have not yet been issued, we do not know how these rules will ultimately impact such arrangements. Accordingly, care must be exercised to make certain that employers do not make any commitments to provide a subsidy that could be found to be discriminatory after the effective date of the rules.

Because non-grandfathered insured group health plans are not yet subject to the nondiscrimination rules, employers may presently offer, in employment agreements and release agreements, to continue post-termination healthcare and/or COBRA subsidies after a highly compensated employee terminates employment. However, employers should carefully review all existing and future employment agreements and release agreements to ensure that the commitment to provide employer-paid coverage and/or subsidies does not extend beyond the end of 2012, in the event that the IRS issues the nondiscrimination regulations during 2012. For example, if a release agreement signed in July 2012 provides that the company will pay the ex-employee's COBRA premiums for 12 months (*i.e.*, through June 30, 2013), and the IRS issues the anticipated nondiscrimination regulations on December 15, 2012, it is possible—depending upon what such regulations state—that the employer's direct payment of COBRA premiums between January 1 and June 30, 2013, will be found to be discriminatory. Therefore, we recommend that any arrangement (whether contained in an employment agreement or a release agreement) that could extend an employer's post-termination subsidy of healthcare for a highly compensated employee beyond December 31, 2012, include language that permits the employer to discontinue the subsidy and instead provide the remainder of the subsidy as a cash payment, in the event that the employer determines that continued provision of the subsidy would cause a violation of the nondiscrimination rules.

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