

# Issue Brief

## How Employers Should Handle MLR Rebates

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As August 1<sup>st</sup> approaches, employers that sponsor an insured group health plan may be receiving a Medical Loss Ratio (MLR) rebate from their insurers. Self-funded medical benefit plans are not subject to these requirements. The rebates raise several fundamental questions for employers including:

- How much (if any) of the rebate must be distributed to plan participants?
- How quickly must I distribute the participant's share?
- What options do I have in distributing the employee's share?
- What are the tax consequences of the various distribution options that are available?

### Background

Under the Affordable Care Act (ACA), health insurers are required to disclose the percentage of medical plan premiums spent on paying claims and health quality improvement initiatives, versus the portion spent on administration, marketing, and insurance company profit. Under the Medical Loss Ratio (MLR) rules, insurers in the large group market (100+ employees) must achieve a loss ratio of at least 85%, while insurers in the individual and small group markets must achieve a loss ratio of at least 80%.

By June 1<sup>st</sup>, every insurance company offering health insurance coverage was required to report its prior year MLR data to the U.S. Department of Health and Human Services (HHS), and if the minimum standards described above were not met, premium rebates must be provided to policyholders no later than August 1<sup>st</sup>.

### How much (if any) of the rebate must be distributed to plan participants?

Department of Labor (DOL) regulations require that insurers pay the total rebate owed to participants of group health plans directly to the plan sponsor. The DOL has also indicated that the portion of the rebate that is attributable to participant contributions must be treated as plan assets. This is significant because the ERISA rules require (in part) that plan assets may not inure to the benefit of the plan sponsor, and, may only be used for the exclusive benefit of the plan participants.

If a plan sponsor paid the entire cost of the insurance (so obviously there were no participant contributions) none of the rebate would be considered plan assets, and the entire amount could flow directly back to the employer. If participants paid the entire cost of the insurance, the entire rebate would be subject to ERISA plan asset requirements.

The most common situation, however, is where both the plan sponsor and participants contribute toward the cost of the coverage. In this case, the plan sponsor must determine the respective portions of total plan cost contributed by both parties so that the MLR rebate can be appropriately allocated between the participants and the employer.

- Plan sponsors will first need to determine total participant contributions for the year used to calculate the MLR rebate. Current rebates are based on premiums paid to the carrier for calendar year 2011.
- The plan sponsor should then calculate the percentage of total plan premiums paid to the carrier due to participant contributions. This includes employee payroll deductions, COBRA premiums paid by participants, premiums paid by participants during an FMLA leave, and any other payment made toward the premium by a participant. The resulting ratio is then applied to the rebate to determine the portion of the rebate that must be distributed to plan participants vs. the portion that may be retained by the plan sponsor.

### Example

- Total group health plan premiums paid to a carrier during 2011 = \$1,000,000
- Total employee payroll deductions during 2011 plus COBRA premium payments received by the employer = \$250,000 (i.e. participants paid 25% of total plan premiums for the year)
- The employer receives a \$15,000 rebate check from the carrier

In this example \$3,750 (25% of the \$15,000) must be returned to participants.

### **Who must receive the participant portion of the rebates?**

Decisions on how to allocate the participants' portion of the rebate are subject to ERISA's general standards of fiduciary conduct, which require that plan fiduciaries act prudently, solely in the interest of plan participants and their beneficiaries, in accordance with the provisions of the plan, and with impartiality to plan participants.

When a plan provides multiple benefit options under separate policies, the participants' share of the rebate must be distributed to the participants and beneficiaries that were covered under the policy to which the rebate applies.

The most obvious decision the employer must make is what group of participants should receive the rebate. The most common approaches are likely to be

1. Returning the rebate to participants covered by the plan in the year in which the rebate is received  
or
2. Returning the rebate to individuals who participate in the plan both in the year in which the rebate is received (2012 in this case), and the year used to calculate the rebate (2011).

DOL guidance points out that it will usually not be necessary to distribute rebates to former plan participants. In the guidance the DOL states "if [an employer] finds that the cost of distributing shares of a rebate to former participants approximates the amount of the proceeds, the fiduciary may properly decide to allocate the proceeds to current participants [only]..." In most cases the amount of the rebate on a per participant basis will be so small that the administrative cost of distributing it to former participants will exceed the value of the rebate.

### **What options do I have in distributing the employees' share?**

As plan sponsors develop an allocation method, many questions are sure to arise. Should participants who are not required to contribute to the plan (e.g., employer provided employee only coverage) share in the rebate? Should participants with family coverage receive more of the rebate than participants with employee only coverage? Should participants in a high option receive more than participants that elected the low option?

Fortunately, the distribution allocation method is not required to exactly reflect the premium activity of individual plan participants. DOL guidance states, "In deciding on an allocation method, the plan fiduciary may properly weigh the costs to the plan and the ultimate plan benefit as well as the competing interests of participants or classes of participants provided such method is reasonable, fair and objective."

As a result, in many situations the most fair, reasonable and objective method of allocation may be as easy as dividing the rebate evenly over all current participants of the plan, even if those participants made different employee contributions to the plan.

Once the allocation method is determined, the next step is to decide exactly how the rebate is to be distributed. There are, of course, tax implications to all three alternatives as will be addressed in the next section. The three most obvious methods of distributing the participants' share of the rebate are:

1. to return the rebate to the participant as a cash payment,
2. to apply the rebate as a reduction of future participant contributions (a so-called, "premium holiday")
3. to apply the rebate toward the cost of benefit enhancements.

Each option has its own advantages and disadvantages but the third option (benefit enhancement) is viewed by many as being the least favorable due to complexity of making a benefit change (for what will normally be a very small "per participant" amount), and the increased cost to the plan in future years when a rebate may not be available.

Based on the historic response of plan sponsors a number of years ago when rebates were provided during the process of insurance company demutualization, it is expected that premium holidays, and return of the rebate through a bonus or compensation adjustment, will be the most common distribution methodologies.

### **What are the tax consequences of the various distribution options that are available?**

In April of this year, the Internal Revenue Service (IRS) published a set of Frequently Asked Questions ("FAQs") related to the tax treatment of various forms of MLR rebate distribution. According to the IRS guidance, if participant contributions were made on a pre-tax basis, the rebate portion returned to the participant as cash or a premium holiday must be treated as taxable income. On the other hand, for contributions made on an after-tax basis the rebate will not be taxable.

#### Pre-Tax Participant Contributions (Rebate limited to individuals that participated in the plan in both the current and prior year):

- If the rebate is distributed as cash it will be taxable due to the participant's income increasing by the amount of the rebate.
- If the rebate is distributed as a reduction in current-year contributions, it will be "effectively taxable" since the amount of the participant's pre-tax contribution toward current year benefits will decrease, their taxable income will increase by a like amount.

#### Pre-Tax Participant Contributions (Rebate distributed to all current year participants even if they did not participate in the prior year):

- For that segment of the current year covered population that were participants in the prior year, the rebate is taxable for the same reasons as described immediately above.
- For employees that were not participants in the prior year, if the rebate is distributed as cash it will be taxable again due to an increase in the participant's income.
- For employees that were not participants in the prior year, if the rebate is distributed as a reduction in current year contributions, it will again be "effectively taxable" again by virtue of the fact that current year pre-tax contributions will decrease thereby leaving more of the participant's income as taxable.

### **How quickly must I distribute the participant's share?**

As established above, ERISA plan assets must generally be held in trust, however due to DOL guidance released a number of years ago, most employer sponsored group health plans are not required to maintain trusts. Fortunately, in guidance published earlier this year the DOL will also not require the rebates to be held in trust, as long as they are distributed to participants within three months of receipt by the plan sponsor.

### **Summary**

Employers should be aware that while employers are not required to send a specific notice regarding the rebate to employees, insurance carriers are required to send notices of rebates to participants. The notices sent by carriers will not include the amount of the rebate but will state that the rebate was sent to the employer and that a portion may be distributed to participants.

Employers receiving a rebate may want to consider sending an employee communication that clarifies if, and how, employees can expect to receive their portion of the rebate. Employers may also want to point out that the rebate will usually be a relatively small amount on a per participant basis. Employees may incorrectly assume that they will be receiving a significant rebate based only on the information included in the carrier notices.

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