How Employers Should Handle MLR Rebates

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It's that time of year again. Employers who sponsor a fully-insured group health plan may be receiving a Medical Loss Ratio (MLR) rebate from their insurers. Self-insured 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 participants' share?
- What options do I have in distributing the participants' share?
- What are the tax consequences of the various distribution options that are available?

Background

The Affordable Care Act (ACA) included new rules that require health insurance companies to disclose the amount of medical plan premiums spent on paying claims and 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 must prove that at least 85% of premiums are spent on claims (the "loss ratio"), while insurers in the individual and small group markets must achieve a loss ratio of at least 80%.

By July 31st, every insurance company offering health insurance coverage is required to report its prior year MLR data to the U.S. Department of Health and Human Services (HHS), and if the minimum loss ratios are not met, premium rebates must be provided to policyholders no later than September 30th.

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

The Department of Labor (DOL) regulations require that insurers return the total rebate for group health plans directly to the plan sponsor. However, the portion of the rebate that is attributable to participant contributions must be treated as "plan assets." ERISA requires (in part) that plan assets may not inure to the benefit of the plan sponsor, and may be used only for the exclusive benefit of the plan participants.

If a plan sponsor paid the entire cost of the insurance (i.e. there were no participant contributions), none of the rebate would be considered plan assets, and the employer could retain the entire MLR rebate amount. The most common situation, however, is where both the plan sponsor and the 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, plan costs, and the employer.

Plan sponsors must first 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 2017. The plan sponsor should then calculate the percentage of total plan premiums paid to the carrier due to participant contributions. This figure includes employee payroll deductions, and any other premium payment made by a participant (e.g. COBRA premiums or premiums paid during FMLA-protected leave). The resulting ratio is then applied to the rebate to determine the portion that must be treated as plan assets.

<u>Example</u>

- Total group health plan premiums paid to a carrier for a plan with 100 covered employees during 2017 = $1,000,000.
- Total employee payroll deductions during 2017 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 from the carrier in 2018.
- In this example, a total of $3,750 is considered plan assets (25% of the $15,000).

What Should the Employer Do With the Plan Assets?
The first place to look to determine how the MLR rebate should be handled is at the employer's plan documents. Some plan documents are written to define the ownership and handling of the portion of the MLR rebate that is determined to be a plan asset. The plan can reserve the right for the employer to retain the entire rebate, including the plan asset portion, as long as the rebate is not used in a manner prohibited by ERISA. Unfortunately, many plan documents do not contain language to properly address this issue. In this case, the employer should consider using the plan asset portion of the rebate in one of two ways: (i) improving plan benefits; or (ii) returning an appropriate amount to plan participants. Since the MLR rebate is typically very small, it is usually not feasible to use it to improve plan benefits, so the most common approach is to return money to plan participants.

Who must receive the participant portion of the rebates?
Decisions about 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 covered under the policy to which the rebate applies.

The most obvious decision the employer must make concerns what group of participants should receive the rebate. The most commonly chosen options are:

1. Returning the rebate to participants covered by the plan in the year in which the rebate is received (current plan year participants in 2018, including COBRA participants), or;
2. Returning the rebate to individuals who participated in the plan both in the year in which the rebate is received (2018 in this case), and in the year used to calculate the rebate (2017).

DOL guidance points out that it will usually not be necessary to distribute rebates to former plan participants. DOL guidance 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. "Former plan participants" refers to previous plan year participants, not COBRA participants or former employees. In other words, current COBRA participants should be included in the rebate distribution.

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 a larger rebate than participants with employee-only coverage?

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.* In many situations, the most fair, reasonable and objective method of allocation may be as easy as dividing the rebate evenly over all current plan participants, even if those participants made different 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 for all three alternatives, as will be addressed in the next section. The three most obvious methods of distributing the plan 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”); or
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 the 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. Premium holidays and return of the rebate through a bonus or compensation adjustment tend to be the most common distribution methodologies.

What are the tax consequences of the various distribution options that are available?
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 that is 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.

<u>Pre-Tax Participant Contributions (rebate limited to individuals who participated in the plan in both the current and the prior year):</u>

- If the rebate is distributed as cash, it will be taxable because of the participants’ 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; because the amount of the participants’ pre-tax contribution toward current year benefits will decrease, their taxable income will increase by a like amount.

<u>Pre-Tax Participant Contributions (rebate distributed to all current-year participants even if they did not participate in the prior year):</u>

- For those who <u>were</u> participants in the prior year, the rebate is taxable for the same reasons as described immediately above.
- For those who <u>were</u> <u>not</u> participants in the prior year, if the rebate is distributed as cash, it will be taxable due to an increase in the participants’ income.
- For those who <u>were</u> <u>not</u> participants in the prior year, if the rebate is distributed as a reduction in current year contributions, it will be “effectively” taxable by virtue of the fact that current year pre-tax contributions will decrease, thereby leaving more of the participants’ 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, according to DOL guidance, employers are not required to hold the rebates 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 although employers are not required to send a specific notice regarding the rebate to employees, insurance carriers are required to send notices of rebates to plan 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 whether, 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 on only the information included in the carrier notices.

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