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What employers need to know about medical loss ratio rebates

Employers may soon receive medical loss ratio rebates from insurers and will have to determine how to allocate the rebate between its premium costs and participants' premium costs.

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In brief

Sponsors of insured group health plans may soon be receiving rebates of premiums paid in 2011 from the plan's insurance carrier ("the insurer") as required under healthcare reform. Under the Patient Protection and Affordable Care Act, insurers are required to make such rebates if they did not spend a specified percentage (generally, 80% or 85%) of premiums earned in 2011 on healthcare services and activities to improve healthcare quality. Insurers must send these "medical loss ratio" ("MLR") rebates for 2011 premiums to policyholders by August 1, 2012. Many employers have already received communications from their insurer regarding pending rebates for group health plans that they sponsor.

If an employer received a MLR rebate

with respect to one or more of its group health plans, the employer must analyze plan documents, including trust documents, if any, to determine whether the rebate constitutes plan assets or must otherwise be used in whole or in part for the benefit of plan participants.

To the extent that employees are entitled to all or a portion of the rebates, employers must also determine the appropriate tax treatment for any resultant cash rebates or premium holidays provided to employees.

The rules give employers flexibility in deciding how to use the rebate attributable to participant contributions -- to provide a premium holiday or pay it directly to participants.



Technical Release 2011-04

Late last year, the Department of Labor ("DOL") issued Technical Release 2011-04 to provide guidance on these rebates, stating that allocation of the rebate received with respect to employer-sponsored group health plans is subject to the general fiduciary requirements of the Employee Retirement Income Security Act of 1974 ("ERISA"). According to the DOL, if the insurance policy is held in trust, the full amount of the rebate will be plan assets that must be used for the benefit plan of participants. Most plan sponsors, however, do not maintain a trust with respect to their fully insured group health plans consistent with guidance provided by the DOL in Technical Release 92-01.

In situations where the employer and participants have each paid a portion of the premiums, the employer may be required to use the portion attributable to participant contributions for the benefit of plan participants. Based on the release, employers may credit such amounts to future participant premiums or may return such amounts to the participants, depending on the circumstances.

In Technical Release 2011-04, the DOL noted that the fact that the employer is the policyholder or the owner of the policy would not, by itself, indicate that the employer may retain the distributions. The DOL goes on to say that in determining who is entitled to the distribution, one would need to carefully analyze the terms of the governing plan documents and the parties' understandings and representations.

Who gets the rebate?

The DOL has provided the following guidance for situations in which the

plan's documents and other extrinsic evidence do not resolve the allocation question.

- The portion of the MLR rebate attributable to participant contributions would be considered plan assets that must be held in trust. However, based on the principles outlined in Technical Release 92-01, such amounts are not required to be placed in trust if they are used within three months of their receipt from the insurer to pay plan premiums or provide refunds to plan participants.
- If the employer paid the full amount of the 2011 premiums without any participant contributions, the employer may be entitled to retain the full MLR rebate.
- If participants paid the full 2011 premium amount, the full MLR rebate must be used to benefit plan participants either through reduction of future participant contributions under the plan or through refunds to plan participants.
- To the extent that the participants paid a fixed percentage of the cost, the percentage of the rebate equal to the percentage of the cost paid by participants would be attributable to participant contributions.
- If participants were responsible for paying costs above a fixed amount paid by the employer, then the rebate is allocable to the participants up to amount of the participant contributions in 2011.
- If the employer was responsible for additional costs above a fixed amount paid by participants, then the rebate is allocable to the employer up to the amount of the employer's contributions in 2011.

- In no event may the employer retain the MLR rebate to the extent it exceeds the 2011 premiums paid by the employer under the plan.

In deciding how the portion of the MLR rebate attributable to participant contributions is allocated among current and former participants, the employer does not have to ensure that each participant who made a plan contribution in 2011 receives a proportionate share of the MLR rebate based on the amount of 2011 premiums paid by each participant. For example, depending on the circumstances, the employer, acting in its role as plan fiduciary, may properly decide to allocate the MLR rebate to current participants, "based upon a reasonable, fair and objective allocation method." However, if the plan provides benefits under multiple policies, the portion of the MLR rebate attributable to participant contributions should be used to benefit participants covered by the policy to which the MLR rebate relates.

If the plan sponsor decides it would be proper to distribute all or a portion of the MLR rebate to current or former participants, but distributing payments to one or more participants is not cost-effective (for example, if such payments would be *de minimis*), the employer, acting in its fiduciary capacity, may utilize the rebate for other permissible plan purposes such as to provide benefit enhancements or to offset future participant contributions.

Although the rebate is generally paid to the employer, insurers are also required to provide notice of the rebate to all policy "subscribers" on or before August 1, 2012. Under a group policy, "subscriber" includes any employee whose eligibility is the basis for enrollment in the group health plan

and who is responsible for the payment of premiums.

Observation: *Employers who believe they are entitled to keep the entire rebate may receive questions from employees covered under the plan who receive the notice of the rebate directly from the insurer. Even if the plan's documentation is clear that any rebate amount should be treated as a return of employer-paid premiums, employees who have contributed toward the cost of coverage may think that they are entitled to a portion of the rebate based on the language that insurers must include in the notices they send directly to employees.*

Tax issues

Earlier this year, the IRS posted FAQs on its website addressing the taxation of MLR rebates. The taxation of cash rebates or premium holidays will vary depending on whether employees paid for their share of the premiums on a pre-tax or after-tax basis.

What if employees paid their premiums on a pre-tax basis through a cafeteria plan?

To the extent a MLR cash rebate is paid to an employee and represents the return of 2011 employee contributions made through a cafeteria plan on a pre-tax basis, the rebate will be taxable to the employee as compensation when paid in 2012 and will be subject to income tax withholding and applicable payroll taxes. If the MLR rebate is used to reduce an employee's future plan contributions in the form of a premium holiday, the employee will experience an increase in 2012 taxable compensation due to a reduction of the amount that would otherwise be withheld from the employee's compensation on a pre-tax basis. However, the amount paid to the

insurer as future premiums will not be taxable to the employee to the extent coverage under the plan is otherwise a tax-free benefit to the employee.

A MLR cash rebate provided to an employee in 2012 who did not participate in the plan in 2011 would also be subject to income and employment taxes.

What if employees paid their premiums on an after-tax basis?

A MLR cash rebate paid to an employee that represents a return of 2011

employee contributions that were paid on an after-tax basis and that were not deducted as a medical expense on the employee's Form 1040 is not taxable when received in 2012. This is because the rebate is a return of previously taxed amounts. However, if the employee had deducted the premium payment on his 2011 Form 1040, any cash rebate or premium holiday would be taxable income in 2012, although it would not be subject to employment taxes as it was subject to employment taxes in 2011.

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