

MLR REBATES: A GUIDE FOR EMPLOYERS

INTRODUCTION

The Patient Protection and Affordable Care Act's (PPACA) minimum Medical Loss Ratio (MLR) provisions require insurers to provide rebates to group health plans purchasing insurance, if the issuer does not spend a minimum percentage of the premium on medical claims and certain quality improvement initiatives. Depending on the employer and plan type, those rebates will come in the form of a premium credit or reduction (sometimes through a so-called "premium holiday"), or lump-sum reimbursement (via cash or check). Employers are then tasked with determining the proper use of an MLR rebate while also considering the related federal tax consequences.

EMPLOYERS' USE OF AN MLR REBATE

Generally, the proper use of an MLR rebate depends on the plan type and structure. This white paper focuses on employer-sponsored plans that are subject to ERISA.* In addition, this MLR rebate discussion assumes that the employer is the policyholder and that employer contributions toward employees' coverage are paid from the company's general assets (rather than from a trust). Finally, because of the multitude of legal and fiduciary liabilities that may arise with respect to MLR rebates, employers should engage outside counsel to assist in the proper use of an MLR rebate.

For employers that receive an MLR rebate, there is a four-step process to determine the proper use of that rebate.

Step 1: The employer must determine the plan to which the MLR rebate applies.

Generally, rebates apply only to a specific plan option (such as an HMO, PPO or an HDHP). So only those contributing to the cost of plan for that coverage option would benefit from the rebate. If a rebate relates to two separate plan options, then the rebate should be applied separately by the employer, based on the separate calculations of the insurer. Remember that using an MLR rebate generated by one plan for the benefit of another plan's participants is a breach of fiduciary duty.

Step 2: The employer must determine the portion of the rebate that relates to employer contributions versus employee contributions toward the plan's premium.

The employer may keep the entire portion of the rebate that relates to employer contributions (i.e., the rebate is simply returned to the employer's general assets). On the other hand, the portion of rebate that relates to employee contributions is generally considered ERISA "plan assets," and therefore may only be used for the benefit of plan participants (and any related administrative expenses). So, for example, if employees contribute 50 percent of the premium, then 50 percent of the rebate would need to be used for the benefit of plan participants.

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Step 3: The employer must determine the participants to whom it will distribute the rebate.

In doing so, the employer can follow these general guidelines:

1. The allocation method must be reasonable, fair and objective (but does not have to reflect the actual contribution cost of each employee). This means that the employer could choose to provide a flat amount rebate to each participant or a percentage of actual contribution, so long as the method is reasonable, fair and objective.
2. If the cost of distributing rebates to former participants approximates or exceeds the amount of the rebate, the employer may decide to limit rebates only to current participants.

Step 4: The employer must determine the method for distributing the rebate to plan participants.

MLR regulations provide four possible methods for distributing the rebate to plan participants:

- Premium reductions for plan participants
- Benefit enhancements to the plan (adding a benefit or service)
- A refund back to plan participants, either through cash or check
- A premium holiday (either by passing along the insurer's or creating its own)

Importantly, if distributing payments to participants is not cost-effective because the amounts are small or would give rise to tax consequences to the participants, the employer may utilize the rebate for other permissible plan purposes, such as applying the rebate toward future participant premium payments or toward benefit enhancements.

Overall, the employer's method for using an MLR rebate should be clearly outlined in the written plan document. This may require an amendment to the plan, which should be done according to the plan's amendment process. In addition, the employer should document the method it used for keeping or distributing an MLR rebate.

TAX TREATMENT OF REBATES

For both employers and employees, the tax consequences of receiving an MLR rebate depend on whether the employees paid premiums on a pre- or post-tax basis.

When employees pay their portion of a premium on a pre-tax basis, the rebate (whether distributed as a reduction of premium cost or as cash) will be subject to federal income tax and employment taxes in the year that the rebate is received. This is because employees who receive a rebate in either of these forms will have an increase in taxable salary equal to the amount of the rebate.

When employees pay their portion of a premium on a post-tax basis, the rebate (whether distributed as a reduction of premium cost or as cash) will generally not be subject to federal income tax. But rebates relating to premium payments deducted on the employee's federal income tax return are subject to federal income tax. In either case, because the MLR rebate is a return of amounts that have already been subject to federal employment taxes, the rebate will not be subject to employment taxes.

SUMMARY

Employers should consult with insurers to determine what, if any, rebates will be received by the employer. The employer should use the above four-step process to determine the proper use of any MLR rebate received from an insurer. Employers should review, and possibly amend (via the plan's formal amendment process), plan documents to ensure that the documents reflect the chosen method for distributing MLR rebates to plan participants. A record should be maintained describing how the rebate payable to employees was determined and to whom it was distributed. Finally, employers should engage outside counsel to assist in the process of determining the appropriate use of MLR rebates received from insurers.

Endnote

*Different MLR rules apply to non-ERISA plans, such as a governmental, school district or church plans. For more information on those rules, contact your advisor.

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