CLIENT UPDATE

WOO-HOO, WE GOT A REBATE! WHAT CAN EMPLOYERS DO WITH "MEDICAL LOSS RATIO" REBATES?

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Employers that fully insure their employee health care benefits may have received, or may soon receive, a "medical loss ratio" rebate from their insurance provider. This Client Update provides guidance on an employer's and plan administrator's ERISA fiduciary responsibilities regarding the rebates.

Under the Patient Protection and Affordable Care Act of 2010, the insurance provider must rebate part of the premiums that it receives to the extent it does not use enough of the premiums (determined by application of a "medical loss ratio") on health care services and activities to improve health care quality. For the 2011 plan year, the provider must send notices to the policyholder (typically the health care plan or the sponsoring employer) and plan participants by August 1, 2012, explaining the medical loss ratio and informing them that they will be receiving the rebate. The rebate check must be sent to the policyholder, also by August 1, 2012.

The notices sent by the insurance provider highlight that under the Employee Retirement Income Security Act of 1974 (ERISA), the employer or plan administrator "may have fiduciary responsibilities regarding use of the Medical Loss Ratio rebates. Some or all of the rebate may be an asset of the plan, which must be used for the benefit of the employees covered by the policy." The notices refer to DOL Technical Release 2011-04 (available at http://www.dol.gov/ebsa/newsroom/tr11-04.html) for further information.

ARE THE REBATES "PLAN ASSETS"?

Whether an asset is an asset of an ERISA-governed plan is determined by "ordinary notions of property rights." In the Department of Labor's (DOL) view, the medical loss ratio rebate is a plan asset, and the employer generally would not have an interest in it, if the *plan* is the policyholder. If the *employer* is the policyholder, whether the rebate is an asset of the plan depends on the terms of the plan documents and "the parties' understandings and representations." Absent other direct evidence, the DOL determines "the parties' understandings" based on who pays the policies' premiums. Therefore, where the employer is the policyholder and there is no other direct evidence that the employer has an interest in the rebate (which is the case for most employer-provided health care plans), the DOL concludes that the portion of the rebate that is attributable to participant contributions constitutes plan assets:

- No part of the rebate is plan assets if the employer paid 100% of the premiums.
- The entire amount of the rebate is plan assets if participants paid 100% of the premiums.
- If participants and the employer each paid a fixed percentage of the premiums, then a percentage of the rebate equal to the percentage of the premiums paid by participants would be plan assets.
- If the employer paid a fixed amount of the premiums and participants paid any additional premiums, then the portion of the rebate up to the amount paid by the participants would be plan assets.
- If participants paid a fixed amount of the premiums and the employer paid any additional costs, then the portion of the rebate up to the amount paid by the employer would *not* be plan assets.

ALLOCATING THE PORTION OF THE REBATE THAT IS "PLAN ASSETS"

ERISA requires the fiduciaries with authority or control over the rebates that are plan assets to act prudently and solely in the interest of the plan participants and beneficiaries. Generally, this means that the portion of the rebate constituting plan assets must be given to plan participants. The DOL observes that the allocation to participants must be done with impartiality, although the allocation does need to "exactly reflect the premium activity of policy subscribers. 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." For example:

- While the amount rebated on or about August 1, 2012 relates to the premiums paid in 2011, the rebate may be applied for the benefit of participants in the plan during 2012, whether or not they also participated in the plan in 2011.
- If the cost of distributing the rebate to former participants approximates the amount of the benefit to the former participants, the rebate may instead be allocated only to current participants.
- If making distributions to any participant is not cost-effective, (for example, the distributions are of de minimis amounts, or taking into account the tax consequences to participants), the rebate may be used for other permissible plan purposes such as applying the rebate toward future participant premiums or benefit enhancements.

Note, however, that a rebate generated by one plan may *not* be used to benefit the participants of another plan.

ERISA'S TRUST REQUIREMENT

Under ERISA, plan assets must be held in a trust. Most employer sponsored health care plans, however, do not have trusts because premiums are paid from the employer's general assets and benefits are paid by the insurance provider. The DOL has previously given relief from the trust requirement for so-called "cafeteria plans" under Section 125 of the Internal Revenue Code of 1986, as amended, and certain other contributory welfare benefit plans. The DOL will not assert a violation of the trust requirement in respect of these plans if the medical loss ratio rebates are used within three months of receipt by the policyholder to pay premiums or refunds as provided in that prior relief. For other plans, the DOL notes that fiduciaries may consider the cost of establishing a trust when determining the cost-effectiveness of distributing the rebates to participants, and may decide that it would be prudent to instead have the provider apply the rebate toward future participant premiums or to provide benefit enhancements, which would avoid the need for a trust.

TAX TREATMENT OF REBATES PAID TO PARTICIPANTS

The tax treatment of participants who receive a share of the medical loss ratio rebate, either by way of a cash payment or a decrease in future premiums, depends on whether the participant paid premiums on a before- or after-tax basis:

- The rebate is not taxable for a participant (such as a retiree or a former employee on COBRA) who pays premiums on an after tax-basis, and does not take a deduction for the premiums. However, if the participant had previously deducted the premium payment, the rebate would be subject to tax.
- A participant who pays premiums on a pre-tax basis would be subject to income tax and employment tax on the amount of the rebate.

Please do not hesitate to contact us if you have any questions.

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