Severance Agreements And Employment Contracts: They May Cost You A Lot More Than Expected

January 24, 2011

In our prior Tax Alert ("Crushing Health Care Taxes and Penalties Delayed," December 30, 2010), we discussed the application of new nondiscrimination rules to third-party insured health coverage. In general, the Patient Protection and Affordable Care Act prohibits employer-provided coverage which favors a highly compensated individual (HCI – generally the top 25 percent of employees when ranked by pay). The cost of discrimination can be quite high. The employer may be required to pay as much as $100 per day for each non-HCI who is provided a lesser benefit. In late December 2010, because of the lack of guidance on how discrimination will be determined and the potentially devastating taxes which could result, the Internal Revenue Service (IRS), Department of Labor and Department of Health and Human Services postponed the effective date until at least mid- to late 2011. The likely effective date for a health plan which operates on a calendar year basis is January 1, 2012.

While no regulatory guidance has yet been issued, it is clear from the statute that the rules which will apply will be similar to those in Internal Revenue Code Section 105(h) which have applied for many years to self-insured health plans. Under Code Section 105(h), if eligibility or employer-provided coverage favors an HCI, then the plan is discriminatory. These rules apply to coverage for former employees as well as for active employees. Discrimination might occur if the employer pays a higher percentage of the cost of a particular level of coverage for an HCI than it pays for the same coverage for non-HCIs. Thus, an employer that maintains a self-insured health plan cannot include a direct subsidy for health insurance premiums in an HCI employment or severance agreement without violating the discrimination rules. Instead, some employers decide to make a general payment to the HCI that may be used to pay insurance premiums or for any other purpose.

The Code Section 105(h) nondiscrimination rule has not applied in the past to third-party insured plans, so employers with those plans have drafted employment agreements and severance agreements that contain language specifically subsidizing post-employment health insurance premiums. With similar rules on the horizon for third-party insured coverage, if the employer subsidizes the cost of premiums payable to a third-party insurer for coverage of an HCI, that subsidy may be impermissibly discriminatory. If so, the employer will be subject to an excise tax of $100 per day for each person who is discriminated against. Though the group of persons upon whom the tax would be based is not certain because no rules have been issued, the number of non-HCI former employees who are eligible for COBRA coverage and who are not benefitting from the same subsidy would seem logical. Thus, if there are five former non-HCI employees who are eligible for COBRA and their premium cost is not similarly subsidized, then the employer faces a $500 per day excise tax – i.e., about $30,000 per month in order to subsidize the cost of coverage for one former HCI.

IRS Notice 2011-1 indicates that compliance with the new nondiscrimination rules is not required, and no sanctions will apply, until after regulatory guidance is issued. Despite this delay in application, employers may not be safe in following existing premium subsidy practices pending IRS guidance. For example, assume that an HCI employee is leaving employment today with a negotiated severance package. The employer maintains a third-party insured health plan operating on a calendar year basis. The employer is accustomed to severance agreements for selected departing management personnel, all of whom are HCIs. The employer agrees to subsidize the departing employee's cost for the post-termination health coverage by reimbursing the HCI in whole or part for their future payments of COBRA premiums. Also assume that the same COBRA premium subsidy is not provided to former employees who are not HCIs. While the HCI subsidy payments may not subject the employer to any adverse tax effects in 2011, future regulations or other IRS guidance may make it clear that a subsidy practice of this sort is discriminatory. Will the IRS grandfather arrangements in existence before the issue date or effective date of guidance so that they may continue without taxation of the employer? If not, the employer already has in place a contract which requires continuation of the subsidy, and, assuming a January 1, 2012 effective date for the nondiscrimination rules, beginning on that date the contract could subject the employer to the excise taxes described above, even though the arrangement was permissible when entered into.

Only time and guidance from the IRS may answer these concerns. An employer must now look a year into the future to consider what might happen when IRS guidance becomes effective. Is the employer willing to take the risk that arrangements that were not discriminatory before the regulations became effective will not be grandfathered? Employers may instead begin to take a more conservative approach and use only arrangements which do not expressly provide for any subsidy.

Should you wish to further discuss nondiscrimination issues, please one of the attorneys in the Firm's Tax Department.