PUBLICATION

Crushing Health Care Taxes and Penalties Delayed

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The Internal Revenue Service (IRS), Department of Labor (DOL) and Department of Health and Human Services (HHS) have postponed until at least mid to late 2011, at the earliest, the effective date of the new Patient Protection and Affordable Care Act (PPACA) non-discrimination rules that may result in substantial taxes and penalties for noncompliance.

Employees and employers are accustomed to the idea of health care benefits that are not taxable to the recipient. However, for self-insured coverage (i.e., plans under which the employer pays all or most of the benefits out of its assets rather than using third-party insurance contracts to provide the benefits), Code Section 105(h) has long contained rules to tax self-insured coverage that discriminates in favor of highly compensated individuals (HCIs). An HCI is generally an employee who is among the top 25 percent of employees when ranked by pay. The tax consequences of such discriminatory coverage are not always recognized, understood or reported, partly because of vague regulations and partly because this has been an area in which the IRS will not issue even informal guidance, such as private letter rulings. It is clear, however, that the prohibited discrimination may occur either with respect to eligibility for benefits generally or with respect to the types or levels of employer-provided benefits.

Under PPACA, fully insured health plans must similarly begin to be concerned about discriminatory coverage, though the effects of discrimination will be dramatically different than those which result from discriminatory self-insured coverage. Rather than taxation of the HCI based on the value of the discriminatory benefits, under the new rules of Code Section 4980D as added by PPACA, an excise tax may be imposed on the employer. The excise tax is $100 per day, for each employee who is discriminated against, but generally limited to the lesser of 10 percent of plan costs or $500,000 per plan per year. For example, if one HCI is provided coverage that is found to be discriminatory in its favor and the employer also employs 100 employees who are treated as having been discriminated against, then the employer is subject to an excise tax of $10,000 per day ($100 x 100 employees), up to the excise tax cap as determined under the facts and circumstances for that plan for that year. The tax would be payable by the employer along with the filing of a Form 8928, not later than the due date of the employer's tax return, without extensions. Given the potential cost to the employer, it becomes crucial to have clear rules about what sort of discrimination is prohibited by PPACA.

There appears to be some relief from these rules for some plans. Plans of small employers (50 or fewer employees) may be exempt from these rules, but the requirements for exemption are not yet clear. This is one of a number of issues which the IRS is considering. Further, HIPAA-excepted benefits (e.g., dental, vision-only plans), retiree-only coverage, diagnostic testing (employee only) and grandfathered plans for PPACA purposes are not subject to the new rules. Additionally, the excise tax may be waived if the employer used reasonable diligence but did not recognize a problem, or if there is other reasonable cause and the discrimination is quickly corrected. Correction will apparently require making the more favorable benefits available to those discriminated against (See IRC Section 4980D(f)(3)(B)), at least for the period of discrimination, so it is possible that the cost of correction may exceed the excise tax.

In addition, because the new non-discrimination rules were added to ERISA, under ERISA's civil enforcement provisions a plan participant or the DOL would appear to have standing to sue the employer to compel non-discriminatory coverage.

Although state and local government plans and the issuers of insurance contracts may not be subject to the excise taxes provided under Code Section 4980D, they may instead be subject to civil penalties under the Public Health Services Act (PHSA), which also equal $100 per person per day for each person discriminated against. However, the PHSA does not contain a cap, so theoretically there is no maximum civil penalty. HHS will make the determinations regarding penalties, based on facts and circumstances. The PHSA does contain exceptions for reasonable diligence and quick correction after discovery.

To complicate matters further, PPACA did not add specific new non-discrimination rules for third-party insured coverage to Code Section 105(h) (which now contains the existing rules for self-insured coverage), nor does PPACA impose the identical non-discrimination rules as those which apply under Code Section 105(h). Instead, PPACA added language to the PHSA to provide that third-party insured plans must satisfy non-discrimination rules which are similar to those which apply under Code Section 105(h). See PHSA Section 2716(b)(1), as amended. Thus, employers and perhaps issuers may be subject to potentially crushing excise taxes or civil penalties for providing discriminatory health insurance to employees under commercial contracts, using standards which are similar to rules which are already vague.

Because the new rules are part of the PHSA, they were scheduled to become effective for plan years which begin after September 23, 2010. For a plan which operates on a calendar year, the scheduled effective date under the statute is January 1, 2011.

This looming, potentially massive problem which would become effective for many plans on January 1, 2011 (and which is technically already effective for some plans), has been temporarily avoided due to the issuance of IRS Notice 2011-1 on December 22, 2010. Along with a request for comments, the IRS has announced that because regulatory guidance is essential to the application of rules similar to those which apply under Code Section 105(h), compliance with the PPACA/PHSA non-discrimination rules for third-party insured coverage is not required until after that regulatory guidance is issued. The IRS anticipates that the new guidance and any excise taxes or penalties will be effective only for plan years beginning after issuance of the guidance. The DOL and HHS concur. This should then mean that for a calendar year, plan enforcement of the non-discrimination rules will not begin before January 1, 2012 at the earliest, and no excise taxes or civil penalties will be applied for any period before that effective date. Comments have been requested to develop the guidance. Because the comment period extends until March 11, 2011, no significant guidance is anticipated until mid to late 2011.

Should you have any questions, please contact any attorney in the Firm's Tax Department or Health Department.