# REPORT ON CERTAIN CONTINUED COVERAGE UNDER INSURED GROUP HEALTH PLANS IN LIGHT OF THE PPACA NONDISCRIMINATION RULES AND IRS NOTICE 2011-1

**Report No. 1236**

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The Patient Protection and Affordable Care Act of 2010, as amended ("PPACA") adds a new Section 2716 to the Public Health Service Act of 1944, as amended (the "PHSA"), which provides that a group health plan (other than a self-insured plan) must satisfy certain nondiscrimination requirements (the "PPACA Nondiscrimination Rules").[1] Depending on the manner in which the PPACA Nondiscrimination Rules are interpreted and implemented by the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS"), as well as other affected regulatory agencies, these new requirements could have broad impact across a wide range of employment and severance agreements and other arrangements. This Report[2] will address whether certain health-related benefits provided by an employer to former employees (after the period of employment has ended) violate the PPACA Nondiscrimination Rules.

## INTRODUCTION

Section 105 of the Internal Revenue Code of 1986, as amended (the "Code")[3] generally provides that if an employee is reimbursed by his/her employer's accident or health plan for amounts paid by the employee for medical care, the employee may exclude the reimbursement from income. For over 40 years, subsection (h) of Section 105 has prevented this tax benefit from being available to certain highly compensated individuals to the extent they receive benefits under an employer's self-insured group medical plan which disproportionately benefits such highly compensated individuals (as compared to other less-highly compensated employees). Under Section 105(h), a medical plan is tested for discrimination both in terms of eligibility to participate in the plan,[4] and in terms of the specific benefits made available to different plan participants.[5] In general terms, if a self-insured plan discriminates in favor of a highly compensated employee, the remedy provided for in Section 105 is that the highly compensated employee must include in taxable income the "excess reimbursement," generally defined as the full amount of any benefit which is only available to highly compensated employees, or as a percentage of benefits paid to the highly compensated employee, as applicable.[6]

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[1] Section 10101(d) of PPACA, adding new Section 2716 to the PHSA.

[2] This Report reflects solely the views of the Tax Section of the NYSBA and Executive Committee not those of the NYSBA or the House of Delegates. The principal drafter of this Report was Andrew L. Oringer. Significant contributions were made by Eric W. Hilfers, Elizabeth Kessenides, Joshua A. Lichtenstein, Elliot Pisem, Michael L. Schler, Jodi J. Schwartz and Diana L. Wollman. Helpful comments were received from S. Douglas Borisky, Samuel J. Dimon, Michael S. Farber, Stephen B. Land, David S. Miller, Andrew W. Needham, and David H. Schnabel.

[3] Unless otherwise indicated, all section references herein are to sections of the Code.

[4] See § 105(h)(2)(A).

[5] See § 105(h)(2)(B).

[6] See § 105(h)(7).

If, on the other hand, the employer maintains an insured group health plan, under which benefits are payable by the insurance company and not the employer, Section 105 still exempts the benefits from employees' income, but historically the Section 105(h) antidiscrimination rules have not applied.[7] Since benefits paid under an employer's self-insured plan are essentially direct payments from the employer to the employee, the special rules under Section 105(h) may be thought of as generally limiting favorable tax-free treatment for amounts which are effectively additional compensation from an employer where those benefits are provided on a discriminatory basis. The 1978 legislative history explains that the then-new Section 105(h) was being applied only to self-insured plans because "underwriting considerations generally preclude or effectively limit abuses in insured plans."[8]

The Treasury regulations under Section 105(h)[9] provide further guidance on certain issues, but do not generally provide specific or other comprehensive guidance regarding a wide range of important questions under Section 105(h), and the IRS does not issue rulings under Section 105(h).[10] Regarding the provision of benefits to former employees, the Section 105(h) regulations state that retirees who were highly compensated must include the amount of any benefits received in income "unless the type, and the dollar limitations, of benefits provided retired employees who were highly compensated individuals are the same for all other retired participants."[11]

Section 2716 of the PHSA states:

> (a) IN GENERAL.—A group health plan (other than a self-insured plan) shall satisfy the requirements of section 105(h)(2) of the Internal Revenue Code of 1986 (relating to prohibition on discrimination in favor of highly compensated individuals).
>
> (b) RULES AND DEFINITIONS.—For purposes of this section—
>
> (1) CERTAIN RULES TO APPLY.—Rules similar to the rules contained in paragraphs (3), (4), and (8) of section 105(h) of such Code shall apply.
>
> (2) HIGHLY COMPENSATED INDIVIDUAL.—The term "highly compensated individual" has the meaning given such term by section 105(h)(5) of such Code.

It is paragraph (1) of Section 105(h) which states that the remedy for a self-insured plan's violating the Section 105(h) non-discrimination rules is that the highly compensated individual must include the excess benefits in taxable income; Section 2716 of the PHSA does not refer to

[7] If the benefits are provided in connection with benefits under a cafeteria plan that meets the requirements of Section 125, such that the amount of the insurance premium is subject to additional favorable tax treatment by being potentially excluded from the income of the participating employee, then the additional Section 125 nondiscrimination rules would apply.
[8] S. Rep. No. 95-1263, at 186 (1978), reprinted in 1978-3 C.B. 315, 484.
[9] Treas. Reg. § 1.105-11.
[10] Rev. Proc. 2011-3, 112 I.R.B. 2011-1, § 3.01(10).
[11] Treas. Reg. § 1.105-11(c)(3)(iii).

Section 105(h)(1). Instead, Section 2716 of the PHSA provides that if a group health plan fails to comply with the nondiscrimination requirements of Section 2716 of the PHSA (what we are referring to as the "PPACA Nondiscrimination Rules"), the plan sponsor (or the plan itself[12]) may be subject to an excise tax under Section 4980D of the Code; and the provision of discriminatory benefits may be a violation of substantive law, resulting in possible civil money penalties under the PHSA and possible civil action to enjoin a noncompliant act or practice or for other appropriate equitable relief under the Employee Retirement Income Security Act of 1974, as amended ("ERISA").[13]

IRS Notice 2010-63[14] specifically invited public comments concerning the application of the PPACA Nondiscrimination Rules. In particular, Section III of Notice 2010-63 requested comments on "what additional guidance relating to the application of Section 105(h)(2) would be helpful with respect to insured group health plans."

The IRS followed Notice 2010-63 with Notice 2011-1,[15] which delayed the compliance date for the new nondiscrimination requirements until after regulations are issued. Notice 2011-1 acknowledges (and we agree) that the new rules are not susceptible to implementation in the absence of regulatory guidance, stating:

> The § 2716(b)(1) reference to rules "similar to" means that guidance must specify in what respects insured plans are subject to the same statutory provisions that apply to self-insured plans under § 105(h)(3), (4) and (8) and in what respects insured plans are subject to rules reflecting a different (although "similar") application of those statutory provisions. Because regulatory guidance is essential to the operation of the statutory provisions, the Treasury Department and the IRS, as well as the Departments of Labor and Health and Human Services (collectively, the Departments), have determined that compliance with § 2716 should not be required (and thus, any sanctions for failure to comply do not apply) until after regulations or other administrative guidance of general applicability has been issued under § 2716. In order to provide insured group health plan sponsors time to implement any changes required as a result of the regulations or other guidance, the Departments anticipate that the guidance will not apply until plan years beginning a specified period after issuance.[16]

Notice 2011-1 also requests comments on a number of specific issues, including the following:

> The basis on which the determination of what constitutes nondiscriminatory benefits under § 105(h)(4) should be made and what is included in the term "benefits." For example, is the rate of employer contributions toward the cost of coverage (or the

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[12] See § 4980D(e)(ii)-(iii).
[13] Section 2716 of the PHSA is incorporated by reference into the Code at Section 9815(a) of the Code and into ERISA at Section 732(a) of ERISA.
[14] I.R.B. 2010-41.
[15] I.R.B. 2011-2.
[16] Notice 2011-1 § III.

> required percentage or amount of employee contributions) . . . treated as a "benefit" that must be provided on a nondiscriminatory basis?
>
> . . . .
>
> The suggestion in previous comments that coverage provided to a "highly compensated individual" (as defined in § 105(h)(5)) on an after-tax basis should be disregarded in applying § 2716.[17]

This Report will focus on the question of whether and under what circumstances an employer may permit a terminating employee and the terminating employee's dependents to continue insured health-care coverage on an employer-subsidized basis, without violating the PPACA Nondiscrimination Rules. In our experience, employers frequently allow terminating executives to continue their health-insurance coverage on a subsidized basis in an ad hoc or other non-uniform basis. These arrangements are sometimes provided for in the executive's employment agreement, and other times are negotiated at the time of the severance.

The legislative history to PPACA does not tell us how Congress intended the PPACA Nondiscrimination Rules to apply to such subsidized continued coverage for terminating employees (and their dependents), and we believe that there may be a range of perspectives on what Congress intended. The varying views on these matters are, for the most part, based upon policy considerations that are unrelated to tax policy. Against that backdrop, we consider the PPACA Nondiscrimination Rules below.

SUMMARY

1. We recommend that the PPACA Nondiscrimination Rules should be interpreted and implemented such that, when a former employee who is eligible for coverage under rules initially added by the Consolidated Omnibus Reconciliation Act of 1985 ("COBRA") (or is eligible under a plan to continue coverage under provisions that satisfy the PPACA Nondiscrimination Rules with respect to the continuation) elects continued coverage, and the employer pays or reimburses the former employee for the COBRA or other premium, in whole or in part, (i) the employer's payment or reimbursement of the premiums is not considered to involve discriminatory coverage or to be a discriminatory benefit under the PPACA Nondiscrimination Rules, and (ii) the employee is taxed in respect of the employer-paid or otherwise reimbursed premium.

2. In formulating regulations to implement the PPACA Nondiscrimination Rules, Treasury and the IRS should provide guidance as to whether or not providing continuing coverage to terminated employees who are no longer eligible for continuation coverage under generally applicable plan provisions for COBRA (or other continued) coverage ("Non-COBRA Coverage") on an ad hoc, non-uniform or discriminatory basis is permissible, and, if it is permissible, what if any

[17] Notice 2011-1 § IV (items 1, 10).

conditions must be met (for example, treating the cost of the coverage as taxable compensation to the former employee).

3. If non-uniform post-employment coverage or benefits are not permitted, we believe that grandfathering and transitional rules should be adopted.

## DISCUSSION

## I. Permissibility of the Provision of Continuing Coverage Through the Payment or Reimbursement of COBRA Premiums

### A. Background

One way in which employers may subsidize post-employment continuation of participation in health plans is to have the terminating employee elect under COBRA to continue group-health coverage, and to pay or reimburse the former employee for the COBRA premiums. Under COBRA, electing employees generally may be required to pay the full (i.e., both the employer's and employee's) cost of the coverage, as determined based on overall costs to all Non-COBRA participants,[18] plus an administrative charge of up to 2%.[19] Thus, an employer could provide the coverage post-employment by paying the premiums (in whole or in part) for the former employee, or by reimbursing the former employee for the premiums (in whole or in part).

### B. Recommendation

The PPACA Nondiscrimination Rules should be interpreted and implemented such that, when an employee eligible for COBRA coverage under an insured plan (or eligible under a plan to continue coverage under provisions that satisfy the PPACA Nondiscrimination Rules with respect to the continuation), elects continued coverage, and the employer pays or reimburses the employee for the COBRA or other premium, in whole or in part, (i) the employer's payment or reimbursement of the premiums is not considered to involve discriminatory coverage or to be a discriminatory benefit under the PPACA Nondiscrimination Rules, and (ii) the employee is taxed in respect of the employer-paid or otherwise reimbursed premium.

### C. Explanation

Prior to PPACA, it was understood that, if the former employer paid, or reimbursed the former employee for, COBRA premiums in the insured context, the benefit was excludible from the former employee's income under Section 106.[20] In the self-insured plan context, it was

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[18] See § 4980B(f)(4); see also ERISA § 604.
[19] See § 4980B(f)(2)(C); see also ERISA § 602(3).
[20] See Rev. Rul. 61-146, 1961-2 C.B. 25 (reimbursement of payments otherwise excludable (under Section 106) is itself excludable from an employee's income where the reimbursement only occurs if the employee has spent the amounts on the applicable coverage); see also Rev. Rul. 82-196, 1982-2 C.B. 53 (employer contributions to an accident or health plan that provides coverage for an employee and the employee's spouse and dependents before and after the employee's retirement and that also provides benefits for a deceased employee's surviving spouse and
(footnote continued)

common in our experience for a former employer to treat discriminatory payments or reimbursements of COBRA premiums as additional taxable compensation (and thus not a benefit to which Section 105 would apply, and, whether or not discriminatory, not something that could be a violation of Section 105(h)).

In Treasury/IRS question-and-answer sessions with the Joint Committee on Employee Benefits of the American Bar Association ("JCEB Q&As"), Treasury and IRS personnel have given informal and nonbinding responses which are consistent with this analysis.[21] In the May 9, 2003 JCEB Q&As, for example, an employer's payment of COBRA premiums for certain terminating employees was viewed as raising neither eligibility nor benefits issues under Section 105(h), "since in that case the employer's payment of the premium is not an extension of coverage or benefits under the plan itself."[22] Thus, under this view, there is no provision of discriminatory coverage (or benefits), but rather only a payment of additional compensation not subject to any anti-discrimination rules.[23] We discuss below whether a similar analysis in the insured context post-PPACA would, be appropriate.

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(footnote continued)
dependents are excludable from the gross income of the employee and the survivors); Rev. Rul. 85-121, 1985-2 C.B. 56 (during a period of layoff, the laid-off worker is an "employee" for purposes of Sections 105 and 106).

[21] See generally JCEB Q&As, May 10-12, 2007, Q&A-1; JCEB Q&As, May 7-9, 2009, Q&As 1-3.

[22] JCEB Q&As, May 9, 2003, Q&A 7; see also JCEB Q&As, May 10-12, 2007, Q&A 3 (agreeing that the arrangement at issue in Revenue Ruling 61-146, 1961-2 C.B. 25 (reimbursement of payments otherwise excludable (under Section 106) is itself excludable from an employee's income where the reimbursement only occurs if the employee has spent the amounts on the applicable coverage), is not subject to Section 105(h), but without expressly commenting on the statement in the JCEB's proposed response that "[t]he reimbursement arrangement is merely the method that is used by the employer to pay the premiums").

[23] While on its face Revenue Ruling 61-146, 1961-2 C.B. 25, could be read to view certain employee-paid coverage as being provided by the employer, we believe that Revenue Ruling 61-146 is ultimately not inconsistent with our view, as expressed above in text. In Revenue Ruling 61-146, the IRS held that a reimbursement of payments otherwise excludable (under Section 106) is itself excludable from an employee's income where the reimbursement only occurs if the employee has spent the amounts on the applicable coverage; the concern there appears to have been that the taxpayer, by including income, would have been unable to benefit from an otherwise available exclusion (i.e., for certain medical coverage), a result which would have been inconsistent with the policy behind the exclusion. In concluding that favorable tax treatment applies in the case of the arrangements described in the ruling, the IRS essentially held that various arrangements were equivalent to those providing for employer contributions to an accident or health plan entitled to favorable tax treatment, without requiring restructuring where a recharacterization as employer contributions was appropriate. It seems evident that, in the absence of a Code provision providing for exclusion from income to the employee, the payment to the ultimate insurer would have been taxable to the employee. Compare Rev. Rul. 61-146 with Rev. Rul. 2002-3, 2002-1 C.B. 316 (holding that, if an employer applies salary reduction amounts (whether or not pursuant to elections) to the payment of health-insurance premiums for employees and then "reimburses" amounts to employees so that employees' after-tax pay remains unchanged, then, although the salary reduction amounts used to pay the premiums are excludable from the employees' gross income under Section 106 because they are employer-paid, there are no employee-paid premiums for the employer to "reimburse," and, therefore, the reimbursements that the employer makes to employees are not excludable from gross income under Section 105(b) because they do not reimburse employees for expenses incurred by the employees), amplified by Rev. Rul. 2002-80, 2002-2 C.B. 925 (holding that, where an employer purports to treat "advance reimbursements" as payments for uninsured medical expenses, and those amounts are paid to the employee regardless of whether the employee incurs expenses for medical care or suffers a personal injury or sickness during the year. the exclusion from gross income under Section 105(b) does not apply to such amounts (and also holding that certain amounts characterized as "loans" are not loans for tax purposes). See also Rev. Rul. 2004-55, 2004-1 C.B. 1081 (discussed in text).

Authority applying the pre-existing Section 104, 105 and 106 regime, in particular Revenue Ruling 2004-55,[24] may be instructive for present purposes. In Revenue Ruling 2004-55, an employer provided long-term disability benefits through a group insurance policy with a third-party insurance carrier. The employer paid the entire premium for the coverage and did not include the cost of the coverage in the employee's gross income. The employer amended the plan to provide that each employee could either continue to have the premiums paid by the employer on a pre-tax basis (in which the benefits received by a disabled employee would be taxable), or irrevocably elect to have the employer pay for the long-term disability coverage on an after-tax basis (in which case, the disability benefits would be tax-free to the disabled employee). Revenue Ruling 2004-55 holds that long-term disability benefits received by an employee who elects to have the employer pay for coverage on an after-tax basis are excludable under Section 104(a)(3) (and also holds that, conversely, the benefits received by an employee whose coverage is paid on a pre-tax basis are includible in gross income under Section 105(a)).

In Revenue Ruling 2004-55, the IRS permitted an employer and employee to decide to treat a potentially nontaxable payment (the insurance premium) as taxable compensation solely to obtain the favorable tax treatment for the ultimate disability benefits, notably without requiring that the employee have any discretionary control over the payment (such as the option to take the cash instead of having the employer pay the premium). One might have thought that such control would have been necessary to cause the payment to be treated as taxable compensation; however, the IRS imposed no such requirement.[25]

Revenue Ruling 2004-55 effectively permits an employer and employee to elect to treat a benefit as taxable compensation and thereby remove it from the scope of health benefits subject to the Section 105(h) nondiscrimination rules. The question is whether for purposes of the PPACA Nondiscrimination Rules, the same flexibility should be permitted. Asked another way, if an employer and employee agree to treat certain health-related benefits as additional taxable compensation, then can they remove those benefits from the scope of the PPACA Nondiscrimination Rules (providing there is no discrimination in terms of who is eligible for the coverage)? Rather than implicating a mere tax advantage, in this context characterization of the

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[24] 2004-1 C.B. 1081.

[25] We note that the IRS has confirmed the result under Revenue Ruling 2004-55 in the case of various plan designs, see, e.g., 200613023 (Dec. 14, 2005); PLR 200527012 (Apr. 1, 2005); PLR 200312001 (Mar. 21,2003), evidencing, in our view, a desire to allow tax characterization of the premiums in a way that is administratively convenient and that results in the applicability of otherwise available favorable treatment for participating employees.

Another example where the making of a taxable payment is viewed as consistent with the policies underlying a requirement that an employee not be provided with additional benefits is found under Section 422. There, an incentive stock option cannot be granted with a per-share exercise price less than the per-share grant-date fair market value of the option. A promise to pay consideration only if the option is exercised could theoretically be viewed as an impermissible reduction in purchase price. However, the statute clearly states that any transfer of property taxable in accordance with the rules of Section 83 is permissible under these rules. See § 422(c)(4) (subparagraph (B) and flush language). Indeed, the regulations expand this flexibility, making it clear that taxable cash payments are likewise not problematic. See Treas. Reg. § 1.422-5(c). As in the case of Revenue Ruling 61-146, the payment of additional taxable compensation is viewed again as not inconsistent with underlying requirements that might otherwise constrain the provision of additional benefits.

payment as being a nontaxable payment by the employer could render the arrangement illegal under the PPACA Nondiscrimination Rules.

Thus, we do not believe that the payment by an employer of premiums required to be paid by the former employee should be viewed as a benefit subject to the PPACA Nondiscrimination Rules. In this case, there is no discrimination in the availability of insurance.[26] We believe the employer's payment or reimbursement of the employee's premium should be viewed just like any other taxable compensation paid to the employee. We do not see any reason that taxable compensation paid in the form of premium payment or reimbursement should be subject to anti-discrimination rules when any other taxable compensation is not.[27]

Furthermore, if the PPACA Nondiscrimination Rules were interpreted so as not to permit the employer to waive or subsidize insurance premiums on a taxable basis, then employers and employees could replicate the same economic results by simply having the employer agree to pay the former employee more compensation without designating that the additional compensation is a reimbursement of the COBRA premiums. It seems to us that a rule that provides that an open payment would be a violation of law, but that would also permit a "disguised" reimbursement, is not good tax policy. If this approach would not be permitted, we believe that a rule that tried to ferret out "disguised" reimbursements and pursue the offenders would be unadministrable and would reward those who were better at disguising the reimbursement.[28]

## II. Continuations of Non-COBRA Coverage (With or Without the Payment or Reimbursement of Premiums)

### A. Background

Prior to PPACA, employers were apparently permitted to provide terminated employees with access (subsidized or nonsubsidized) to Non-COBRA Coverage on a discriminatory or other non-uniform basis. This practice could raise additional considerations under the PPACA Nondiscrimination Rules which are not raised in the context of the discussion in Section I above, and, as a result, different rules could apply. Congressional intent in expanding the non-discrimination rules beyond self-insured plans is not clear, and therefore guidance is necessary.

### B. Recommendation

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[26] Situations involving expanded access are discussed in Section II below.

[27] We believe that the analysis in text of the payment or reimbursement of COBRA premiums would be equally applicable in a case in which the employer pays or reimburses the premiums for coverage under a conversion policy (essentially, an individual (or family) policy obtained through converting group coverage) or under some other individual (or family) insurance policy. Like COBRA payments or reimbursements, any premiums paid for or reimbursed by the employer on a taxable basis to the employee should not generally be treated as the provision of discriminatory coverage or benefits, even where such taxable payments are only made on behalf of highly compensated individuals.

[28] We note that our reasoning herein could possibly have application in the case of differing premium payments by current employees, where the differential of any lower premium for the more highly paid employees is includible in such employees' income.

In formulating regulations to implement the PPACA Nondiscrimination Rules, Treasury and the IRS should provide guidance as to whether or not providing Non-COBRA Coverage on a discriminatory basis is permissible, and, if it is permissible, what if any conditions must be met (for example, treating the cost of the coverage as taxable compensation to the former employee).

C. Explanation

1. The View That Discriminatory Access Should Always Be Proscribed

One view of Section 2716 of the PHSA is that the PPACA Nondiscrimination Rules prohibit any discriminatory access to benefits under an employer plan, including benefits that are continued after termination of employment. Under this view, highly compensated employees could not have discriminatory post-employment access to the employer's medical plan even if such employees pay out of pocket for the coverage or are taxed on the coverage.

This view is supported by the fact that Section 2716(a) of the PHSA unconditionally requires that an insured plan satisfy the requirements of Section 105(h)(2), and Section 105(h)(2) is solely a prohibition on discrimination. Moreover, although Section 2716(b)(1) of the PHSA states that rules "similar" to those in Section 105(h)(3), (4), and (8) shall apply, those rules refer solely to the definition of discriminatory treatment. Specifically, nothing in Section 2716 of the PHSA refers to Section 105(h)(1), which provides for income inclusion as the sole penalty for violation of Section 105(h). (This is consistent with the fact that the various penalties for a violation of the new provisions of the PHSA do not involve inclusion in income.) Therefore, we believe that an income inclusion such as that in Section 105(h)(1) is arguably not sufficient to avoid a violation of Section 2716 of the PHSA. However, we acknowledge the absence of legislative history on this question.

2. The View That Post-Tax Non-COBRA Continuation May Be Permitted Without Regard to the PPACA Nondiscrimination Rules

a. In General

Other interpretations of the statute may also be possible. In the self-insured context, there are indications that Section 105(h)(1) does not apply if Non-COBRA Coverage is extended to solely highly compensated former executives, so long as the premiums are paid by the former executive or reimbursed by the employer in a manner that results in taxable income to the former executive.[29] If such an extension of Non-COBRA Coverage does not violate 105(h) in the case of a self-insured plan, then an argument can be made that it should not violate the PPACA

[29] Certain JCEB Q&As appear to support the exclusion of employer-paid premiums (which are taxable to the employee) for post-employment coverage. See generally JCEB Q&As, May 10-12, 2007, Q&A-1; JCEB Q&As, May 7-9, 2009, Q&As 1-3. It is interesting to note that the arguably favorable results in the Section 105(h) context arise even though former employees are required to be treated separately from current employees. See Treas. Reg. § 1.105-11(c)(3)(iii).

Nondiscrimination Rules in the case of an insured plan, since the PPACA Nondiscrimination Rules are essentially effected by cross reference to the rules in Section 105(h).[30] In this regard, the reference in Section 2716 of the PHSA to rules "similar to" the rules under Section 105(h) of the Code would arguably call for mere technical adjustments to rules previously applicable in one context (self-insured plans) for use in another context (insured plans). Under this view, the extension of the same results arising for a plan subject to Section 105(h) to plans subject to the PPACA Nondiscrimination Rules could be appropriate.

We do not mean to suggest that (assuming arguendo that Section 105(h) would not reach discriminatory access to Non-COBRA Coverage under a self-insured plan) there necessarily must be consistent results under Section 105(h) and PPACA. In this regard, we acknowledge that any favorable results under Section 105(h) may be driven by a technical lack of application of Sections 104, 105 and 106 to employee-pay-all coverage, and that such results therefore do not inexorably apply under the PPACA Nondiscrimination Rules. Stated another way, while Section 105(h) fundamentally approaches the question of discriminatory health benefits in the context of determining taxable income, the PPACA Nondiscrimination Rules are generally concerned with prohibiting employers from providing insurance on a discriminatory basis as a matter of substantive law. We also note again that Section 2716 of the PHSA refers to the definition of discrimination under Section 105(h), but not to the penalty under Section 105(h)(1) of income inclusion for violation of the Section 105(h) discrimination rules. Thus, even if the ultimate result under Section 105(h) is that taxable post-employment Non-COBRA Coverage is outside the scope of Section 105(h) because it is taxable, it is not clear that this result should control for purposes of PPACA.

However, the potential application of non-tax as well as tax penalties to programs which had previously not been subject to any non-discrimination regime, by reference to existing rules which do not themselves impose any such employer penalties, might be viewed as something which should result only from more explicit Congressional direction. Further, it would arguably be somewhat anomalous to have insured plans, which were previously altogether unregulated, now be subject in this respect to rules that are more onerous than those rules which were, and continue to be, applicable to self-insured plans, which have been regulated for years and which will not be subject to the PPACA Nondiscrimination Rules. We also note that the PPACA provisions at issue here are arguably aimed at fundamental health coverage provided by employers to active employees in the ordinary course, and not necessarily to post-employment benefits continuation provided on a fully taxed or employee-pay-all basis.[31]

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[30] We note our view, as indicated previously herein, see note 27 above, that the better analysis for a case in which the employer pays or reimburses the premiums for coverage under a conversion or other individual (or family) insurance policy is the analysis described in Section I above, not analyses considered in this Section II that might apply in the case of non-COBRA continuation under a group plan generally. In the case of the employer's payment or reimbursement of premiums for coverage under a conversion or other individual (or family) policy, (i) the amount of the payment or reimbursement is straightforward (i.e., the amount of the paid or reimbursed premium), as in the case of the COBRA payment or reimbursement, and (ii) there would not generally be any issues regarding the scope of access to the underlying coverage as, by hypothesis, the individual has qualified for and in fact is being issued (or has been issued) an individual (or family) policy.

[31] We also note that PPACA generally is intended to increase coverage. See PPACA § 1501(a)(2)(C)-(G). On the other hand, Section 2716 of the PHSA on its face constrains the provision of discriminatory benefits.

One advantage to an approach which would permit Non-COBRA Coverage on a fully taxable basis, even if discriminatory, is that it may be easier for affected employers to administer, without requiring a fundamental alteration to years of existing practices or agreements. As noted above, if Treasury and the IRS determine that more restrictive rules should apply to insured plans than self-insured plans, then a wide variety of employment and separation agreements, and other arrangements will have to be changed (and such changes may not be possible where unilateral amendments are not permitted under the terms of such agreements). We recognize that the need to address existing agreements may be ameliorated somewhat with transitional relief, as suggested in Section III below. However, any such amelioration would not be comprehensive. For example, (i) the impact of the new PPACA rules on a multitude of arrangements that are not fundamentally part of a group health plan or other health-care arrangements (e.g., employment and separation agreements) would still be present on a going-forward basis, introducing difficult new rules and dynamics outside of the basic health-care system, (ii) grandfather relief would not diminish the need to identify and inventory these arrangements in light of compliance concerns, and (iii) transitional relief may not apply to renewed contracts, and the type of employment agreement likely to include health care continuation of this type frequently contains automatic-renewal (so-called "evergreen") provisions, thus potentially serving as a trap for the unwary when an agreement is automatically renewed (and, even when an employer focuses on this issue, dislocating and other difficult issues may be raised in the context of an agreement which, but for this issue, might simply automatically renew with no further negotiation).

If taxable Non-COBRA Coverage is permitted to be made available on a discriminatory basis, we recognize the compliance issues potentially raised where coverage is provided other than through the reimbursement of COBRA premiums or the payment by the former employee of the cost of the coverage. In particular, an employer may fail to report subsidized coverage as being taxable. We believe that any decision by Treasury and the IRS to permit an employer to allow after-tax access to continued coverage on a discriminatory basis should be conditioned on the proper reporting of the applicable amounts.[32]

b. Amount of Inclusion

If Treasury and the IRS were to decide to permit the provision of discriminatory (non-uniform) Non-COBRA Coverage on an after-tax basis,[33] employers and employees will need to determine the amount of taxable compensation to be included in the former employee's income.[34] We recognize that the out-of-pocket cost to the employer may not equal the "value" of the benefit to the former employee. We also recognize that the "value" to the employee could be

[32] Cf. Treas. Reg. § 1.83-6(a)(1), (2) (effectively conditioning the service recipient's deduction under Section 83(h) on the service recipient's timely satisfaction of all requirements under Section 6041 or Section 6041A).
[33] See also notes 27, 30 (relating to conversion and other individual policies).
[34] Where the amount in question is an actual COBRA premium paid for or reimbursed by the employer while a former employee is eligible to continue coverage under COBRA, as discussed in Section I, above, the includible amount should never exceed the amount of the COBRA premium, regardless of the extent to which the COBRA rate might be less than generally applicable market value. In such a case, the former employee could conclusively purchase the coverage at the COBRA rate.

defined in numerous ways and there is no generally applicable authority that we are aware of that resolves the question of how value should be determined for this purpose.[35]

Although the IRS has not issued generally applicable guidance on the amount required to be included in income with respect to the provision of benefits under a group health plan, the issue has arisen in other contexts. In Private Letter Ruling 200108010 (Nov. 17, 2000), the IRS specified certain tax results in a case where income was to be included as a result of the provision of taxable health coverage by a certain voluntary employees' beneficiary association, where "[t]he Fund uses, as the value of the domestic partner coverage, the projected fair market value of the Fund's health care coverage, as determined on an annual basis for purposes of determining the rates charged for COBRA coverage under section 4980B(f). Specifically, the domestic partner coverage is valued in accordance with the actuarially determined rates for individual or family COBRA coverage (as may be applicable . . .), less any payment that a Participant may be required to pay the Fund for domestic partner coverage."[36] Evident advantages to this approach include ease of administrability and certainty of results. However, we recognize that, in the ruling, the IRS did not specifically approve this valuation methodology.

We acknowledge that COBRA premiums may reflect some distortion of the fair market value of coverage because (i) COBRA premiums may reflect rate advantages deriving from group coverage and (ii) COBRA premiums are based on general costs for Non-COBRA participants, and thus ignore such things as the age of the individuals seeking coverage and other possible individual circumstances that could result in upwards pressure on costs under currently applicable law. If Treasury and the IRS view these considerations as problematic for the use of COBRA premiums as determinative of fair market value, we would encourage the exploration of the use of COBRA premiums as a baseline, which could be increased by a percentage to be established by Treasury and the IRS after consideration of factors such as those noted in the foregoing sentence. We are concerned that, if Treasury and the IRS do not proceed in some fashion based on existing COBRA or other group rates, then the task of valuing the coverage may become daunting and unadministrable, especially since actuarial valuations of the expected cost of an insurance policy purchased in the individual market with terms conforming to the employer's group plan may not be readily available or determinable.[37] In addition, we are extremely concerned that the adoption of an approach to valuation issues that would require market-based valuations could have substantial collateral consequences by raising questions regarding proper valuation in other contexts (e.g., the amount of imputed income in the case of domestic-partner coverage).

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[35] From time to time, there have been indications that Treasury and IRS personnel demur on the question of what is the proper method of valuation. See, e.g., JCEB Q&As, May 7-9, 2009, Q&As 1, 2; cf. JCEB Q&As, May 7-9, 2009, Q&A 3 (where it was indicated that, where coverage is provided to an individual not entitled to exclusion from taxation, the fair market value of the coverage is considered income, even if the additional coverage does not result in increased marginal cost).

[36] See also PLR 9850011 (Sept. 10, 1998) (prior ruling for the same fund); PLR 200339001 (June 13, 2003) ("The excess of the fair market value of the medical and dental coverage provided by Taxpayers to a domestic partner who does not qualify as a section 152 dependent of the employee, over the amount paid by the employee for such coverage, is includable in the employee's gross income and is subject to income tax withholding and employment taxes.").

[37] A minority of the Executive Committee feels that Treasury and the IRS should give consideration to permitting affected parties to use lower values where a lower valuation can be established by clear and convincing evidence.

We also believe that, in determining the amount of inclusion for Non-COBRA coverage, Treasury and the IRS should consider the question of whether to make reference to COBRA premiums as adjusted downwards to eliminate the administrative charge permitted to be charged under the COBRA rules.[38] Using the COBRA premium, less the administrative charge, as a baseline for any formula based or other adjustments described above could yield a more accurate estimate of the value of coverage, since the determination would be based on the cost of coverage and not the cost of unrelated administrative services.[39]

Eventually, the determination of the amount of inclusion may not be as complex or uncertain following the implementation of state insurance exchanges, as required by Section 1311 of PPACA. Once an insurance exchange is operating in a state, it may be sensible to use the average cost of insurance coverages offered on that state's exchange at the "level of coverage"[40] into which the plan would fall if it were an exchange-offered plan. For example, if the employer's insured group health plan is designed to provide benefits worth 90% of the full actuarial value of the benefits provided under the plan, then the employer would determine the inclusion amount by taking the average value of all plans at the platinum level offered through the exchange. This method could allow employers to determine the expected cost of obtaining coverage comparable to the employer's group plan in the individual market with greater accuracy, without imposing the types of onerous or expensive administrative difficulties described above.

## III. Transitional and Grandfathering Concerns

### A. Background

When employers provide post-employment continuing coverage on a non-uniform or case-by-case basis, such arrangements are frequently set out in an employment contract (during the period of employment) or a severance agreement (entered into at the time of termination) or some other agreement – in each case, an agreement that is not a part of the established group health plan. If the PPACA Nondiscrimination Rules are interpreted so as to prohibit such non-uniform post-employment benefits, then employers will need to review all of their existing written obligations (both those currently operating for former-employees and those set to go into effect when a current employee retires or is terminated). Each agreement will need to be evaluated to determine if it can be unilaterally amended, and negotiations and amendments may

[38] Cf. PLR 200108010 (Nov. 17, 2000) (where the employer reported inclusion using the projected fair market value as determined on an annual basis for purposes of determining the rates charged for COBRA coverage (i.e., valuing coverage in accordance with the actuarially determined rates for COBRA coverage)); JCEB Q&As, May 7-9, 2009, Q&A 3 (where it was specifically proposed that inclusion be based on the amount of the COBRA premium less the 2% administrative charge permitted by COBRA, although the Treasury/IRS answer declined to comment on that particular proposal).
[39] We note, however, that a reduction for the COBRA administrative charge in the case of post-COBRA continuation could have the possibly counterintuitive result of including in the income of an individual not eligible for COBRA coverage an amount that may be less than the amount included in income for the COBRA participant, if the inclusion for the COBRA participant is for the full COBRA premium.
[40] See PPACA §1302.

ensue. Even if grandfathering is available, questions will arise for grandfathered agreements that are required to be renewed periodically and agreements that are amended (even for example if the amendments do not alter the health benefits provisions).

B. Recommendation

If non-uniform post-employment coverage or benefits are not permitted, we believe that grandfathering and transitional rules should be adopted.

C. Explanation

It may not be possible or feasible, given a variety of concerns (e.g., contractual concerns, tax concerns arising where grandfather treatment is being sought under Section 409A or other Code provisions), for an employer to make unilateral changes to existing arrangements, thus raising the prospect of potentially large PPACA penalties if employers are actually or effectively unable to change existing contracts which are considered to run afoul of the PPACA Nondiscrimination Rules. In addition, the type of employment agreement likely to include health-care continuation of this type frequently contains evergreen provisions, thus potentially serving as a trap for the unwary when an agreement is automatically renewed, particularly before employers have had the opportunity to become accustomed to the new rules once finalized.

Given that the policies behind PPACA would not support punishing those employers and employees who entered into non-PPACA compliant agreements prior to the issuance of regulations interpreting and implementing the PPACA Nondiscrimination Rules, we believe that transition and grandfathering rules are appropriate. Thus, we are encouraging flexibility regarding the application of the new rules to existing arrangements, and specifically suggest that special attention may need to be given to those agreements that cannot be changed unilaterally.[41]

[41] Treasury and the IRS may wish to consider expressly providing that for purposes of Section 1251 of PPACA (relating to grandfathered plans) any changes made to an employment, severance, or other agreement which is not a core health-plan document should not be considered a change to existing coverage under a group health plan that might compromise a plan's grandfathered status under PPACA generally.