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OVERVIEW OF MEDICAL LOSS RATIO REBATES

The Affordable Care Act requires health insurers to spend a minimum percentage of their premium dollars on medical claims and quality improvement. Insurers in the large group market must achieve a medical loss ratio (MLR) of 85%, while insurers in the individual and small group markets must achieve an MLR of 80%. Insurers that fail to achieve these percentages must issue rebates to their policyholders. The first of these MLR rebates are due in August of 2012, so plan sponsors should begin planning how to handle any rebates they might receive.

Which Plans Are Covered?

The MLR rules apply to all fully insured health plans (even grandfathered plans). Self-funded plans are exempt. Certain types of insured coverage, such as fixed indemnity, stand-alone dental and vision, and long-term disability, are also exempt.

If a rebate is payable to a group policyholder, the insurer must issue a single rebate check to the plan. The plan sponsor must then decide whether and how to pass the rebate on to the plan's participants.

Calculating a Medical Loss Ratio

The calculation of an MLR is not specific to each policyholder, but is a state-by-state aggregate of the insurer's overall MLR within a particular market segment (e.g., individual, small group, or large group). Thus, even if a specific employer plan has a low MLR (i.e., favorable claims experience), the employer may not necessarily receive a rebate.

States are permitted to set higher MLR targets. In those states, insurers must comply with the more stringent state requirements.

Notices to Subscribers

Insurers must send written notices to their subscribers, informing them that a rebate will be issued. Plan sponsors should be prepared to respond to questions from participants who receive these notices, particularly if the sponsor does not intend to share any of the rebate with those participants.

Likewise, even if an insurer meets the MLR requirements, it must notify subscribers that no rebate will be issued. This notice must be included with the first plan document provided to enrollees on or after July 1, 2012. Model notices are available on the Centers for Medicare & Medicaid Services website.

How to Allocate MLR Rebates

The Department of Labor (DOL) issued Technical Release 2011-04, summarizing how ERISA plan sponsors should handle MLR rebates. To the extent that all or a portion of the rebate constitutes a "plan asset," the sponsor may have a fiduciary duty to share the rebate with plan participants.

In the absence of specific plan or policy language, the determination of whether an MLR rebate is considered to be a plan asset will depend, in part, on the identity of the group policyholder. If the *plan or trust* is the policyholder, the MLR rebate will likely be considered a plan asset under ordinary notions of property rights.

However, if the *employer* is the policyholder, the determination will hinge on the source of the premium payments and the percentage of premiums paid by the employer, as opposed to plan participants. If the premiums were paid entirely out of plan assets, the DOL's view is that the entire amount of the rebate would be considered a plan asset. In other circumstances, only the portion of the rebate that is attributable to participant contributions will be considered a plan asset.

If all or a portion of a rebate *does* constitute a plan asset, then the plan sponsor will have to determine how and to whom to allocate the rebate. For example, must a portion of the rebate be allocated to *former* plan participants? The selection of an allocation method must be reasonable and it must be made solely in the interest of plan participants and beneficiaries.

However, a plan fiduciary may weigh the costs to the plan - and the ultimate plan benefit - when deciding on an allocation method. Thus, for example, if the cost of calculating and distributing shares of a rebate to *former* participants approximates (or exceeds) the amount of the proceeds, a fiduciary is permitted to limit the allocation to *current* plan participants.

Similarly, if it is not cost-effective to distribute cash payments to plan participants (because the amounts are de minimis, or they would produce negative tax consequences for the participants), a fiduciary may use the rebate for other permissible plan purposes. These might include a credit against future participant premium payments or benefit enhancements.

Tax Consequences

Before deciding to pass an MLR rebate on to participants, a plan sponsor will want to understand the tax implications of doing so. The IRS has issued a set of questions and answers on this topic. Because this guidance is entirely in the form of examples, with few general principles provided, the tax treatment may not always be clear. What *is* clear is that a number of factors will affect the taxability of an MLR rebate.

For *individual* policyholders receiving an MLR rebate, the IRS treats the rebate as a return of premiums (i.e., a purchase price adjustment). As long as the premium payments were not deducted on the individual's federal tax return, the MLR rebate should not be taxable. However, if an individual did deduct the premium payments, the MLR rebate will be taxable to the extent the individual received a tax benefit from that deduction.

For participants in a *group* plan, the tax consequences will depend on factors such as the source of the premium payments (employer versus participant), whether participant premiums were paid on an after-tax or pre-tax basis, and whether a participant who paid premiums on an after-tax basis later deducted those premiums on his or her federal income tax return.

Another key factor is whether the rebates are passed through only to participants who participated in the plan during *both* the year to which the rebate relates *and* the year it is received, or to all participants who participate during the year the rebate is received (i.e., without regard to whether they also participated during the year to which the rebate relates).

For instance, if a participant paid premiums on an after-tax basis and the MLR rebate is specifically conditioned on the participant having participated in the plan during both the year to which the rebate relates and the year it is received, any rebate allocated to that participant will generally not be taxable - regardless of whether the rebate takes the form of a cash payment or a reduction in future premium payments. However, if the participant claimed a tax deduction for the premium payments (as might be the case for a self-employed individual), the rebate will be taxable to that participant.

On the other hand, if an MLR rebate is passed through to *all* current plan participants (regardless of whether they participated in the plan during the year to which the rebate relates), the rebate should not be taxable even if a participant took a tax deduction for premiums paid during that year.

Finally, if a participant paid premiums on a *pre-tax* basis (i.e., through a cafeteria plan), the return of those premiums - whether received in cash or as a credit against future premiums - will be subject to both income and employment taxes.

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