

Employment, Labor & Benefits Advisory

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IRS Issues FAQs on Tax Treatment of MLR Rebates

BY [ALDEN J. BIANCHI](#)

On April 19, 2012, the Internal Revenue Service (IRS) issued a set of [Frequently Asked Questions](#) (FAQs) explaining the tax treatment of premium rebates under the Medical Loss Ratio (MLR) requirements imposed by the Patient Protection and Affordable Care Act (the Act).

The Act requires group health issuers in the individual and group markets to report plan costs for the purpose of calculating the insurers' medical loss ratio (the percentage of insurance premium dollars spent on reimbursement for clinical services and activities to improve health care quality). Absent an express waiver, large group insurers must spend at least 85% of premium dollars on claims and activities to improve health care quality, and individual and small group insurers must spend at least 80% of premium dollars on claims and activities to improve health care quality. The calculations are based on each carrier's aggregate experience by state. While these rules apply to virtually all carriers, there are some adjustments (e.g., to prevent market destabilization and for mini-med and expatriate plans).

Beginning in August 2012, health plans must provide rebates to enrollees if the plan's medical loss ratio does not meet the minimum standards for a given plan year. The IRS issued the FAQs for the purpose of providing information on the federal tax consequences to a health insurance issuer that pays a MLR rebate and an individual policyholder or plan participant who receives the MLR rebate.

The table below summarizes the tax consequences to various parties to the MLR rebate under commonly occurring facts and circumstances.

Entity	Tax Treatment
(1) Insurance Companies	MLR rebates paid by an Insurance Company, either as cash payments or as premium reductions, are return premiums. Return premiums reduce an Insurance Company's taxable income.
(2) Policies Purchased on the Individual Market	(a) If the policyholder purchased coverage with after-tax dollars (i.e., he or she did not deduct the premium payments on IRS Form 1040 Schedule A), the rebate is not taxable, irrespective of whether received as a cash payment or applied as a reduction in the amount of the next year's premiums. (b) If the policyholder deducted the premium payments on his or her IRS Form 1040 Schedule A, then his or her MLR rebate is subject to federal income tax.
	The MLR rebate is a rebate of part of the policyholder's prior year premiums (what the FAQs refer to as a "purchase price adjustment").

<p>(3) Group Policies— Employee After-Tax Premium Payments</p>	<p>The taxpayer paid taxes on his or her compensation in the prior year and used part of the after-tax income to pay his or her portion of the current premiums. Because he or she did not deduct the premiums, the rebate is not taxable.</p> <p>The result is the same if the policyholder receives a cash distribution of the MLR rebate. The cash in this instance is a reduction in the cost of future premiums.</p> <p>But if the policyholder had previously deducted his or her premium payments, the MLR rebate would be subject to federal tax on his or her Form 1040.</p>
<p>(4) Group Policies— Employee Pre-Tax Payments (MLR rebate limited to employees participating in a group health plan both in the year the employee paid the premiums being rebated and the year the MLR rebates are paid)</p>	<p>Where MLR rebates are provided only to employees participating in a group health plan both in the year the employee paid the premiums being rebated and in the year the MLR rebates are paid, and where the employer applies the rebate to reduce current premiums, the rebate is taxable. Because the MLR rebate is distributed as a premium reduction, the amount the employee pays for premiums through a salary reduction contribution in the subsequent year is decreased by \$X. As a consequence, there is a corresponding increase of \$X in his or her taxable salary (that is wages also subject to employment taxes).</p> <p>The result is similar if the MLR rebate is paid in cash: The employee has an \$X increase in taxable income for the year in which the rebate is paid.</p>
<p>(5) Group Policies— Employee Pre-Tax Payments (MLR rebate paid regardless of whether the employee who receives the MLR rebate participated in the plan during the plan year covered by the MLR rebate)</p>	<p>As to previously covered employees, the result is the same as (4) above.</p> <p>As to employees who were not previously covered, if the MLR rebate is distributed as a premium reduction, the amount the taxpayer pays for premiums through a salary reduction contribution is decreased by \$X. As a consequence, there is a corresponding increase of \$X in his or her salary, which is taxable income (that is wages also subject to employment taxes).</p> <p>If the employee instead receives an \$X cash payment, he or she will have \$X more taxable income in the year the rebate is paid. The amount the taxpayer pays for premiums for health insurance is subtracted from his or her salary on a pre-tax basis under his or her employer's cafeteria plan. The MLR rebate is a return to the employee of part of that untaxed compensation that is no longer being used to pay for health insurance. Therefore, the MLR rebate is an increase in taxable income (that is wages also subject to employment taxes).</p>

There are no surprises here: The tax consequences set out above are consistent with fundamental principles of federal income taxation. The IRS rightly takes the position that the immediate consequence of a premium rebate triggers a corresponding increase in taxable income. The FAQs achieve this result in a way that does not impose further reporting burdens on the plan sponsor.

For employers and employer-sponsored group health plans, items (4) and (5) above are of greatest interest. The vast majority of employer-sponsored health plans require some contribution by employees toward the cost of premiums, and the vast majority of these take advantage of the cafeteria plan rules under which employee contributions are made on a pre-tax basis. The Department of Labor, in its Technical Release 2011-04, provided a roadmap on apportioning MLR rebates where premium contributions come from both employers and employees. This guidance generally supports the apportionment of MLR rebates by way of a premium reduction regardless of whether employees participated in the plan during the plan year covered by the MLR rebate. This is good news for employers, since it will minimize additional administrative effort.

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