

Tax Action Memo®

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Helping Clients Deal with the New COBRA Subsidy Rules

<p>Type of Clients: Businesses who maintain group health plans covering at least 20 employees.</p> <p>Situation: The business involuntarily terminates an employee anytime between 9/1/08 and 12/31/09.</p> <p>Deadline: ASAP, but no later than 4/18/09 when notices will need to begin.</p>	<p>Tax Action Required: Read this release to get up to speed on what affected clients are required to do so you'll be ready to help when they call.</p>
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Background

Employers who maintain group health plans covering at least 20 employees are required to offer terminated employees and their dependents (i.e., qualified beneficiaries) the opportunity to continue to participate in the group health plan for up to 18 months. The employer must notify the plan administrator (typically the insurance company) within 30 days of the qualifying event (i.e., loss of employment). Within 14 days of receiving this notice, the plan administrator must notify the qualified participants of their rights under COBRA. Generally, employers offer this *COBRA continuation coverage* to qualified beneficiaries by having the individual pay the actual cost of the coverage plus a 2% administrative fee.

Note: Sometimes the employer is the plan administrator. In this case, the employer has 44 days to notify qualified participants of the COBRA rights. To determine whether the employer is the plan administrator, you'll need to check the plan document. In fact, that's really the first thing you need to do when a client calls for advice on dealing these new rules, as that's the only way to determine for certain who is responsible for what under these new rules.

One of the primary purposes of the COBRA continuation coverage requirements is to ensure that employees can maintain their health insurance when they change jobs—voluntarily or otherwise. Although the former employers can pay for the COBRA coverage, they are not required to do so and typically do not. So, except in the case of laid-off employees who are lucky enough to be covered by a severance package that includes health coverage, most former employees have to pick up the full bill (plus the 2% administrative fee) to continue their coverage. This is, of course, next to impossible for someone who has been laid off in a bad economy with dismal job prospects. So, Congress came to the rescue in the American Recovery and Reinvestment Act of 2009 (Stimulus Act).

For periods of coverage beginning after 2/16/09, the Stimulus Act provides that the government will pick up (subsidize) 65% of an eligible individual's tab for up to nine months of COBRA premiums. It's hard to argue with the individual's need for help here and it sounds simple enough, right? Not so much—although former employers are not on the hook for paying the subsidy, they are likely on the hook for administering a large part of the process and the mechanics of how this is suppose to work is likely to have your business



clients pulling out their hair (all for their 2% administration fee—we hope). They'll probably be looking to you for help, so here's the deal.

Note: The Stimulus Act is silent regarding whether the subsidy applies to the COBRA premiums with or without the 2% administrative fee. We think it's included, but we can't be certain without additional guidance from the IRS.

The Mechanics

Specifically, the Stimulus Act provides for a 65% government-paid subsidy for COBRA continuation payments for up to nine months to Assistance Eligible Individuals (AEIs) for periods of coverage beginning after 2/16/09. (Generally, this means for coverage beginning 3/1/09, since most plans offer coverage on a monthly basis.) Of course, the government is not going to pay its 65% share of the premiums directly. Instead, the entity that receives the former employee's COBRA premium—typically the former employer—gets that honor. Here's how this is suppose to work:

1. *Step 1*—the AEI pays to the former employer 35% of the COBRA premium.
2. *Step 2*—the former employer timely pays the full premium (i.e., the 35% received from the AEI and the 65% subsidy) to the insurance company, or, in the case of a self-insured plan, it accepts the 35% payment as the full payment.
3. *Step 3*—the former employer is treated as having paid (i.e., deposited) payroll taxes equal to the portion of the premium it pays (i.e., the 65% subsidy) for each AEI [IRC Sec. 6432(c)(1)]. If the amount of COBRA subsidies it pays exceeds its payroll tax liability, the excess will be credited as an overpayment to the next quarter or refunded. The term *payroll taxes* means amounts required to be deducted and withheld from employees for Federal income tax withholding (FITW) and FICA, as well as the employer's portion of FICA taxes [IRC Sec. 6432(d)(1)].

Note: In some cases, a party other than the former employer is party that receives the COBRA premium and, thus, is the proper party to provide the subsidy and take the credit on its Form 941. For example, this likely will be the case if the COBRA coverage is provided by one of the multiemployer plans commonly marketed to smaller employers. These plans are typically responsible for all elements in administering the plan, including collecting the COBRA premium, so they will be the party to provide the subsidy and be reimbursed by taking a credit on its Form 941. (This means the sponsoring employer is off the hook for COBRA subsidy payments and notices discussed in this release.) However, for our purposes, we will refer to the responsible party as the former employer.

Practice Tip: The AEI must actually pay the 35% premium to the former employer and the employer must then timely pay the total COBRA premium to the insurer *before* the premium assistance payments can be used to reduce a required payroll tax deposit or the liability reported on Form 941. For self-insured plans, the employer is deemed to have paid the 65% subsidy when it receives the AEI's 35% premium.

Observation: The 65% government subsidy applies irrespective of the amount (if any) that the employer pays for active employees' premiums. Therefore, AEIs may end up paying less than they did before they were terminated and less than their former cohorts who are still employed.

Assistance Eligible Individuals (AEIs) Defined

An AEI is an employee whose employment has been involuntarily terminated between 9/1/08 and 12/31/09, and who is eligible for and elects COBRA coverage. AEIs also include family members who are eligible for and elect COBRA coverage due to their relationship to the involuntarily terminated employee (e.g., the employee's spouse and dependents who were covered immediately prior to the employee's termination).

When is an employee considered to be involuntarily terminated? Good question, as this term has not been defined. This is apparent sometimes. For example, an employee who is laid off without cause is clearly involuntarily terminated, whereas an employee who voluntarily quits or is fired for gross misconduct is not. But, what about an employee who is offered and accepts early retirement? The Treasury has indicated that it's working on guidance on this definition. So, hopefully guidance will be forthcoming in the near future.

Second Chance Election. AEIs involuntarily terminated after 8/31/08 and before 2/17/09 who did not enroll for COBRA benefits at the time of their termination or who did elect COBRA, but are no longer enrolled, have a special extended 60-day period in which to elect (or reelect) COBRA benefits. They can make this election anytime during the period beginning on 2/17/09 and ending 60 days after the date on which the notice regarding the extended election period is provided to them.

The COBRA coverage elected during the extended election period must begin with the first coverage period beginning after 2/16/09—typically 3/1/09. It does not allow the employee to elect retroactive coverage back to the date of termination. Also, the maximum COBRA coverage period (generally 18 months) runs from the AEI's termination date, not March 1.

Required COBRA Subsidy Notices

Plan administrators are required to notify *all* individuals who have a COBRA qualifying event during the period from 9/1/08 through 12/31/09—even those who are not involuntarily terminated—about the COBRA subsidy. The notices can be sent separately or along with other notices that are normally provided following a COBRA qualifying event. Obviously, individuals who terminated after 8/31/08 and before 2/17/09 and who have already received their COBRA notice without the COBRA subsidy notice, will need to be sent a separate subsidy notice.

Note: Although the plan administrator and the employer can be one and the same, in this discussion, we presume that the plan administrator is the insurance company. You'll need to check the plan document to properly identify the administrator of a specific plan.

Practice Tip: The required notices must contain specific information, including enrollment rights and election forms. Plan administrators can draft their own notices. However, to ensure that all the necessary elements are included, it is strongly recommended that they use the DOL model notices posted at www.dol.gov/ebsa/cobramodelnotice.html.

The timing of the COBRA subsidy notices depends on when the COBRA qualifying event took place:

1. For AEIs who had elected COBRA continuation coverage as of 2/17/09, the COBRA subsidy notice is required to be provided by 4/18/09. The COBRA subsidy must begin with the first coverage period beginning after 2/16/09—typically 3/1/09.

Practice Tip: As the subsidy notice (including the reduced premium amount) doesn't have to be provided to the AEI until 4/18/09, it is likely that many AEIs will have paid the full COBRA premium (rather than the reduced 35% portion) for March and April. In this case, the employer must allow the excess premium to be refunded or used as a credit against subsequent premiums. However, if the credit won't be used within 180 days, it must be refunded within 60 days.

2. For AEIs who are eligible for a second chance election (see earlier discussion), the COBRA subsidy notice is also required to be provided by 4/18/09. The individual has 60 days after the notice is received to make a new COBRA election (which must be effective with the first coverage period beginning after 2/16/09—typically 3/1/09) and, presumably based on normal COBRA rules, another 45 days to pay the premium.

Observation: How the plan administrator is supposed to locate these individuals is not addressed. Presumably, a good faith effort will suffice.

3. For AEIs who become COBRA eligible after 2/16/09, the COBRA notices (including the COBRA subsidy notice) must be made within 44 days of the termination. (The employer has 30 days to notify the plan administrator of the termination. The plan administrator then has 14 days to provide the COBRA notices.) Again, the individual generally has 60 days after the notice is received to make the COBRA elections and another 45 days to pay the reduced premium.

Practice Tip: The employer should wait until it receives the AEI's payment before paying the COBRA premium to the insurer. The government will not reimburse the employer unless (and until) the AEI pays his or her 35% share.

Failure to provide the subsidy notice (including providing notices that don't contain all the required information) is treated as a failure to meet the COBRA notice requirements. Thus, failure to provide the notice can subject the plan administrator to a penalty of \$110 per day/per AEI. Ouch!

Enrollment Process

As noted earlier, the COBRA notices (including the subsidy notice) must be sent to *all* individuals who have a COBRA qualifying event during the period from 9/1/08 through 12/31/09—even those who are not involuntarily terminated. The plan administrator makes the determination as to whether the individual qualifies for the subsidy when the potential AEI submits the completed forms and elections. Individuals can appeal rejections to the Department of Labor, who is required to give the individual a ruling within 15 business days of receiving the appeal notice.

AEIs can be allowed to enroll in COBRA coverage that is different (e.g., has fewer benefits) from the coverage that was in effect when employment was terminated. However, the premium for this coverage cannot cost more than it did for the coverage the employee had on the date of termination; must also be offered to the employer's active employees at the time the election is made; and cannot provide only dental, vision, counseling, or referral services (or a combination of those services). Additionally, coverage under a cafeteria plan flexible spending account (FSA) is not acceptable as COBRA coverage.

A business that terminates its health plan is not required to provide COBRA continuation coverage or to make the subsidy payments. For example, a business that shuts down, terminates its group health plan, and lays off all its employees is not required to provide COBRA coverage or pay the government subsidy. However, as long as the group health plan is continued, AEIs must continue to be covered and subsidized.

Form 941 Reporting Requirements

The COBRA subsidy payments made during the quarter are reported on the 2009 Form 941 on line 12a. These payments are added to the actual payroll tax deposits made (which are reported on line 11), and compared to the total net payroll tax liability after advance EIC payments, to determine if there is a balance due or overpayment for the quarter. The payroll report is the only way for an employer to be reimbursed for subsidy payment.

Instead of claiming the credit on Form 941 for the quarter during which the COBRA subsidy payments are made, the employer may choose to claim the credit on the Form 941 filed for a later quarter in the same calendar year. However, if the employer reduces its payroll tax deposits during a quarter by the amount of the COBRA subsidies paid during that quarter (or during a previous quarter), it must claim the credit for those payments on the Form 941 filed for the quarter during which it reduced the payroll tax deposits. Alternatively, if the employer has not claimed the credit on the original Form 941 for the quarter during which the COBRA premium assistance payments are made, it can file a Form 941-X for that quarter.

Caution: The employer should carefully track when it claims the credit (and if it reduces any payroll tax deposits, which deposits are reduced), so that the credit for each COBRA premium assistance payment is taken only once (i.e., reported on only one Form 941 or Form 941-X).

Note: The COBRA subsidy payments may be used to reduce payroll tax deposits or shown only on Form 941 as a credit. If the amounts are shown only on Form 941 at the end of the quarter, the employer will likely have an overpayment that it can request to be refunded or carried forward to the next quarter.

Practice Tip: According to the IRS, if payroll deposits are reduced by the subsidy payment, the payment subcategory breakdown (between FITW, FICA, etc.) should not be entered in the EFTPS system or on the paper coupon. This breakdown is not required and if the entries don't reconcile to the actual amount of the deposit (which they won't because there is no place to enter the subsidy payment), the deposit will not be posted properly.

Required Recordkeeping

Employers claiming the COBRA subsidy payments as a credit to their payroll tax liability are required to maintain documentation supporting the amounts claimed. The required documentation is *not* submitted with the Form 941. This documentation includes (but is not limited to):

1. Dates and amounts received for each AEI's 35% share of the COBRA premium.
2. For insured plans, a copy of the premium invoice or other supporting documentation from the insurer, and proof of timely payment of the full premium (as required under COBRA) to the insurer.
3. For self-insured plans, proof of the premium amount and coverage provided to each AEI.
4. Attestation of the involuntary termination, including the date (which must be between 9/1/08 and 12/31/09), for each AEI whose involuntary termination is the basis for eligibility for the subsidy.
5. Proof of each AEI's COBRA eligibility at any time between 9/1/08 and 12/31/09 and the COBRA election.
6. The social security number of all AEIs, the amount of the subsidy reimbursed with respect to each AEI, and whether the subsidy was for one individual or two or more individuals.
7. Any other documents necessary to verify COBRA subsidies paid and credited on Form 941.

How Long Does the Subsidy Last?

Individuals can remain eligible for the 65% subsidy for up to nine months. However, if earlier, the subsidy will end on the date: (1) they become eligible for coverage under another group health plan (e.g., a spouse's plan) or Medicare, or (2) the maximum period for COBRA coverage ends.

For the individual to be considered eligible for coverage under another health plan, the new plan must provide benefits beyond dental, vision, counseling, or referral services (or a combination of those services). Additionally, coverage under a cafeteria plan FSA is not acceptable coverage.

Of course, the employer will have no way of knowing when the individual becomes eligible for coverage under another group health plan or Medicare. Fortunately, it's not the employer's problem. Instead, the AEI who becomes ineligible is required by the law to notify the former employer. Failure to do so timely will result in the AEI being assessed a penalty of 110% of the subsidy paid after the eligibility ended. [See IRC Sec. 6720C(a).] However, the penalty won't apply if the ineligible AEI stops paying the reduced COBRA premium once eligibility ends. (This only makes sense, as the former employer won't pay the subsidy if the reduced COBRA premium is not received.)

Observation: How the IRS will monitor this remains to be seen. Currently, there's no way for them to know when an AEI is covered by a group health plan and getting that information won't be an easy task.

Effect of the Premium Subsidy on AEIs

The premium subsidy is not included in the AEI's income for Federal income tax or FICA purposes. However, taxpayers with modified adjusted gross income (MAGI) between \$125,000 and \$145,000 [\$250,000 and \$290,000 for married taxpayers filing joint returns (MFJ)] will have to repay some or all of any COBRA subsidy they receive. Specifically, their Form 1040 tax *liability* will be increased to achieve the repayment.

Once again, employers will have no way of knowing if an AEI will have MAGI over \$125,000 (\$250,000 for MFJ) and, fortunately, this is not their responsibility. However, as part of the COBRA election process, plan administrators are required to allow an otherwise AEI to permanently elect to waive the subsidy.

Warning: Making the election to waive the COBRA subsidy will prevent the AEI from having to repay the subsidy. However, the election is permanent. Once made, the individual is not entitled to a subsidy even if MAGI turns out to be less than the applicable threshold for the year the election is made or a later year. For example, an AEI who elects out of coverage for 2009 is not eligible for the subsidy in 2010 even if his or her MAGI drops below the threshold. Accordingly, the election shouldn't be made unless the AEI is certain that the subsidy will not apply in any year.

Observation: How the IRS will track who has received the subsidies so that it can identify those who have MAGI over the threshold remains to be seen. Employers should be alert for further developments regarding additional reporting requirements to assist the IRS in identifying AEIs and the amount of the subsidy.

Conclusion

There you have it. As we said in the beginning, this will likely be a painful process for employers that have to deal with it. It's unfortunate that many of these employers are the businesses already hit hard by the down economy—after all that's likely the reason they laid the employees off in the first place. If you have affected business clients, they'll likely need any help you can give them.

Practice Tip: As there are a number of essential questions that still need answering, it is clear that information will continue to be issued by the responsible government agencies (the IRS and DOL). The Employee Benefits Security Administration (EBSA), an agency of the DOL, has created a dedicated website for guidance on the COBRA subsidy provision: www.dol.gov/ebsa/COBRA.html. Applicable regulatory guidance is supposed to be posted on this website as it is issued. Users can sign up to receive email updates when new items are posted. The IRS has also been posting information at www.irs.gov.

References:

IRC Secs. 6432 and 6720C.

Subscriber Note: This *Tax Action Memo* was written by Robin Tuttle Christian, CPA. Ms. Christian is Managing Editor of this publication, as well as a coauthor and contributing editor of several PPC publications.

Note: For additional information on payroll and compensation issues, see *PPC's Payroll Tax Deskbook* and *PPC's Guide to Compensation and Benefits*. For information on these guides, visit ppc.thomson.com or call (800) 323-8724.