Tax Risks of Providing Self-Insured Health Plan Benefits to RIF’d Executives

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One of the thornier problems an employer faces in offering exit incentives or severance benefits to U.S. executives is the possibility that the self-insured health benefits the employer would like to provide would be taxable. This problem arises because employer-provided self-insured health plan benefits are taxable to highly compensated employees (generally, persons in the top-paid 25 percent of the workforce) if plan coverage or benefits discriminate in favor of them. See Internal Revenue Code ("Code") § 105(h).

Code Section 105(h) has been on the books for about 30 years, but the only real guidance on its application concerns regulations issued around 28 years ago. Those regulations are complex, and most knowledgeable experts regard them to be seriously flawed. Because there is little anecdotal evidence of rigorous IRS enforcement, employers generally seem comfortable in interpreting Section 105(h) liberally, generally only viewing health benefits to be taxable if they are palpably discriminatory.

Of course, most self-insured health plans for active employees do not discriminate in favor of highly paid employees because eligibility, contributions and benefits are the same for all employees, the plans are offered to broad nondiscriminatory groups of employees, and most employees buy coverage.

Unfortunately, that same happy situation often ceases to exist if active employee benefits are continued in a preferential way for executives following termination of employment. For example, if active employee benefits are continued during severance payment periods that are longer for executives than for rank-and-file employees, or if executives are charged less than rank-and-file employees, Section 105(h) discrimination will be an issue. Likewise, if executives who buy COBRA are reimbursed by the employer, but rank and filers are not reimbursed or reimbursed to a lesser extent, the same tax issue will arise. Similarly, if executives are permitted to buy active employee coverage for longer than rank-and-file employees and are charged less than the fair market value of the coverage – which generally will be higher than the employer’s blended average cost, e.g., COBRA cost – the same tax issue will arise.

How Section 105(h) taxes discriminatory health benefits is as murky as when it taxes benefits.

First, employer-subsidized benefits, not the value of employer-subsidized coverage, is what Section 105(h) purports to tax. (Try explaining to an executive that he or she will be taxed on the $1 million value of a heart transplant, but please do that after the transplant.)

Second, highly compensated employees could be taxed on benefits as a result of discrimination that only benefits other highly compensated
employees.

Third, it is unclear whether adverse tax consequences could be avoided if highly compensated employees are treated as buying the coverage on an after-tax basis, such as by buying the self-insured coverage with after-tax dollars or by having the value of the coverage they receive imputed as income to them. Although a reasonable argument in favor of this could be made, especially if they buy the coverage without reimbursement, this argument only is reasonable if highly compensated employees pay the *fair market value* of the coverage they receive (or that value is imputed as income to them), and that cost often will exceed the employer's average blended cost of coverage.

Employers contemplating providing self-insured health benefits to U.S. executives who are being laid off or offered exit incentives should, therefore, investigate whether those benefits would be provided in a manner that favors highly paid employees. If so, they likely should consider the following alternatives for reducing or eliminating the Section 105(h) tax risk:

**Make the Benefits Non-Discriminatory**

- Expand the group to whom the health benefits are being offered so that they are being offered to a nondiscriminatory group.

- Try to justify the health benefits as nondiscriminatory by aggregating them with other health benefits offered to arguably similarly situated individuals. For example, if executives are given an opportunity to resign in exchange for exit incentives including continued active-employee health benefits, to the extent those benefits would be made available to rank-and-file employees simultaneously being laid off, depending on the facts, a basis might exist for considering the executive health benefits to be nondiscriminatory.

- Modify the health benefits to eliminate the discrimination.

- Sell the coverage to the executive for fair market value. A reasonable basis may exist for asserting that coverage provided in this manner is wholly employee-paid and, therefore, that health benefits are tax-free under Code Section 104(a)(3).

**Provide the Benefits Through Insurance**

- Provide health benefits under insured plans the employer already offers, because insured health benefits can be provided on a discriminatory basis to executives without any tax consequences.

- Provide health benefits under a specially arranged insured plan, if feasible.

- Provide health benefits through individual insurance (which normally should be available), assisting executives in securing it and paying for the insurance or reimbursing the executive (with substantiation) for the insurance.

**Provide the Benefits on Taxable Basis**

- Provide discriminatory self-insured health benefits but impute the fair market value of the employer-subsidized coverage as income, withholding taxes on the imputed amount as required (e.g., by requiring the executive to pay the amount that needs to be withheld). This is a bit aggressive, since Section 105(h) makes benefits taxable. However a reasonable basis may exist for asserting that coverage provided in this manner is wholly employee-paid, and, therefore, that health benefits are tax-free under Code Section 104(a)(3). Because of this residual risk, it normally would be prudent to specify that the benefits are being treated under a separate plan within the health program providing the benefits, so as to limit the tax risk to persons receiving the discriminatory benefits.
• Same as above, but also pay the executive what the executive would have to pay for the health coverage, i.e., fair market value. If this is paid whether or not the executive buys the coverage, this amount will be taxable. If it is only paid if the executive buys the coverage, this approach would be no different than the preceding approach.

• Gross the executive up for the taxes he or she incurs on the coverage or the cash in lieu of subsidized coverage.

Use a Combination of Approaches
• For example, provide benefits on a nondiscriminatory basis to the extent feasible, and thereafter provide them through insurance.

• Or, provide benefits on a nondiscriminatory basis to the extent feasible, and thereafter provide them in a taxable manner.

The provision of health benefits to executives following termination of employment can raise complicated issues, as the foregoing discussion demonstrates. For example, when taxable benefits are provided, it will be necessary also to comply with Code Section 409A or make sure it is inapplicable, although Section 409A compliance should not be particularly troublesome as to taxable health benefits.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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