

NEW COBRA RULES

The economic stimulus bill passed by Congress—the American Recovery and Reinvestment Act of 2009 (H.R. 1)—contains a significant modification of the COBRA continuation coverage rules, which is generally effective March 1, 2009. Very generally, under the bill, individuals who become eligible for COBRA by reason of an involuntary termination of employment during the September 1, 2008 and December 31, 2009 period are only required to pay 35% of the COBRA premium. The remainder of the premium is generally subsidized by the employer, which is reimbursed through a payroll tax credit. With respect to any individual, this subsidy expires can last up to nine months. High-income individuals generally must repay the subsidy through a recapture tax.

Notably, the bill did not include another provision, which had only been in the House bill. Under that provision, the 18-month limit on COBRA would not have applied to covered employees who (1) have attained age 55 or completed 10 or more years of service, and (2) are eligible for COBRA coverage by reason of a termination of employment (voluntary or involuntary) or a reduction in hours.

Set forth below is a more detailed discussion of the COBRA provisions contained in the bill. Here are the topics addressed below:

- Who is entitled to the subsidy?
- When does the subsidized coverage begin?
- Second chance to elect COBRA.
- Notice rules.
- What is an involuntary termination of employment?
- Who can pay the reduced premium?
- What coverage does the subsidy apply to?
- Plan sponsor option to offer less expensive coverage.
- Treatment of retiree health coverage.
- When does subsidy end?
- How much is the subsidy?
- How does the payroll tax credit work?
- What entity receives the credit?
- Does the credit cover plan sponsors' actual costs?
- How does the subsidy apply to spouses and dependent children?
- Recapture of the subsidy with respect to high-income individuals.
- Miscellaneous.

Who is entitled to the subsidy? Individuals who are qualified beneficiaries under COBRA are entitled to the subsidy if they (1) become eligible for COBRA between September 1, 2008 and December 31, 2009 by reason of an involuntary termination of employment and (2) elect COBRA. These individuals are referred to as “assistance eligible individuals”. Thus, there

is a closed class of individuals who can be entitled to the subsidy by electing COBRA. This closed class consists of:

- (1) individuals who are currently covered by COBRA by reason of an involuntary termination on or after September 1, 2008;
- (2) individuals who were previously eligible for COBRA coverage by reason of an involuntary termination on or after September 1, 2008 but did not elect COBRA;
- (3) individuals who were previously eligible for COBRA coverage by reason of an involuntary termination on or after September 1, 2008, elected COBRA, but are no longer covered as of the date of enactment (“DOE”) (because, for example, the individual did not pay the required premium); and
- (4) other individuals who are eligible for COBRA coverage by reason of an involuntary termination during the September 1, 2008 to December 31, 2009 period.

As described in more detail below, individuals described in the second and third categories above must be notified of the subsidy and given an additional opportunity to elect COBRA coverage and thereby become assistance eligible individuals.

The above definition of assistance eligible individuals raises questions about the treatment of individuals who are covered by COBRA coverage but who are not qualified beneficiaries. For example, assume that a covered employee gets married on or after the qualifying event and the new spouse is added to the COBRA coverage. Such new spouse is not a qualified beneficiary under COBRA and thus is not an assistance eligible individual. Does the subsidy only apply to the coverage of the covered employee? If so, this would require that the cost of the coverage be bifurcated into two parts—one related to the covered employee, which is eligible for the subsidy, and one related to the new spouse, which is not eligible for the subsidy. Similar issues arise when a domestic partner is covered by COBRA, since domestic partners are not qualified beneficiaries. The language of the statute would suggest that bifurcation is required but it is unclear if this was intended. Hopefully, Treasury and the IRS can provide guidance on this issue.

When does the subsidized coverage begin? The subsidy begins with respect to any “period of coverage beginning on or after the date of enactment” of the bill. The bill defines “period of coverage” as “a reference to a monthly or shorter period of coverage with respect to which premiums are charged with respect to such coverage.” Thus, if COBRA premiums are charged on a monthly basis, as is the norm, the subsidy will begin as of March 1, 2009. (For convenience of presentation, the remainder of this memorandum assumes that COBRA is billed on a monthly basis.)

March 1, 2009 is a very fast effective date that does not give employers any real chance to set up administrative systems to (1) identify all individuals who have terminated employment since September 1, 2008, (2) determine which of those individuals were involuntarily terminated

(other than by reason of gross misconduct), (3) determine which of those individuals currently have COBRA coverage, (3) establish a new billing system to only charge those individuals 35% of the COBRA premium, (4) establish a mechanism to recoup the subsidy through payroll tax credits, (5) identify the individuals involuntarily terminated (other than by reason of gross misconduct) since September 1, 2008 who are not currently covered by COBRA, but are given a second chance to elect COBRA under the bill, and (6) perform the myriad of other tasks described below.

To address this problem, the bill generally establishes a special rule under which it appears to be permissible for the plan sponsor to charge assistance eligible individuals the full premium for the first two months to which the subsidy is applicable (i.e., March and April). However, the plan sponsor receiving any such full premium must repay the excess 65% within 60 days or provide the individual with a credit of such amount against future COBRA premiums. In general, the plan sponsor may choose the credit approach as long as it is reasonable to believe that the credit will be used within 180 days of the date of the overpayment. Obviously, if an eligible assistance individual ceases to be covered by COBRA, it is no longer reasonable to believe that the credit approach will work, triggering an obligation to pay a refund within 60 days.

This two-month period is helpful, but what happens if a plan sponsor's system is not fully implemented in time for May? If a plan sponsor overcharges some or all assistance eligible individuals for May (or a later month), but is able to refund such overpayments quickly or provide credits against future COBRA premiums, is that a violation of COBRA? The answer appears to be yes, but some relief may still be available under the general COBRA provisions, such as the Code rule making the COBRA excise tax inapplicable to reasonable violations that are corrected within 30 days of the date that the plan sponsor (or other responsible persons) knew or should have known of the violation.

Unfortunately, the bill does not provide any period during which good faith compliance with a reasonable interpretation of the statute will be considered compliance with the law. Hopefully, Treasury will provide for such a period, but there is no assurance that this will happen.

Second chance to elect COBRA. As noted above, if an individual who would otherwise currently be an assistance eligible individual by reason of a prior involuntary termination of employment is not covered by COBRA as of the DOE, such individual is provided a second chance to elect COBRA. This election may be made at any time starting on the DOE and ending 60 days after the individual receives the notice described below regarding the subsidy and the special election period. If such an individual elects COBRA coverage, the coverage commences as of the effective date of the subsidy (i.e., generally, March 1, 2009). However, it appears that, pursuant to the generally applicable COBRA rules, such individual has 45 days from the date of the election to make a premium payment. So it is possible that such an individual could be paying a COBRA premium for almost half a year of coverage when he or she makes that first payment. If an employer has many such individuals, the initial subsidy could be quite large.

Notice rules. The bill creates new notice rules. In the case of individuals who become eligible for COBRA coverage during the September 1, 2008 to December 31, 2009 period, the COBRA notice generally required to be provided to such individuals must include information about:

- 1) the availability of the subsidy,
- 2) the obligation of the individual to notify the plan of his or her eligibility for other coverage or Medicare (and the penalty for not doing so) (discussed below under “When does the subsidy end?”),
- 3) the second chance to elect COBRA described above, and
- 4) if applicable, the option of electing less expensive alternative coverage (discussed below under “Plan sponsor option to offer less expensive coverage”).

Alternatively, the above information may be provided in a separate document.

A special timing rule applies with respect to this notice in the case of assistance eligible individuals (or individuals who would be assistance eligible individuals if they had elected COBRA) who (1) are covered under COBRA coverage as of the DOE, (2) previously elected COBRA but are no longer covered as of the DOE, or (3) did not elect previously available COBRA coverage. For example, this special rule would apply to an individual who had an involuntary termination in the fall of 2008 and fell into one of those three categories. Under the special rule, the plan administrator must provide the notice described above to such individuals within 60 days after the DOE.

In general, the notice must be provided to all individuals who become eligible for COBRA for any reason during the period beginning September 1, 2008 and ending December 31, 2009, including individuals who are clearly not eligible for the subsidy. Despite language to the contrary in the legislative history, the statute indicates that this would include individuals whose qualifying event is unrelated to a termination of employment, such as a divorce. There is some lack of clarity, however, with respect to the treatment of individuals who were eligible for COBRA prior to the DOE, but could not become eligible for the subsidy. Technically, in some cases, the notice must have been provided to such individuals prior to the DOE, since the special 60-day rule described in the prior paragraph does not apply to them. This obviously does not make sense. It would seem to make sense to proceed as if the special 60-day rule does apply to them.

Within 30 days after the DOE, the Secretary of Labor, in consultation with the Treasury and HHS Secretaries, is directed to issue model notices that plans may use.

What is an involuntary termination of employment? Neither the statute nor the legislative history provides any guidance on this issue. So, there will be difficult issues to deal with in determining who qualifies as an assistance eligible individual. For example, if an individual terminates employment to avoid being laid off, is that voluntary or involuntary? Unfortunately, there is no clear “conservative” path to take on this issue. If an employer incorrectly treats a termination as voluntary, it would be violating COBRA by overcharging for COBRA coverage. On the other hand, if an employer incorrectly treats a termination as involuntary and charges a reduced premium, any payroll tax credit claimed by the employer would be invalid, resulting in a failure to pay payroll taxes.

The bill does not modify the current-law rule under which an individual who is terminated by reason of gross misconduct is not eligible to elect COBRA coverage.

Who can pay the reduced premium? The 35% may be paid by the assistance eligible individual or by anyone else (other the individual's employer) on behalf of the individual. Thus, for example, the 35% may be paid by a parent, a guardian, a State agency, or a charity.

What coverage does the subsidy apply to? The subsidy applies to all COBRA coverage (including continuation coverage provided under a plan maintained by a Federal or State government) other than (1) coverage described in ERISA section 609 (which includes coverage pursuant to medical child support orders, coverage of adopted dependent children, and coverage of pediatric vaccines), and (2) health flexible spending arrangements under a cafeteria plan. Thus, any other coverage subject to COBRA (such as on-site medical facilities) is eligible for the subsidy. In addition, the subsidy applies to coverage under a State program that provides “continuation coverage comparable to” COBRA coverage for plans not subject to the Federal COBRA rules, such as small plans. In order to be comparable, the State law right must generally be a right to continue substantially similar coverage (or coverage that is substantially similar to coverage provided to similarly situated beneficiaries) at a monthly cost that is a specified percentage of the group health plan's cost; a State law that does not limit the premium that may be charged is not “comparable” for this purpose.

Plan sponsor option to offer less expensive coverage. In this economic climate, many laid off individuals may not be able to afford COBRA coverage, even at a 65% discount. So the bill provides an option to plan sponsors to offer group health plan coverage that is no more expensive than COBRA coverage. In this regard, it appears that the determination of whether coverage is less expensive is determined based on the premium charged to the individual, not based on the total cost of the coverage.

Such alternative coverage must be also offered to active employees. And the alternative coverage must not consist of the following (referred to below as “non-core” coverages): solely dental, vision, counseling, or referral services (or a combination thereof), coverage under a health flexible spending arrangement, or coverage under an on-site medical facility that consists primarily of first-aid services, prevention and wellness care, or similar care (or a combination thereof).

If alternative coverage that satisfies the above requirements is offered to assistance eligible individuals, it is deemed to be COBRA coverage and thus eligible for the subsidy. Clearly, under current law, alternative coverage chosen by a qualified beneficiary during a generally applicable open enrollment period qualifies as COBRA coverage; the special rule in the bill clarifies that certain alternative coverage may also be treated as COBRA coverage if it is elected in a special enrollment period only available to COBRA beneficiaries.

The bill provides that if the plan sponsor makes this alternative option available, assistance eligible individuals shall have 90 days to elect such other coverage after notice of the option is provided. This 90-day period does not fit well with other 60-day election periods under current law and otherwise applicable to assistance eligible individuals as described above. For example, if an individual was laid off in the fall of 2008 and did not elect COBRA, such individual has, after notice is provided, 60 days to elect COBRA coverage and 90 days to elect this alternative coverage that is deemed to be COBRA coverage. This does not seem appropriate; the plan sponsor should be able to establish one 60-day period in which an individual is to

choose between COBRA and the alternative coverage. Perhaps Treasury can address this issue in guidance, but until that happens, plan sponsors should adhere to the specified election periods.

The bill does not expressly address whether the alternative coverage may be elected retroactively or only prospectively. For example, assume that an individual was laid off in the fall of 2008 and did not elect COBRA. As discussed below, such individual must have the option to elect COBRA coverage as of the effective date of the subsidy provision, i.e., generally March 1, 2009. If the individual elects alternative coverage, could that be effective March 1, 2009? Although the bill does not address this issue, there does not seem to be any reason that a plan sponsor could not make the alternative coverage retroactive to March 1, 2009. It would make little sense to make an individual elect COBRA coverage for a month or two and then switch to alternative coverage.

Treatment of retiree health coverage. Under the COBRA regulations, an employer may offer an individual a choice between COBRA coverage and coverage under the employer's retiree health plan. If the retiree health plan does not qualify as COBRA coverage, such coverage would not be eligible for the subsidy and the payroll tax credit, unless it qualifies under the alternative coverage rule specified above. One possible obstacle with respect to retiree health coverage qualifying under the alternative coverage rule above is that the alternative coverage must also be offered to active employees.

When does the subsidy end? The subsidy ends upon the earliest of the following: (1) nine months after it started, (2) the date that the individual's COBRA coverage ends (subject to the clarification described below), and (3) the individual's eligibility for coverage under any other group health plan (other than non-core coverage) or eligibility for Medicare. Thus, for example, if an individual becomes eligible under a "core" plan maintained by the employer of his or her spouse, the individual would no longer be eligible for the subsidy. Under COBRA, an individual's COBRA coverage generally ends when he or she becomes **covered** by another group health plan or **entitled** to Medicare; the subsidy ends when an individual becomes **eligible** for such other coverage or Medicare.

An individual eligible for the subsidy is required to notify the group health plan if his or her right to the subsidy ends by reason of eligibility for other group health coverage or Medicare. An individual who fails to provide such a notice may be subject to a penalty tax equal to 110% of the subsidy that is actually provided to the individual but should not have been provided due to eligibility for other coverage or Medicare.

The bill clarifies how long COBRA lasts in one situation. Assume that by reason of an involuntary termination, an individual first became eligible for COBRA as of a date prior to the DOE (such as September 1, 2008) but is not covered by COBRA as of the DOE. As noted above, such individuals must be given another chance to elect COBRA as of the effective date of the subsidy (generally, March 1, 2009) The maximum COBRA period would be determined as if the individual had originally elected COBRA; the maximum period is not measured from the date COBRA coverage begins.

How much is the subsidy? Under the bill, an assistance eligible individual is treated as having paid the required COBRA premium if such individual pays 35% of the premium that the individual would otherwise be required to pay. Thus, for example, if the applicable premium is

\$1,000 and the employer charges \$1,020 (i.e., the permitted 102% of the applicable premium), the individual would be required to pay 35% of the \$1,020 amount. The employer would need to make up the difference.

The bill appears to create an anomalous and unfortunate result. Assume, for example, that a plan sponsor currently subsidizes COBRA directly as part of a severance agreement. Assume that 102% of the applicable premium is \$800, and the employer currently pays 70% of that amount, i.e., \$560, and the individual pays the remaining \$240. Under the bill, the individual must be entitled to COBRA upon a payment of 35% of the \$240 amount, i.e., \$84. This means that the plan sponsor must pay a total of \$716 (\$800 minus \$84) and is entitled to a payroll tax credit of \$156 (\$240 minus \$84). This result significantly punishes the employer for having subsidized COBRA. If the employer had not subsidized COBRA, the employer could have paid much less money (\$520 instead of \$716) and received a far greater credit (\$520 instead of \$156).

The statutory language and legislative history lead to this adverse result. And informal discussions with Treasury indicate that Treasury reads the law this way.

How does the payroll tax credit work? The plan sponsor recoups the subsidy by claiming a credit equal to the subsidy against the requirement to make deposits or payments of “payroll taxes”. Payroll taxes are defined as income tax withholding, employee FICA withholding, and employer FICA taxes. Here are the rules applicable to payroll tax deposits. In general, employers must make such deposits twice a week (pursuant to a specific schedule). Small employers, however, must only make such deposits on a monthly basis, i.e., on or before the 15th day of the month following the month in which the payroll tax obligation arose. For this purpose, a small employer is defined as an employer that reported less than \$50,000 in payroll taxes for the one-year period ending June 30th of the preceding year.

Plan sponsors that make deposits twice a week would appear to have a mechanism available to recover the subsidy without significant delay, as long as their payroll periods are not too long. Small employers will have a longer period prior to recovery of the subsidy. It seems, however, that there will be very few, if any, situations where an employer subject to COBRA will be a small employer for purposes of the rules regarding the deposit of payroll taxes. It is true that State continuation coverage rules can apply to small employers, and, as noted, the subsidy and payroll tax credit rules apply to comparable State continuation coverage. But in those cases, as discussed below, it is generally the insurer that is eligible for the payroll tax credit. Presumably, the insurer will charge the small employers the discounted premium or will be able to promptly refund the excess upon receipt of the payroll tax credit.

No payroll tax credit may be claimed until the reduced premium has been received from an assistance eligible individual. If the plan sponsor claims a bigger tax credit than it is entitled to (e.g., by incorrectly treating a termination as involuntary), the plan sponsor is treated as having an underpayment of payroll taxes.

Plan sponsors that claim a credit must provide “attestations of involuntary terminations” with respect to the individuals with respect to whom the credit is claimed. The plan sponsor must also provide a report on the credit claimed and an estimate of the credit to be claimed for the next reporting period. In addition, the plan sponsor must report the following: the taxpayer identification number of all covered employees, the amount of subsidy reimbursed with respect

to each covered employee and qualified beneficiaries, and a designation as to whether the subsidy reimbursement is for coverage of one individual or two or more individuals. These reports must be submitted at such time and in such manner as the IRS requires. Guidance on this timing and form issue is needed quickly. There is not a current mechanism to submit such information under the current payroll tax deposit rules, nor under the quarterly employment tax returns.

In addition, Treasury and the IRS are authorized to require additional verification of the correctness of the payroll tax credit claimed.

What entity receives the credit? For convenience of presentation, this memorandum refers to the “plan sponsor” as receiving the credit. Here are the actual rules in that regard. Generally, it is the employer that provides the subsidy and is eligible for the payroll tax credit, subject to two exceptions. First, if the plan is a multiemployer plan, then it is the plan that is eligible for the payroll tax credit. Second, if fully insured COBRA coverage is provided under a State continuation coverage regime, the insurer is the one that is eligible for the payroll tax credit.

Does the credit cover plan sponsors' actual costs? There are questions as to whether the credit is sufficient to cover employers' real costs. Employers providing COBRA coverage at 102% of the applicable premium are generally providing coverage at a significant loss because generally less healthy individuals elect COBRA coverage (i.e., adverse selection) . If the number of individuals covered by COBRA increases significantly due to the subsidy, as might be expected, employers' losses might be correspondingly increased. At least some government officials believe, however, that the subsidy will help reduce adverse selection, since a lower premium could encourage healthier individuals to elect COBRA. This is an area where data would be helpful with respect to future policy discussions.

How does the subsidy apply to spouses and dependent children? The subsidy (with the corresponding payroll tax credit) applies to each qualified beneficiary. Thus, for example, assume that a covered employee is involuntarily terminated and has a spouse and a dependent child. The subsidy applies to the cost of coverage for the family. Assume further that shortly thereafter, the employee and spouse are divorced, and the dependent child ceases to be a dependent child under the plan. In addition, assume that each of the three individuals continues to be covered under COBRA. The subsidy would apply to the coverages provided to all three of them. The same result would apply if the covered employee were to die and the other two remained covered by COBRA.

Recapture of the subsidy with respect to high-income individuals. The subsidy is recaptured with respect to high-income individuals by requiring such individuals to “repay” the subsidy by paying additional income taxes equal to the subsidy. For this purpose, a high-income individual is a taxpayer with modified adjusted gross income of at least \$145,000 (\$290,000 in the case of a joint return). Also, the subsidy is phased out ratably for taxpayers with modified adjusted gross income of more than \$125,000 and less than \$145,000 (those figures being \$250,000 and \$290,000 for joint returns). These rules apply on a year to year basis, so a taxpayer might be required to repay the subsidy for one taxable year but not for another year.

A high-income individual can avoid the recapture by making an election to permanently waive the subsidy and notifying the plan sponsor of such election.

The technical reach of this recapture is broader than it might seem initially. The recapture applies to a taxpayer if the subsidy is provided to the taxpayer, the taxpayer's spouse, or to any dependent of the taxpayer (somewhat broadly defined). So, for example, assume that a high-income taxpayer has a dependent who has ceased to be a dependent child under the plan but has continued separate COBRA coverage. The taxpayer must “repay” any subsidy provided to such dependent.

In order to effectuate this recapture tax, Treasury has the authority to require plan sponsors to report to the IRS and to each assistance eligible individual the amount of any subsidy provided.

Miscellaneous.

- The subsidy is not includible in the income of the individual receiving it.
- For purposes of determining the gross income of the employer and any welfare benefit plan, the subsidy is treated as an employee contribution.
- Individuals receiving the subsidy shall not be eligible for the health care tax credit under Code section 35.
- The Social Security trust funds will be held harmless, so effectively the Federal government's general assets will be the source of the subsidy.
- Assume that an individual is not covered under COBRA as of the DOE by reason of not having electing COBRA or ceasing to be covered prior to the expiration of the maximum period. If such individual elects COBRA under the second chance provided by the bill, the period from the qualifying event until the effective date of the COBRA coverage (generally March 1, 2009) is disregarded for purposes of the rules that limit the ability of a group health plan to impose pre-existing condition limitations.
- Subsidy denials are subject to de novo 15-day reviews by the Secretary of Labor.
- Special rules are included in the legislative history regarding the treatment of U.S. possessions.
- The stimulus bill includes other COBRA provisions related to the health care tax credit under Code section 35.