

REFORM *Update*

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One aspect of health care reform requires employers to report the cost of employer-sponsored health coverage on each employee's W-2. Initially, this requirement was to be effective for the 2011 tax year. However, because the government delayed the effective date last fall, this requirement is now effective for W-2s applicable to the 2012 tax year.

The IRS recently released Notice 2011-28, providing additional guidance on the W-2's informational reporting requirement. This Notice clarifies a number of employers' concerns:

- The reporting requirement is for informational purposes only. It does not in any way cause the health coverage to become taxable for employees. (Use code DD when reporting the cost in box 12 of the W-2; this indicates the amount is non-taxable.)
- The reporting requirements generally apply for the 2012 calendar year, specifically to W-2s issued in January, 2013.

The Notice is designed to provide interim guidance, as the government has requested comments from stakeholders. They assure employers that any subsequent changes made to this guidance will be effective prospectively, giving employers adequate time to implement any required changes.

This *Update* will review:

- Plans that should be included in the informational reporting
- Employers subject to informational reporting
- Acceptable methods for calculating the cost of health plan coverage

Many employers have already begun investigating how to track the cost of health care coverage for W-2 reporting. This guidance provides additional details that must be considered when complying with the reporting requirement.

Plans That Should Be Included In Informational Reporting

The health care reform legislation requires that the aggregate cost of employer-sponsored health plan coverage be included on each employee's W-2. Aggregate cost is generally referred to as the "applicable premium" for COBRA purposes. Any employer contributions to an Archer MSA (Medical Savings Account) or to an HSA (Health Savings Account) should **not** be included in the aggregate cost. In general, any salary reductions an employee makes to a medical FSA (Flexible Spending Account) should also **not** be included in the aggregate cost. However, if an employer funds part of a medical FSA, that amount may need to be reported, depending on the situation. (More information on this will be covered later in the *Update*.) In addition, the Notice states that employers should **not**

include their contributions to an HRA (Health Reimbursement Arrangement) in the aggregate cost. If the only coverage an employer provides is through an HRA, then the employer does **not** need to report the cost of coverage on the W-2.

Employers should ensure they are reporting only the aggregate cost of plans that are considered group health coverage. There are a number of benefits not considered employer group health coverage, including:

- Long term care coverage
- Any coverage under a separate policy, certificate or contract of insurance which provides benefits that are substantially all for the treatment of the mouth or eyes (separate dental or vision coverage)
- Any coverage which is not excludible from gross income and for which a deductible is not allowed under Section 162(l), including:
 - ▶ Coverage that is only for accidents or disability income protection or any combination thereof
 - ▶ Coverage issued as a supplement to liability insurance
 - ▶ Any coverage that is considered liability insurance, including general liability insurance and automobile liability insurance
 - ▶ Workers' compensation or similar insurance
 - ▶ Automobile medical payment insurance
 - ▶ Credit-only insurance
 - ▶ Other similar insurance coverage in which benefits for medical care are secondary or incidental to other insurance benefits
- Coverage, not viewed as medical coverage, that is offered on an independent, non-coordinated basis, including:
 - ▶ Coverage for a specified disease, such as critical illness coverage
 - ▶ Hospital indemnity or other fixed indemnity insurance

These plans must be considered excepted benefits under HIPAA and must be paid for by the employee with post-tax dollars.

In addition, if an employee does not receive compensation from the employer during the year, then the cost of coverage need not be reported on the employee's W-2. Specifically, the Notice refers to retirees who may receive health plan coverage, but typically not income, from the employer.

Employers Subject To Informational Reporting

The requirement to report the cost of employer-sponsored health coverage on the W-2 applies to most employers providing such coverage at some point during the calendar year. This includes private employers, public employers such as federal, state and local governmental entities, churches and other religious organizations. It even applies to employers that are not subject to COBRA.

Two notable exceptions to this requirement are federally-recognized Indian tribal governments and self-insured group health plans that are not subject to any federal continuation coverage requirements. This latter exception is quite limited, as most self-insured plans are subject to COBRA, continuation under the Public Health Service Act, or continuation under the Federal Employee Health Benefits program. Another exception is made for the federal government, state government and any political subdivision that provide health coverage to members of the military and their families.

Some small employers may also be excepted. The Notice does stipulate that if an employer is required to file fewer than 250 W-2s for the preceding calendar year, then that employer's W-2 reporting requirement is optional in the current year. For example, if a small employer issues fewer than 250 W-2s in 2012, the W-2 reporting is optional for the year 2013.

The Notice further specifies that employer contributions to a multi-employer plan are not considered reportable contributions.

Acceptable Methods for Calculating Cost of Health Plan Coverage

The Notice provides examples illustrating how to calculate the aggregate cost of the employer-sponsored health plan. However, it does not include additional details on acceptable methods to calculate COBRA rates.

There are two possible methods to determine aggregate cost; however, as long as employers calculate the premium in good faith compliance with current guidance on setting COBRA rates, those methods will be acceptable as well. Reportable costs can be determined by:

- **Premium charged method:** This method applies to fully insured plans and allows the employer simply to use the COBRA-applicable premium as the reportable cost. In this case, employers could look to a reportable period, such as month, and use the monthly COBRA premium to determine reportable cost. If an individual is covered for the whole year, then the monthly premium is multiplied by 12 to determine the reportable aggregate cost.
- **Modified COBRA premium method:** If an employer subsidizes the cost of COBRA, then the employer can use a good faith estimate of the unsubsidized COBRA premium to determine reportable cost.

In very limited circumstances, an employer contribution to a medical FSA may need to be included in the reportable cost. This situation applies **only** when employers have a full credit-based Section 125 cafeteria plan. In these plans, the employer offers credits that employees can use to purchase qualified benefits under the plan (medical, dental, vision, and more). If employees have credits remaining after benefits are elected, then those excess funds can be directed to a medical FSA. There is no impact on the reportable cost if the annual employee contributions for all qualified benefits taken on a pre-tax basis exceed the amount elected for the medical FSA for the plan year. However, if the amount contributed to a medical FSA exceeds the employee's contributions for qualified benefits during the year, then the reportable cost is calculated by subtracting the employee's contributions for other qualified benefits from the employee's medical FSA contributions.

This is complicated, an example will help. An employer offers a credit-based flexible benefit program. The employer provides \$2,000 in flex credits to an employee. The cost of the qualified benefits that the employee elects is \$4,000 per year. In addition, the employee sets aside \$1,500 in the medical flexible spending account for the year. In this case, the employee's net cost for benefits is \$2,000 (\$4,000 pricetag less the \$2,000 in employer flex credits). Since \$2,000 is greater than the \$1,500 set aside in the FSA, the employer should not include any portion of the medical FSA election in the reportable cost.

The Notice also addresses a number of common situations that employers will face in determining the aggregate reportable cost:

- **Plans with non-calendar renewal years that experience cost increases at renewal.** Reportable cost must be determined on a calendar basis. Therefore, employers that experience renewal cost changes during the year must account for the cost changes in determining the reportable cost.
- **Mid-year qualified changes in status, like marriage or the birth of a child.** When an employee experiences a mid-year qualified change in status affecting the reportable cost for employer-sponsored health coverage, then the employer must take these changes into account when determining reportable cost. For example, let's say an employee is single for six months and then marries in June and adds his wife to his coverage. A higher rate is charged for two-person coverage. To determine the reportable cost, the employer uses six months of the single rate and six months of the two-person rate. If an employer allows changes to be effective mid-month, then the employer can use any reasonable method in accounting for that month, including using the cost at the beginning of month, the cost at the end of the month or a pro-rated cost based on the actual date of the change.
- **Plans that determine rates on an employee composite basis.** If a plan determines rates by using one rate for employees and any covered dependents, then that composite rate can be used when determining reportable cost.
- **Reportable cost for employees that terminate during the year.** A number of issues arise when an employee terminates mid-year:
 - ▶ The Notice stipulates that an employer is not required to report the aggregate health plan cost for an employee that terminates mid-year and requests a W-2 upon termination.
 - ▶ In determining reportable cost, the employer can pro-rate the annual cost for the time that an employee was covered under the plan. The employer also has the option to include the cost for any COBRA continuation coverage in effect during the plan year. However, the employer must address the COBRA situation consistently during the plan year. Thus, if the employer chooses to include any period of COBRA in the reportable cost for one employee, then the same must be done for all employees electing COBRA during the year.

Finally, the Notice clarified that the aggregate reportable cost includes **both** employer and employee contributions for coverage.

Concluding Thoughts

This guidance will certainly help employers to comply with the requirement to report the cost of employer-sponsored health plan coverage on employees' W-2s. However, employers also wanted the government to provide more detail on the acceptable methods for determining COBRA rates, the cost of which can be used to determine the reportable cost on the W-2. The government expects to receive comments and will likely issue more guidance in the future.

Until then, employers should work with their HRIS and payroll providers to discuss the best way to capture the information needed to determine reportable cost. The penalties for non-compliance with this requirement - \$200 per W-2, capped at \$3 million per employer – are substantial.

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