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REFORM Update

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The IRS recently released Notice 2012-9 to amend and clarify Notice 2011-16, the initial guidance on the new W-2 reporting requirement. Notice 2011-16 was discussed in our Reform Update at http://www.mcwent.com/Reform_Update/2011/Reform_Update_26.pdf.

Employers must include the cost of employer-sponsored health plan coverage on 2012 W-2s issued in January 2013. The reportable cost needs to reflect any mid-year changes. This latest guidance answers many of the questions employers had on W-2 reporting. It includes new information and amends details from the initial guidance. It also gives practical examples on how to handle certain aspects of the requirement.

Employers can rely on Notice 2012-9 until the IRS issues more guidance. Any new guidance will include prospective effective dates so that employers will have time to make any changes.

Employee Assistance Plans, Wellness Plans and Onsite Medical Clinics

Employers were uncertain about how to handle Employee Assistance Plans (EAPs), wellness plans and onsite health clinics. The IRS makes clear that if employers follow formal COBRA rules for these programs, then the deciding factor for including them on the W-2 is whether the employer charges premiums for the continuation coverage. If employers charge a premium for any of these plans for COBRA coverage, then the plans must be included in the reportable cost on the W-2. If the employer simply allows COBRA continuation without charging a premium, then the cost does not have to be included.

In order to comply with the new guidelines, employers need to know when they must offer COBRA for these types of benefits. EAPs are COBRA-eligible if the plan covers medical care including visits to a mental health professional or even counseling from a medical provider on the telephone. COBRA does not apply to an EAP that does not provide medical care. Wellness plans are also considered COBRA-eligible if the plan offers medical care, such as biometric screenings. In contrast, a wellness plan that provides only fitness challenges, “lunch and learns” and program discounts does not provide medical care, and is not subject to COBRA. Finally, onsite clinics providing care beyond treatment for workplace injuries are COBRA-eligible.

This clarification is transitional. Although employers can rely on this interpretation for now, the IRS may amend these rules in the future.

Third Party Sick Pay

Some employers hire third party vendors to administer sick pay or short-term disability payments. Some vendors report sick pay or disability benefits directly to the employer for inclusion on the W-2. Others actually issue W-2s for the benefits they pay.

The new guidance clarifies that third party payers are not required to include the reportable cost for health insurance on the W-2s they issue. However, the W-2s employers furnish must include the aggregate reportable health benefit cost for the year. For example, assume a third party vendor pays two months of sick pay benefits, and issues a W-2 for those two months of benefits. The employer must issue a W-2 that reflects the income for the other 10 months of the year. The employee in question continued medical coverage during the sick leave under the FMLA rules. Therefore, the employer's W-2 would include 12 months of reportable health plan coverage costs even though it reflects only 10 months of income.

Family Status Changes After December 31

It is not uncommon for employees to report changes in family status after the fact. This issue can be troublesome for employers when they try to calculate the reportable value. The IRS has clarified that **the reportable cost may be based on the information available to the employer as of December 31** each year. If the employee notifies the employer of a change affecting coverage after December 31, then that change does not have to be reflected in the reportable cost.

For example, an employee's divorce becomes final on November 30, 2012, and is reported to the employer on January 15, 2013. The health plan cost changed retroactively to December 1, 2012, when the employee switched from two-person to single coverage. Since the employer received the divorce notification after December 31, 2012, the employer can use the two-person cost for determining the reportable value for all of 2012.

This ruling should help employers because they can use the coverage believed to be in effect as of December 31 to calculate reportable values. They will not need to make retroactive adjustments for family status changes reported after December 31.

Reporting Value of Coverage Exempt Under Notice 2011-16

Initial guidance did not require employers to include Health Reimbursement Arrangements (HRAs) in the reportable cost. This guidance was considered transitional and subject to change.

In response to employer feedback, the IRS will now allow employers the option to include the HRA benefits in the reportable cost. Employers can choose to include the HRA cost or exclude the HRA cost. They must use a consistent approach with all employees. Employers do not need to report the specific utilization of each employee in the reportable cost. They should simply utilize the rate developed for COBRA purposes to determine the reportable cost of the HRA.

Medical Flexible Spending Accounts (FSAs)

Medical flexible spending account elections **are not included** in the reportable cost except when the employee's medical FSA election exceeds the salary reduction for the year. For this to occur, employers would have to fund part of the medical FSA or offer credits under a credit-based flex plan. The latest guidance includes several examples. In one, the employee's total salary reduction is $2,000, including $1,500 for the medical FSA. None of the FSA election should be included in the reportable value because the salary reduction is more than the medical FSA election.

Another example illustrates a credit-based flex plan. The employer offers a flex credit of $1,000 to purchase benefits. The total cost of the employee's election is $3,000, with $1,500 for the medical FSA. Since the employer offers $1,000 in credits, the actual employee salary reduction is only $2,000. The $2,000 salary reduction is more than the $1,500 medical flexible spending account election. In this example, none of the FSA election should be included in the reportable value.

The final example also deals with a credit-based flex plan. In this situation, the employer matches the employee's salary reduction. One employee elects to set aside only $700 in the medical FSA, with the employer matching that election. The total FSA election is $1,400, but the employee's salary reduction is just $700. As a result, $700 needs to be included in the reportable value on this employee's W-2.

Employees of Multiple Employers in a Calendar Year

Unless it is explicitly excluded, every employer must include the reportable value of health coverage on the W-2. In some situations, an employee may have more than one employer, and those employers may be related. If one of the related employers is a common paymaster, that paymaster must include the reportable value for all the related employers involved on the employee's W-2. Related employers using a common paymaster, who are not the paymaster themselves, **must not** report the value of employer-provided health coverage.

If related employers do not use a common paymaster, then each of those employers must include the reportable value of health plan coverage on the employee's W-2.

Clarifications on Excluded Employers

The new guidance provides additional details on excluded employers:

- Some Indian tribal governments are excluded. Until further guidance is issued, the reporting requirement will not apply to tribally chartered corporations that are wholly owned by federally-recognized Indian tribal governments.
- Certain small employers are excluded. 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 2011, then the W-2 reporting is optional for the year 2012. The new guidance also includes details on agents that employers may hire to issue W-2s on their behalf. To determine the small employer exception, the total number of W-2s an agent issues on behalf of the employer must be counted toward the 250-person small employer limit. The employer would provide the reportable values to the agent for inclusion on the W-2s.
- Self-insured group health plans that are not subject to any federal continuation coverage requirements are exempt. This exemption would apply to self-funded church plans.
- The federal government, state government and any political subdivision that provides health coverage to members of the military and their families are also exempt.

Finally, employers that participate in multiple employer welfare plans do not need to include the reportable costs for the health plan on the W-2.

These employer exclusions may change in the future.

Health Reimbursements or Premiums Included in Gross Income

In certain situations, employers must include premium payments or excess reimbursements in the gross income of the employee. The notice covers the three following situations:

1. A 2% or more shareholder in Subchapter S corporations.
2. Excess reimbursements included in income because of a discriminatory self-funded plan.
3. Domestic partners or others that do not qualify for federal tax-favored health benefits.

The employer must include health plan premiums in actual gross income for a 2% or more shareholder/employee in a Subchapter S corporation. This means the employer is not required to include the reportable health plan cost for these shareholder/employees.

Discriminatory or excess benefits are taxable if an employer provides such benefits to highly compensated individuals in a self-funded plan. This situation occurs when a self-funded health plan fails Section 105(h) nondiscrimination tests. The employer must calculate the excess reimbursement and then add that amount to the employee's taxable income. In essence, the highly compensated employee loses tax-favored status on only the discriminatory benefits. The amount of that excess reimbursement does not need to be included in the reportable value. For example, assume the employer's self-funded plan has a reportable cost of $12,000 for an employee with family coverage. If an employee receives $4,000 in excess reimbursement, that amount is added to his gross income. Because the excess reimbursement is not included in the reportable cost, this employee's reportable cost would be $8,000.

Some employers cover certain individuals, such as domestic partners, who are not qualified for tax-favored health benefits under federal government rules. In this situation, the aggregated reportable cost **should include** the cost of coverage, even though it is not tax-favored. Suppose an employee covers a domestic partner and two children under the employer's group health plan, and the reportable cost for family coverage is $12,000. The employer pays 100% of the cost of coverage. Part of that cost represents coverage for the domestic partner, who is generally not permitted to have tax-favored benefits. The value of the domestic partner's coverage is $4,800, and the employer must impute income on that amount. However, the reportable value for W-2 purposes should still be $12,000.

Calculating the Cost of Coverage

The initial guidance provided several methods for calculating the cost of reportable coverage. In general, employers should use COBRA rates less the 2% administrative fee. The recent guidance provides more details and examples to help employers calculate the reportable cost.

These clarifications include the following:

- The reportable cost is the COBRA premium calculated in good faith compliance with the COBRA regulations.
- If a plan is fully insured, employers can use the premium charge method. They can use insured rates to calculate reportable cost.
- Plans can also use the modified COBRA premium method. In one example of the modified COBRA premium method, an employer has a rate of $350 for single coverage in 2011. In 2012, the employer knows the COBRA cost has not decreased and thus chooses not to calculate new COBRA rates for 2012. The employer uses $350 as the 2012 single rate. For the 2012 reportable cost, $350 should be used for single coverage.

  In another example, the employer charges $350 as the premium for single coverage in 2011. The employer makes a good faith estimate of $500 as the 2012 single coverage premium. Since the employer does not actually calculate a COBRA premium for 2012, only $350 is charged to ensure good faith compliance with COBRA. In this case, the employer should use $500 as the reportable cost for single coverage.
- If an employer charges a composite rate, that rate can be used for the reportable cost. In some cases, an employer may use a composite rate for active rates, but develop tiered COBRA rates. If this is the case, the employer can use either the composite rate or the tiered COBRA rates. However, the employer must be consistent when determining the reportable cost. The employer cannot use the composite rate for some employees and the tiered rates for others.
- An employer may offer a plan that includes some applicable health coverage along with a plan that is not health coverage. For example, a long term disability plan providing specific limited health benefits. Employers may use any reasonable method to allocate the health coverage portion. If that portion is incidental in comparison to the other benefits provided, then the employer is not required to include it in the reportable cost. On the other hand, if the primary purpose of a plan is medical coverage, and other coverage provided with the plan is incidental, then the cost of the other coverage does not need to be extracted before calculating the reportable cost.

Pay Periods that Straddle Calendar Year

Many employers will use their payroll systems to track reportable cost. Some will not have pay periods that end on December 31. The employer has several options if a pay period straddles the calendar year:

1. Use a reasonable allocation method to apportion the cost of coverage between the calendar years.
2. Treat the pay period that includes December 31 as the part of the calendar year.
3. Treat the pay period immediately prior to the pay period including December 31 as part of the calendar year.

Employers can choose the method that makes the most sense. The only requirement is that they consistently apply the method they select to all employees.

Clarification for Hospital Indemnity Plans

If employers contribute to hospital indemnity plans or specific illness or dread disease plans, they should include these plans in the reportable cost. If they do not contribute, but permit their employees to purchase these plans with pre-tax dollars through a Section 125 plan, then employers must include these plans in the reportable cost. However, if an employer simply provides access to the coverage, and employees pay the entire premium with after-tax dollars, then employers do not need to include these plans in the reportable cost.

Clarifications on Dental and Vision Coverage

Employers do not need to include the cost for dental and vision coverage in the reportable cost if the dental and vision plans are considered excepted benefits under HIPAA. To be considered excepted, dental and vision coverage must be offered under a separate policy, certificate or insurance contract. If not, then the plan cannot link the dental and vision coverage to a medical plan election. Participants must have the ability to elect coverage independently and to pay an additional contribution for dental and vision benefits.

Most dental and vision plans are considered excepted benefits under HIPAA. But if your organization ties dental and vision coverage to the medical election, and there is not a separate carrier or vendor providing these benefits, then your plans are not excepted. If this is the case, you must include the cost for dental and vision coverage in the reportable cost on the W-2.

Concluding Thoughts

The W-2 reporting requirements apply to the 2012 calendar year for the W-2s issued in January 2013. It may seem premature to consider the specifics related to this reporting now. However, since employers need to reflect mid-year changes on the W-2, it makes sense to begin developing your process for tracking reportable costs.

The IRS has clarified the guidelines and added new details in Notice 2012-9. This guidance answers a number of questions that employers have asked about this new reporting requirement. The IRS has not resolved every issue, so employers can expect more guidance. That guidance will include a prospective effective date so that employers will have time to comply.