EMPLOYCO USA
The Power to Compete

Compliance Overview

Highlights

General Information

- A medical opt-out arrangement involves offering a cash incentive for employees to waive coverage under the employer's group health plan.
- While these arrangements are generally allowed, they must be carefully structured to comply with applicable laws.

Key Legal Concerns

- A cash-out option must be offered as part of a written Section 125 cafeteria plan.
- Opt-out payments may impact a health plan's affordability under the ACA's pay-or-play rules, depending on how the arrangement is structured.
- Offering the opt-out payments only to employees with a history of high health claims violates HIPAA.
- Offering the opt-out payments only to Medicare-entitled individuals violates the MSP Rules.

Offering Medical Opt-out Payments

Some employers offer eligible employees a cash incentive for waiving or declining coverage under their group health plan. Known as "opt-out payments" or "cash in lieu of benefits," these arrangements are typically geared toward employees who are eligible for health coverage through another source, such as a spouse's employer-sponsored plan.

Under this incentive arrangement, the employer avoids paying for its share of health plan premiums, while employees receive extra taxable compensation. In most cases, opt-out payments are significantly less than what the employer would have spent on premiums. Employers typically make payments over the course of a year rather than in a lump sum to limit their losses if the employee leaves the company.

Medical opt-out payments are generally permissible, but designing them involves navigating several legal considerations, including compliance with the Affordable Care Act (ACA) and the Health Insurance Portability and Accountability Act (HIPAA). Employers should work with their advisors before rolling out a cash-out option to make sure the arrangement complies with applicable laws. In addition, before offering a cash-out option for an insured plan, employers should confirm that it does not violate minimum participation requirements or other insurance contract terms.

Links and Resources

- IRS Notice 2015-87 and proposed regulations, addressing how opt-out payments affect the affordability of health coverage under the ACA's pay-or-play rules
- Departments' FAQs stating that offering opt-out incentives only to employees who have a history of high health claims violates HIPAA's nondiscrimination rules
- CMS website on MSP Rules

Compliance Overview

Federal Tax Issues

Opt-out payments are taxable to the employee as compensation. Group health coverage itself is generally nontaxable, but opt-out payments are taxed like any other form of employee pay. Employers must include these payments in the employee's gross income on Form W-2, and the payments are subject to federal income tax withholding, along with standard federal employment tax withholding (FICA and FUTA).

Also, because opt-out payments give employees a choice between health coverage and taxable compensation, they **must be offered through a cafeteria plan** under Section 125 of the Internal Revenue Code (Code). Offering an opt-out payment outside a valid cafeteria plan risks subjecting participants who elect health coverage to taxation under the IRS's constructive receipt doctrine.

ACA Compliance

Proof of Other Coverage

A common design for medical opt-out payments is to require a certification or other form of proof that the employee has health coverage through another source, such as through a spouse's employer. Conditioning the availability of the cash incentive on an employee's purchase of an individual insurance policy likely creates an employer payment plan that violates the ACA's market reforms. Violating the ACA's market reforms can trigger penalties, including excise taxes of $100 per day for each applicable employee.

Also, the ACA's pay-or-play rules for applicable large employers (ALEs) require certain ALEs to provide employees with an effective opportunity to decline health plan coverage. This requirement applies to ALEs whose health plan coverage does not meet the ACA's affordability and minimum value requirements. Employers may require employees to provide proof of other group health plan coverage to obtain a cash-out payment, but ALEs that do not offer affordable, minimum value coverage cannot require employees to provide this proof to decline the ALE's group health coverage.

Affordability Calculation

To avoid potential penalties under the pay-or-play rules, ALEs must offer affordable, minimum value health coverage to substantially all full-time employees. In general, the affordability of an employer's offer of health coverage depends on whether the employee's required contribution for self-only coverage exceeds a certain percentage of the employee's household income. The IRS has released Notice 2015-87 and proposed regulations to provide guidance on how medical opt-out payments impact the affordability calculation.

In general, until final regulations are issued, medical opt-out arrangements that were adopted before Dec. 16, 2015, will not increase the cost of employer-provided health coverage. The impact on affordability for medical opt-out arrangements adopted after this date depends on how the payments are structured. The IRS's guidance groups medical opt-out arrangements into two general categories:

1. **Unconditional medical opt-out payments** – An arrangement where the opt-out payments are conditioned solely on an employee declining coverage under an employer's health plan and not on an employee providing proof of other coverage. According to Notice 2015-87, it is generally appropriate to treat unconditional opt-out payments as increasing an employee's contribution for health coverage beyond the amount of the employee's salary reduction contribution. For example, an employee whose required self-only contribution for health coverage is $200 per month, but who is eligible for a cash payment of $100 per month if coverage is waived, would be treated as having a required contribution of $300 per month when determining if the coverage is affordable.

2. **Conditional medical opt-out payments** – An arrangement where the opt-out payments are conditioned on an employee declining coverage under an employer's health plan and providing proof of other coverage. According to the proposed regulations, these payments would increase an employee's required contribution when

determining the health plan's affordability, unless the arrangement qualifies as an "eligible opt-out arrangement." An eligible opt-out arrangement is one where the opt-out payments are available only to employees who decline employer-sponsored coverage and provide reasonable evidence that they and their expected tax dependents have or will have minimum essential coverage other than individual market coverage during the plan year. Payments under eligible opt-out arrangements will not be treated as increasing an employee's required contribution until the proposed regulations are finalized.

Other Legal Concerns

HIPAA Special Enrollment Rights

HIPAA's special enrollment rights allow eligible individuals to enroll in a health plan outside of the standard open enrollment period following specific life events, such as getting married, having a baby or losing eligibility for other health coverage. Employees who waive coverage and take the cash-out option may be eligible to enroll in the health plan later in the year if they experience a HIPAA special enrollment event. Employers may want to ask employees to waive their special enrollment rights as a condition of receiving the opt-out payment, but it is uncertain whether such a waiver would be enforceable. As another option, employers may consider amending their health plan eligibility rules so that employees who elect the opt-out incentive are specifically excluded from participation for the year, although whether this approach would survive a legal challenge is also unclear.

Nondiscrimination

HIPAA prohibits group health plans from discriminating against individuals with regard to eligibility, premiums or coverage based on a health-status-related factor. According to FAQs issued by the U.S. Departments of Labor (DOL), Health and Human Services, and the Treasury (Departments), offering opt-out incentives only to employees who have a history of high health claims violates HIPAA's nondiscrimination rules. While it is permissible to have more favorable rules for eligibility or reduced premiums or contributions based on an adverse health factor (sometimes referred to as benign discrimination), the Departments do not interpret cash-or-coverage arrangements offered only to employees with a high claims risk as permissible benign discrimination.

In addition, depending on how an employer defines eligibility for the opt-out incentives, other federal laws, such as the Americans with Disabilities Act or the Age Discrimination in Employment Act, could be implicated.

Medicare Secondary Payer (MSP) Rules

In general, the MSP Rules prohibit employers with 20 or more employees from offering any "financial or other incentive" to Medicare-entitled individuals not to enroll (or terminate enrollment) under a group health plan. An opt-out incentive directed toward Medicare-entitled employees would violate the MSP Rules prohibition on incentives and could trigger penalties of up to $11,823 per violation (adjusted for inflation). The Centers for Medicare and Medicaid Services (CMS) has informally indicated that no violation occurs when employees who are entitled to Medicare have the same rights to opt-out incentives as other employees under a Code Section 125 cafeteria plan; however, CMS has not formalized this guidance.

Fair Labor Standards Act (FLSA)

The FLSA requires employers to pay employees at least the federal minimum wage for all hours worked and overtime pay—at a rate of 1.5 times their regular pay rate—for all hours worked over 40 in a workweek. DOL regulations address how employer contributions to benefit plans impact the calculation of overtime payments. Under this guidance, opt-out incentives are generally included in employees' regular pay rate when calculating overtime payments.