

December 2010

Post-Employment Medical Benefits for Executives After Health Care Reform

How the discrimination rules under § 105(h)(2) of the Internal Revenue Code apply to medical plans has never been completely clear. However, many employers did not have to confront the ambiguities in the health plan discrimination rules under § 105(h)(2) because the rules applied only to self-insured arrangements and the rules were rarely enforced or ruled upon by the Internal Revenue Service. Beginning in 2011, the Patient Protection and Affordable Care Act of 2010 (the "Act") provides that discrimination rules similar to those under § 105(h)(2) will apply to insured medical plans. The Act does not resolve the ambiguities in the existing regulations, although it is anticipated that the Internal Revenue Service will issue guidance in 2011 implementing the extension of the discrimination rules to insured plans.

The Act also imposes monetary penalties on employers when insured plans discriminate and appears to give employees a private right of action to enforce the discrimination requirements against employers. To further complicate matters, § 409A of the Internal Revenue Code – which regulates most types of deferred compensation – may, in certain instances, limit an employer's ability to amend existing arrangements.

This client publication focuses on the impact that the Act will likely have on post-employment medical benefits offered to senior executives as part of severance arrangements. This client publication also identifies the potential limitations imposed by § 409A of the Internal Revenue Code on changes to existing arrangements contained in employment agreements and severance plans and suggests a number of possible ways to address these limitations.

Client action is required now, as the discrimination provisions of the Act for many insured plans will begin to take effect in 2011.

§ 105(h) and the Act

Impact of the Act

The Act provides that discrimination rules similar to those under § 105(h) of the Internal Revenue Code will apply to insured plans.¹ The Act limits application of the new discrimination rule to insured plans that are not grandfathered. However, it is anticipated that plan sponsors will find it difficult to maintain the grandfathered status of their plans.² Therefore, as a practical matter, most, if not all, insured plans will eventually be subject to the new discrimination rule.

The Mechanics and Ambiguities of Current § 105(h)(2)

The Act contemplates that the new discrimination rule for insured medical plans will be "similar" to the rules under current § 105(h) of the Internal Revenue Code, so it is worth reviewing briefly the basic mechanics and ambiguities in the current law.

Current § 105(h)(2) prohibits discrimination in favor of highly compensated individuals with respect to eligibility and benefits under a self-insured plan.³ A highly compensated individual ("HCI") is an employee who is (i) one of the top five paid officers, (ii) a 10% shareholder or (iii) among the highest paid 25% of all employees.⁴ The definition of HCIs in § 105(h) differs from the definition of "highly compensated employees" applicable to the discrimination rules under the Internal Revenue Code for retirement plans. The Act specifically provides that the definition of HCIs is to apply for purposes of discrimination testing for insured medical plans.

To comply with § 105(h)(2), a plan must satisfy separate tests regarding eligibility and benefits. Generally, a plan satisfies the eligibility test if the plan benefits:

- 70% or more of all employees (other than excludable employees); or
- 80% or more of all of the employees who are eligible to benefit under the plan, if 70% or more of all employees (other than excludable employees) are eligible to benefit under the plan.⁵

Both numerical eligibility tests focus on employees that benefit under the plan and make no reference to the proportion of benefitting employees who are HCIs. The eligibility tests are applied on a controlled group basis, subject to certain

¹ §§ 1001(5) and 10101(d) of the Patient Protection and Affordable Care Act of 2010 (adding and amending § 2716 of the Public Health Services Act (hereinafter, "PHSA § 2716")). PHSA § 2716 is effective for plan years beginning on or after September 23, 2010, which, for calendar year plans, would be January 1, 2011. *See also* §§ 105(h) and 9815 of the Internal Revenue Code and §§ 715 and 732 of the Employee Retirement Income Security Act of 1974, as amended.

² Note 12 and the related text have additional information on grandfathered plans.

³ § 105(h) of the Internal Revenue Code; Treas. Reg. § 1.105-11.

⁴ Treas. Reg. § 1.105-11(d).

⁵ Treas. Reg. § 1.105-11(c)(2)(i).

exclusions.⁶ Alternatively, a plan can satisfy the eligibility test by covering a classification of employees that does not discriminate in favor of HCIs.⁷ For example, a plan covering all hourly employees would likely pass the eligibility test, whereas a plan covering only the top five paid officers of an employer would likely not. For controlled groups of companies, it should also be possible to base a non-discriminatory classification on separate subsidiaries or business units.⁸

The benefits test requires that the benefits provided to HCIs be provided to all other participants. To comply with this test, the plan document must not permit discrimination in benefits and the plan must comply in operation.⁹

The regulations implementing the eligibility and benefits tests raise a number of questions and issues that remain unresolved. For example:

- What is a "plan" for purposes of the tests?
- How is the eligibility test applied to a medical plan that applies only to former employees?
- How are "benefits" defined for purposes of the benefits test?
- Do "benefits" include subsidies such as employer-paid COBRA coverage?
- How is the benefits test applied for plans with multiple benefit arrangements or with benefit structures that vary by region?

While the current Treasury regulations under § 105(h) do not define "benefits," they suggest that the term is to be broadly construed. The regulations provide that "benefits subject to reimbursement" must not discriminate in favor of HCIs¹⁰ and that the amount of benefits provided to HCIs must be provided to all other participants.¹¹ Based on this language, it appears that "cash" benefits, such as employer-paid COBRA coverage, would likely be subject to § 105(h), where the payment is conditioned up the former employee's election of such coverage.

⁶ § 105(h)(8) of the Internal Revenue Code. The following employees may be excluded for purposes of testing under § 105(h): (i) employees who have not completed three years of service, (ii) employees who have not attained age 25 prior to the first day of the plan year, (iii) part-time employees whose customary weekly employment is less than 35 hours and seasonal employees whose customary annual employment is less than nine months respectively, if other employees performing similar work for the employer work more than 35 hours per week and 9 months per year, respectively, (iv) certain employees covered by a collective bargaining agreement and (v) employees who are non-resident aliens with no earned income from the employer from sources in the U.S. Treas. Reg. § 1.105(h)-11(c)(2)(iii).

⁷ Treas. Reg. § 1.105(c)(2)(ii) (the determination of a non-discriminatory classification is based on facts and circumstances applying the standards as are applied in § 410(b)(1)(B) of the Internal Revenue Code).

⁸ See Treas. Reg. § 1.410(b)-4 (a plan satisfies the non-discriminatory classification test if the classification is reasonable and non-discriminatory). Reasonable classifications generally include specified job categories, nature of compensation, geographic location and similar bona fide business criteria. Treas. Reg. § 1.410(b)-4(b).

⁹ Treas. Reg. § 1.105-11(c)(3). Whether a plan complies in operation is based on facts and circumstances. Treas. Reg. § 1.105-11(c)(3)(ii).

¹⁰ Treas. Reg. § 1.105-11(c)(3)

¹¹ Treas. Reg. § 1.105-11(e)(4), Ex. 1.

Exceptions Offered by the Act

The Act excludes two types of medical arrangements from the new discrimination rule, but the scope and continued availability of these exclusions is unresolved. First, as noted above, the Act provides that the new discrimination rule will not apply to grandfathered plans. A grandfathered plan is generally one that was in effect on March 23, 2010 and continues to maintain benefits and cost sharing requirements within parameters set by government regulations.¹²

Second, it appears that the new discrimination rule does not apply under the Act to insured plans in which fewer than two active employees participate ("**Former Employee Plans**").¹³ This is a complicated exemption to parse. The Act applies the new discrimination rule to insured plans and incorporates the rule into ERISA and the Internal Revenue Code.¹⁴ The Act also amends ERISA and the Internal Revenue Code to provide that, to the extent that any provision of part 7 of Title I ERISA (covering group health plans) or subchapter B of chapter 100 of the Internal Revenue Code (covering group health plans) conflicts with the provisions of the Act applying the new discrimination rule to insured plans, such provisions of the Act will apply.¹⁵ The exclusion for Former Employee Plans lies in §§ 732(a) of ERISA and 9831(a) of the Internal Revenue Code, which provide that part 7 of Title I ERISA and chapter 100 of the Internal Revenue Code do not apply to group health plans that have fewer than two active employees as participants. As nothing in the Act appears to conflict with these sections, it seems reasonable to anticipate that the new discrimination rule will not apply to Former Employee Plans.

Consequences of Non-Compliance

If a self-insured plan does not satisfy the requirements of current § 105(h), HCIs are taxed on the value of the discriminatory benefit, which is referred to as an excess reimbursement. In the case of a benefit available only to HCIs, the amount of the excess reimbursement equals the total amount reimbursed to the HCI with respect to such benefit.¹⁶ If a self-insured plan fails to pass the eligibility test, the excess reimbursement is determined by multiplying the total amount reimbursed to an HCI by a fraction, with the numerator equal to the total amount reimbursed during the plan year to all HCIs and the denominator equal to the total amount reimbursed during the plan year to all plan participants.¹⁷

¹² A plan will lose grandfathered status if it increases the cost sharing requirement or copayment amount or decreases the employer contribution rate in excess of the specified threshold in the Act (which is measured against the March 23, 2010 cost-sharing percentage or amount, copayment or employer contribution rate, as applicable). See Treas. Reg. § 54.9815(b)-1251T. For additional information on the Act's grandfathering provisions, you may wish to refer to the following Shearman & Sterling LLP client publications: <http://www.shearman.com/health-reform-update---health-care-reform-grandfathering-rules-require-careful-scrutiny-by-plan-sponsors-06-24-2010/>; <http://www.shearman.com/a-look-at-grandfathering-under-health-care-reform-05-11-2010/>; <http://www.shearman.com/self-insured-medical-plans-after-health-reform-04-29-2010/>.

¹³ 75 F. R. 34538, 34539 (June 17, 2010).

¹⁴ § 715(a)(1) of ERISA and § 9815(a)(1) of the Internal Revenue Code (each incorporating all provisions of part A of Title XXVII of the Public Health Services Act ("PHSA"), which includes PHSA § 2716).

¹⁵ See § 715(a)(2) of ERISA and § 9815(a)(2) of the Internal Revenue Code (providing that, to the extent that Part 7 of ERISA or subchapter B Part 100 of the Internal Revenue Code conflict with the PHSA, the PHSA will apply). Part 7 of Title I of ERISA includes §§ 715 and 732 of ERISA. Subchapter B of Chapter 100 of the Internal Revenue Code includes § 9815 of the Internal Revenue Code.

¹⁶ Treas. Reg. § 1.105(h)-11(e)(2).

¹⁷ Treas. Reg. § 1.105(h)-11(e)(3).

In contrast, under the Act, if an insured plan does not comply with the new discrimination rule, the plan sponsor is subject to the taxes, remedies and penalties that generally apply for a plan failing to comply with chapter 100 of the Internal Revenue Code. The amount of the penalty is \$100 per day of violation per employee who was discriminated against, capped at the lesser of 10% of the amount paid by the sponsor during the preceding year for the group health plan and \$500,000.¹⁸

A participant in an insured plan who is not an HCI would also appear to have the right to file a lawsuit to compel the plan sponsor to provide non-discriminatory benefits and to refrain from violating the new discrimination rule. This individual right of action arises under § 502(a)(1) of ERISA, which provides that a participant or beneficiary may bring a civil action to enforce the provisions of Title I of ERISA and enjoin any act or practice that violates Title I.¹⁹

Applying the Discrimination Rules to Post Employment Medical Coverage for Executives

It is a common practice for employment agreements and executive severance plans to provide some form of medical continuation benefit for executives who terminate employment under circumstances where severance is payable. These medical continuation benefits vary among employers but typically fall into one of three basic types: (1) continued participation in the plan for a limited period of time on terms available to active employees (a "Continued Coverage Arrangement"); (2) payment or reimbursement of COBRA or regular plan premiums for a specified period (a "Premium Arrangement"); and (3) a cash subsidy for a specified period to permit the executive to purchase replacement coverage (a "Cash Subsidy Arrangement"). Typically, Continued Coverage Arrangements and Premium Arrangements end when the executive is either eligible for, or is actually covered by, the medical plan of a new employer. Continued Coverage Arrangements and Premium Arrangements are likely to be problematic for insured plans under the new discrimination rule if the benefit is available only to HCIs. On the other hand, Cash Subsidy Arrangements that are not contingent upon an HCI electing coverage under an employer sponsored plan should not be subject to the new discrimination rule or current § 105(h)(2).

Sponsors of self-insured plans have in the past attempted to justify Continued Coverage Arrangements and Premium Arrangements for HCIs on the theory that the group medical plan pursuant to which the benefit is provided covers a broad group of employees and the benefits provided to executives following termination of employment do not differ from those offered under the plan to active employees.²⁰ However, to the extent that eligibility to continue plan coverage after employment is limited only to HCIs, it is possible that the medical plan could be treated by the Internal Revenue Service as discriminating as to either eligibility or benefits. Other employers have justified Continued Coverage Arrangements and Premium Arrangements for self-insured plans by offering these benefits under severance plans to all employees who

¹⁸ Notice 2010-63. See § 4980D(c)(3) of the Internal Revenue Code (applies to violations of Chapter 100 of the Internal Revenue Code, including § 9815 of the Internal Revenue Code, which requires group health plans to comply with the Discrimination Rule). § 4980D imposes liability on a controlled group basis, in the event that the plan sponsor fails to pay the tax.

¹⁹ See Notice 2010-63.

²⁰ See Notes 3-9 and corresponding text.

terminate employment under circumstances where severance is payable. The latter approach would likely comply with § 105(h)(2) if all eligible employees are viewed as benefiting under the arrangement.

Cash Subsidy Arrangements may not be subject to the new-discrimination rules and are arguably not subject to current § 105(h)(2) to the extent that the cash payments are not linked to continuation of medical coverage. In essence, the executive receives the cash subsidy as part of severance whether or not the executive elects COBRA coverage or otherwise loses medical coverage or benefits provided by the employer.

In preparing for compliance with the new discrimination requirements, a first and obvious step is for employers to review existing employment agreements and severance plans to identify those that provide post-employment medical coverage to executives that may be discriminatory. This review should encompass both insured and self-insured plans, as the renewed emphasis on discrimination rules for insured plans will undoubtedly spill over to the current § 105(h)(2) provisions that apply to self-insured plans.

The second step is to determine whether the arrangement under consideration is a separate plan or part of a broader employer-sponsored plan. If it is possible to demonstrate that the arrangement is a separate insured plan in which fewer than two active employees participate, the arrangement may be covered by the exception to the new discrimination rule for Former Employee Plans. Another workable approach might be to assure that post-employment medical continuation for HCIs is provided only under an insured arrangement that covers only former employees.

A third key step, where possible, is to buy time for insured arrangements by preserving grandfathered status under the Act. As noted above, preservation of grandfathered status would require plan sponsors to defer or limit any increase in the plan's cost sharing requirement or copayments, any decrease in the employer contribution rate, in each case, in excess of the specified threshold in the Act or any change in the plan's annual limits.²¹

A fourth step, which we turn to in the next section, is to identify what remedial action is possible to correct any medical arrangement that is arguably subject to the new discrimination rule and that most likely does not comply with the rule.

Correction

It is possible that IRS guidance implementing the new discrimination rule for insured plans will provide some meaningful compliance transition period. Eventually, however, all medical continuation arrangements that are discriminatory either under the new discrimination rule for insured plans or current § 105(h)(2) for self-insured plans will need to be corrected to avoid the penalties on the employer (in the case of insured plans) or the income tax penalties on the covered HCIs (in the case of self-insured plans).

Where the potentially discriminatory benefits are found in an employment agreement or a severance agreement with an individual executive, the nature of these individual arrangements may require the executive's consent to any change. However, depending on the terms of the agreement, it may be possible to take the position that the obligation to provide the discriminatory benefit is not binding on the employer insofar as providing the benefit would be a violation of law.

²¹ See note 12 and corresponding text.

In addition, where an employer intends to replace a potentially discriminatory benefit with one that complies with the applicable discrimination requirements, the employer will also need to consider whether the replacement is an impermissible substitution or an impermissible payment deferral or acceleration under § 409A. In the next section, we provide a brief overview of § 409A and conclude with some correction alternatives that appear to comply with § 409A.

§ 409A Overview

As a general matter, § 409A of the Internal Revenue Code applies to plans or arrangements that provide for a deferral of compensation.²² Compensation deferred under a plan subject to § 409A may be paid only at a specified time, or pursuant to a fixed schedule, or upon the occurrence of certain enumerated events.²³ The final regulations implementing § 409A (when read in combination with the proposed regulations under § 125 of the Internal Revenue Code) also preclude service provider elections between taxable and non-taxable benefits (other than pursuant to a cafeteria plan)²⁴ and broadly prohibit service providers and service recipients from substituting other compensatory arrangements for deferred compensation amounts that are subject to the rule.²⁵ Unless the requirements of § 409A are met, the amounts deferred under a nonqualified deferred compensation plan will be currently includable in the income of the service provider (to the extent not subject to a substantial risk of forfeiture) and are subject to an additional tax.²⁶

What constitutes a deferral of compensation under § 409A has been broadly construed by the final regulations. The final regulations do not categorically exempt medical reimbursement arrangements from the requirements applicable to traditional deferral arrangements. Moreover, the final regulations provide that, unless a specific exception applies to a particular arrangement, § 409A requirements will apply where an employee has a legal right (whether or not conditional) to compensation in a taxable year that may be payable in a later taxable year.²⁷ An arrangement for the reimbursement of medical expenses may be subject to § 409A either because: (i) an employee may incur an expense in a taxable year that is

²² For additional information on the application of § 409A, you may wish to refer to the following Shearman & Sterling LLP client publications:

<http://www.shearman.com/Treasury-and-IRS-Issue-Guidance-under-§-409A-on-Correcting-Documents-Failures-01-14-2010>; http://www.shearman.com/eceb_cm_091207;
http://www.shearman.com/eceb_101305; http://www.shearman.com/eceb_1004; http://www.shearman.com/eceb_1204.

²³ They are the employee's death, disability or other separation from service with the employer, the occurrence of an unforeseeable emergency with respect to the employee or the occurrence of a change in control event. I.R.C. § 409A(a)(2)(A). In general, the payment event under § 409A must be set at the time the election or decision to defer the compensation is made. See I.R.C. § 409A(a)(4)(B) (initial elections); § 409A(a)(4)(C) (subsequent elections); § 409A(a)(3) (prohibition on acceleration).

²⁴ See Treas. Reg. § 1.409A-1(b)(1) ("A legally binding right to an amount that will be excluded from income when and if received does not constitute a deferral of compensation, unless the service provider has received the right in exchange for, or has the right to exchange the right for, an amount that will be includable in income (other than due to participation in a cafeteria plan described in section 125)"). See also Proposed Treas. Reg. § 1.125-1(b) ("Section 125 is the exclusive means by which an employer can offer employees an election between taxable and nontaxable benefits without the election itself resulting in inclusion in gross income by the employees").

²⁵ See Treas. Reg. § 1.409A-3(f).

²⁶ I.R.C. §§ 409A(a)(1)(A)-(B). The amount of the additional tax is equal to 20 percent of the amount included in the employee's income, plus the amount of interest that would have been imposed (at the underpayment rate prescribed by § 6621 of the Internal Revenue Code, plus one percent) had the compensation been included in income in the year in which first deferred or, if later, no longer subject to a substantial risk of forfeiture. § 409A(a)(1)(B) of the Internal Revenue Code.

²⁷ See Treas. Reg. § 1.409A-1(b)(1).

reimbursable under the arrangement in a later taxable year; or (ii) the employee may have the legal right in a taxable year to coverage (or to receive reimbursement for expenses that may be incurred) in a later taxable year.

The final regulations indicate that § 409A does not apply to the following types of medical reimbursement arrangements:

Non-Taxable Medical Benefits. Reimbursement arrangements (including medical reimbursement arrangements) are not to be subject to § 409A of the Internal Revenue Code, insofar as the payments under the arrangement are not includable in taxable income at the time they are paid to the employee, unless the service provider has the right to exchange, or in fact has exchanged, an amount that would be includable in income for the right to the non-taxable benefit.²⁸ The final regulations under § 409A extend this principle in a special exception for reimbursement arrangements that satisfy the requirements of § 105 and § 106 of the Internal Revenue Code.²⁹ A self-insured Continued Coverage Arrangement that discriminates under current § 105(h) would not be eligible for this exception, because the arrangement would result in taxable benefits to HCIs. Contrariwise, a discriminatory insured Continued Coverage Arrangement would result in penalties to the employer but would continue to be eligible for this exclusion because the new discrimination rule would not result in taxable income to HCIs.

Post-Employment Medical Benefits. § 409A generally does not apply where a service provider receives reimbursement following termination of employment of medical expenses that would otherwise be allowable as a deduction for federal income tax purposes, as long as reimbursements do not extend beyond the period during which the service provider would otherwise be entitled to continuation coverage under COBRA under the employer's plan.³⁰ This exception does not require that the reimbursement be non-taxable to the service provider and would, therefore, appear to be available for Continued Coverage Arrangements and Premium Arrangements that discriminate in favor of HCIs under current § 105(h) or the new discrimination rule.

Other Post-Employment Benefits. The final regulations under § 409A provide a general exception for any other benefits that are to be provided to a service provider upon a termination of employment, up to the amount of the applicable limit for the year of termination under § 402(g)(1)(B) of the Internal Revenue Code.³¹ (In 2011, this amount is \$16,500.) Again, there is no requirement under this exception that the reimbursement be non-taxable to the service provider.

Involuntary Separation Pay. The final regulations under § 409A also appear to except, subject to certain dollar limits, amounts that are paid no later than the second taxable year following the year of separation of the service

²⁸ See Treas. Reg. § 1.409A-1(b)(1).

²⁹ Treas. Reg. § 1.409A-1(a)(5). This may include, for example, insured arrangements that are not yet subject to the Discrimination Rule under § 105.

³⁰ See Treas. Reg. § 1.409A-1(b)(9)(v)(B).

³¹ Treas. Reg. § 1.409A-1(b)(9)(v)(D).

provider, if the benefit is to be provided to the service provider only in the event of a termination of employment that will qualify as an "involuntary" separation from service for purposes of § 409A.³²

Short-Term Deferrals. Lastly, where none of the other exceptions apply, it may nevertheless be possible to characterize a reimbursement arrangement as a "short-term deferral."³³ This would be the case, for example, where the benefit is conditioned on the performance of substantial services by the employee and is payable within a specified period after the services are performed.³⁴ A post-employment arrangement may qualify as a short-term deferral, to the extent the benefits under the arrangement are conditioned on the employee's continued service and must be received by the employee no later than the 15th day of the third month following the year in which the termination occurs.³⁵

Based on these principles, it would appear that certain approaches to correcting potentially discriminatory post-employment medical arrangements are possible without triggering adverse tax consequences under § 409A for service providers.

The most obvious approach is to eliminate the discriminatory benefit without providing an alternative arrangement. This approach would be possible, for example, where the HCI's consent to the elimination of the benefit is (or has been) obtained or where the employer has reserved the right to eliminate the benefit without such consent. Elimination without replacement may also be possible where the employer concludes that the obligation to provide the medical benefit violates law. Moreover, an employer's conclusion not to pay a benefit on the basis of a violation of law is not necessarily contingent upon provisions in the documents (e.g., "subject to applicable law" and the like) that condition the payment on legality.

A second alternative is to continue to maintain a Continued Coverage Arrangement under a discriminatory, non-grandfathered insured plan. In this circumstance, the employer would be subject to tax penalties, but the benefits provided to the employee would continue to be non-taxable and, therefore, presumably eligible for the § 409A exclusion described above for medical reimbursement arrangements that comply with § 105 of the Internal Revenue Code, with the result that all reimbursements are non-taxable.³⁶ Under this approach, the employer would essentially be treating the penalty as a cost of maintaining the arrangement. The risk here, however, is a legal action by employees to require compliance with the new discrimination provision.³⁷

A third alternative, noted above, would be to replace a Continued Coverage Arrangement that utilizes an insured or group health plan that covers current and former employees with a Continued Coverage Arrangement that utilizes an insured

³² See Treas. Reg. § 1.409A-1(b)(9)(iii). The amounts under this exception are limited to two times the lesser of (i) the employee's annual rate of pay for the preceding year and (ii) the limit for the year of termination under § 401(a)(17) of the Internal Revenue Code. Treas. Reg. § 1.409A-1(b)(9)(iii)(A). An "involuntary" separation for purposes of § 409A may include a resignation for good reason that meets the requirements of Treas. Reg. § 1.409A-1(n)(2).

³³ See generally Treas. Reg. § 1.409A-1(b)(4).

³⁴ Specifically, the payment must be received on or before the 15th day of the third month following the end of the taxable year in which the service condition is satisfied by the employee. Treas. Reg. § 1.409A-1(b)(4)(A).

³⁵ This would typically be the case under a severance agreement or similar arrangement where the termination of employment is required to be involuntary.

³⁶ See text at note 29.

³⁷ See text at note 19.

Former Employee Plan. This approach is typically expensive and might not be able to replicate the types of benefits provided by the broader group health plan that is being replaced, particularly where the group health plan is self-insured.

In circumstances where a post-employment medical arrangement is not currently subject to § 409A, as a fourth alternative, it should also be possible, without triggering taxation under § 409A, for an employer to replace it with another type of arrangement that also is not subject to § 409A, as long as the affected employees are not given a choice as to the type of replacement. For example, an employer arguably could replace a Continued Coverage Arrangement under an insured plan (whether or not discriminatory) with a series of cash severance payments under an involuntary severance arrangement that satisfies the two year duration and dollar limitations of the final regulations.³⁸ Alternatively, an employer should be able to substitute a Continued Coverage Arrangement under an insured plan that is discriminatory with a non-discriminatory Premium Arrangement that does not extend beyond the COBRA continuation period. Each of these substitutions is based on the conclusion that § 409A does not regulate elections between two or more types of compensation that do not constitute deferred compensation for purposes of § 409A.³⁹ It also assumes that the arrangement in question treats all payments as separate payments for purposes of § 409A and that the service provider does not have the option to choose between taxable and non-taxable benefits.

Certain correction methods would likely be problematic under § 409A. For example, where a Continued Coverage Arrangement under a self-insured medical plan is discriminatory and extends beyond the normal COBRA continuation period, it is likely that any taxable or non-taxable arrangement that an employer substitutes for this benefit would violate § 409A. The principal concern would be that the replacement changes the time of payments. Use of the short-term deferral rule under § 409A may also be problematic. Although in theory it should be possible to substitute a cash benefit that is a short-term deferral for a discriminatory insured medical arrangement, it is also possible to read the final regulations as permitting this only where the medical arrangement was subject to a substantial risk of forfeiture at the time of the substitution (and remains subject to a substantial risk of forfeiture or otherwise satisfies the requirements for short-term deferrals).⁴⁰ Finally, § 409A may not apply to a change in the time or form of payment of a medical arrangement to the extent the service provider does not have a legally binding right to the original benefit under the discriminatory plan. Where there is no legally binding right in effect, § 409A requirements frequently will permit the employer to set the time and form of payment of the replacement benefit at the time the replacement arrangement is put in place. This analysis would apply, for example, to the extent that the employer's continuing to provide the original benefits in violation of the new discrimination rule may be viewed as a violation of law. In this case, even where the right to the original benefit is provided by contract, it would be difficult to view the contractual provision as providing the basis for a legally binding right.

³⁸ Treas. Reg. § 1.409A-1(b)(9)(iii).

³⁹ Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. 19234, 19243 (April 17, 2007) ("Generally, an election between compensation alternatives, none of which provides for a deferral of compensation within the meaning of section 409A, will not cause the election to be subject to the section 409A timing restrictions").

⁴⁰ See Treas. Reg. § 1.409A-1(b)(4).

Next Steps

Although employers continue to face a great deal of uncertainty surrounding the application of the new discrimination requirement, the rule nevertheless generally takes effect for insured arrangements in 2011, and it is reasonably clear that many executive medical arrangements will raise discrimination issues under the rule. Given the strict requirements of the new discrimination rule, including significant monetary penalties for the employer and the direct causes of action available to employees, employers are encouraged to put processes in place to identify potentially non-compliant arrangements and to review with legal counsel strategies for optimizing their compliance under the rule.

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This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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