

Health Insurance Rebates Could Be Taxable

Cross References

- Public Law 111-148, *Patient Protection and Affordable Care Act*
- www.irs.gov

Beginning January 1, 2011, health insurance companies are required to spend most of the premium dollars on health care, not on profits and overhead (85% in the large group market and 80% in the small group and individual market). The insurance company is required to rebate any excessive overhead to enrollees. The insurance company must file reports that disclose the percentage of premiums they spend on items other than health care costs, such as bureaucracy, marketing, or executive compensation. The money required to be rebated is called medical loss ratio (MLR) rebates.

The first MLR rebates under this rule were required to be disbursed to health insurance policyholders by insurance companies on or before August 1, 2012. Employers that operate self-insured plans are exempt from this rule.

Whether a particular MLR rebate is taxable depends upon a number of variables. Some individuals are receiving their premium rebate checks directly from the health insurance provider. Others are receiving the rebate indirectly from their employers, either as cash payments or in the form of 2012 premium offsets. Some employers are using the rebates to cover plan expenses.

Author's Comment

Even though an employer may receive a rebate check from the insurance company, ERISA rules do not require the employer to directly pass through the rebate to its employees. Employers have some discretion as to how to use or dispose of their rebates, as long as they act prudently, solely in the interest of the plan participants and beneficiaries, and in accordance with the terms of the plan.

Tax consequences of rebates. If a tax benefit was previously gained on the premiums now being refunded, the rebate is taxable. If no tax benefit was gained, the rebates are tax free to the recipient.

For example, if employees make premium contributions with pre-tax dollars through a cafeteria plan, then any rebate is subject to federal income and employment taxes. This is true regardless of whether the rebates are distributed to the employees in the form of cash or a credit or offset against future premiums.

The IRS recently provided guidance on their website to determine specifically when MLR rebates are subject to tax, and when they are not.

A. Insurance Company

Q1. Insurance Company issues health insurance both in the individual market and the group market during 2011. After determining that it is required to pay MLR rebates on both types of policies issued by Insurance Company during 2011, Insurance Company pays the rebates to the individual policyholders as cash payments in July 2012 and pays the rebates to the group policyholders as premium reductions for coverage in July 2012.

What are the federal tax consequences to Insurance Company?

A1. MLR rebates paid by Insurance Company, either as cash payments or as premium reductions, are return premiums. Return premiums reduce Insurance Company's taxable income. The year in which Insurance Company takes the reduction and whether Insurance Company may take an estimated reserve for the return premium are not addressed by this FAQ.

For a cash rebate paid to an individual policyholder, Insurance Company is not required to file a Form 1099-MISC with respect to that payment or furnish a Form 1099-MISC to the individual policyholder unless (1) the total rebate payments made to that policyholder during the year total \$600 or more, and (2) Insurance Company knows that the rebate payments constitute taxable income to the individual policyholder or can determine how much of the payments constitute taxable income. If Insurance Company is required to file a Form 1099-MISC with respect to the rebate payment, it must also furnish a copy to the individual policyholder. See Q&As 2 through 4, below, for guidance on whether a cash payment or premium reduction constitutes taxable income to an individual policyholder.

For a rebate paid to a group policyholder as a premium reduction, Insurance Company is not required to file a Form 1099-MISC or furnish a copy to the group policyholder unless (1) the group policyholder is not an exempt recipient for Form 1099 purposes, (2) the total rebate payments to that group policyholder during the year total \$600 or more, and (3) Insurance Company knows that the rebate payments constitute taxable income to the group policyholder or can determine how much of the payments constitutes taxable income. Exempt recipients for which Forms 1099 generally are not required to be provided include corporations, tax-exempt organizations, and federal and state governments. Insurance Company can rely on a recipient's claim of exempt recipient status on a Form W-9. See the Instructions for Form W-9 or the General Instructions for Certain Information Returns. See Q&As 5-14 for guidance on whether a premium reduction or cash payment constitutes taxable income to employees participating in a group health plan. (Q&As 5-9 address after-tax premium payments and Q&As 10-14 address pre-tax payments.)

B. Policies Purchased on the Individual Market

Q2. In 2011, Aaron purchased and paid premiums for a health insurance policy for himself. Aaron does not deduct the premium payments on his 2011 Form 1040 and does not receive any reimbursement or subsidy for the premiums. Based on his enrollment during 2011, Aaron receives an MLR rebate on July 1, 2012.

Is Aaron's MLR rebate subject to federal income tax?

A2. No. The MLR rebate that Aaron receives on July 1, 2012, is a rebate of part of his 2011 insurance premiums (a purchase price adjustment). Because Aaron did not deduct the premium payments on his 2011 Form 1040, the rebate is not taxable whether received as a cash payment or applied as a reduction in the amount of premiums due for 2012.

Q3. The facts for Beatrice are the same as the facts for Aaron in Question 2 except that she deducts the premium payments on Schedule A of her 2011 Form 1040.

Is Beatrice's MLR rebate subject to federal income tax?

A3. Yes. The MLR rebate that Beatrice receives on July 1, 2012, is a rebate of part of her 2011 insurance premiums (a purchase price adjustment). Because Beatrice deducted the premium payments on Schedule A of her 2011 Form 1040, the MLR rebate that Beatrice receives on July 1, 2012, is taxable to the extent that she received a tax benefit from the deduction, whether the rebate is received as a cash payment or applied as a reduction in the amount of premiums due for 2012. For more information on determining whether there is a tax benefit from the deduction, see Itemized Deduction Recoveries in Publication 525, *Taxable and Nontaxable Income*.

Q4. The facts for Charlie are the same as the facts for Beatrice in Question 3, except that Charlie is self-employed so he deducts the premium payments on line 29 of his 2011 Form 1040.

Is Charlie's MLR rebate subject to federal income tax?

A4. Yes. The MLR rebate that Charlie receives on July 1, 2012, is a rebate of part of his 2011 insurance premiums (a purchase price adjustment). Because Charlie deducted the premium payments on line 29 of his 2011 Form 1040, the MLR rebate that Charlie receives on July 1, 2012, is taxable to the extent that he received a tax benefit from the deduction, whether the rebate is received as a cash payment or as a reduction in the amount of premiums due for 2012. For more information on determining whether there is a tax benefit from the deduction, see Non-Itemized Deduction Recoveries in Publication 525, *Taxable and Nontaxable Income*.

C. Group Policies—Employee After-Tax Premium Payments

In Questions 5 through 7, assume that the MLR rebates are provided only to employees participating in a group health plan both in the year employees paid the premiums being rebated (in these examples, 2011) and the year the MLR rebates are paid (in these examples, 2012).

Q5. In 2011, Daniel participated in his employer's group health plan and received health coverage under the group health insurance policy purchased directly by his employer under the plan. The plan provides that Daniel's employer pays for 60% of the premium for each employee, and the employee pays for 40% of the premium on an after-tax basis. Daniel does not deduct the premiums on his 2011 Form 1040.

On July 1, 2012, Daniel's employer receives an MLR rebate of part of the 2011 group health insurance policy premiums. The MLR rebate is made in the form of a reduction in the current year premium for coverage under the group health insurance policy. In accordance with the terms of the group health plan and consistent with applicable Department of Labor (DOL) guidance, 60% of the rebate is used to reduce the employer portion of the premium due for 2012 and 40% of the rebate is used to reduce the employee portion of the premium due for 2012, but only for participants under the plan who also were participants under the plan during 2011.

Because Daniel participated in the plan during 2011 and 2012, he is entitled to an MLR rebate. As a result of the rebate and corresponding premium reduction, Daniel's premium for 2012 coverage under the group health plan is reduced.

Is Daniel's MLR rebate income subject to federal income tax?

A5. No. The MLR rebate that Daniel receives in 2012 is a rebate of part of his 2011 insurance premiums (a purchase price adjustment). Daniel paid taxes on his compensation as an employee and used part of the after-tax income to pay his portion of the 2011 premiums. He did not deduct the premiums; therefore, the rebate is not taxable when applied as a reduction in the amount of premiums due for 2012. In addition, because the MLR rebate is a return of amounts that have already been subject to federal employment taxes, the rebate is not subject to federal employment taxes.

Q6. Would Daniel's MLR rebate be subject to federal income tax if the insurance company had paid the MLR rebate in cash and then the employer distributed the MLR rebate in cash to Daniel [consistent with applicable Department of Labor (DOL) guidance] rather than reducing the premiums due for 2012?

A6. No. If Daniel receives a cash distribution because of the MLR rebate, the cash also is a reduction in the cost of his 2011 insurance premiums (a purchase price adjustment) and is not taxable. In addition, because the MLR rebate payment is a return of amounts that have already been subject to federal employment taxes, the payment is not subject to federal employment taxes.

Q7. Would Daniel's MLR rebate be subject to federal income tax if Daniel had deducted his premium payment on his 2011 Form 1040?

A7. Yes. If Daniel deducted the premium payments on his 2011 Form 1040 and receives an MLR rebate in 2012, the MLR rebate is taxable to the extent that he received a tax benefit from the deduction, regardless of whether the rebate is provided as a cash payment or a reduction in the premium due for 2012. For more information on determining whether there is a tax benefit from the deduction, see Itemized Deduction Recoveries in Publication 525, *Taxable and Nontaxable Income*. Because the MLR rebate is a return of amounts that have already been subject to federal employment taxes, the rebate (whether applied

to reduce Daniel's 2012 premium or provided as a cash payment) is not subject to federal employment taxes.

In Questions 8 and 9, assume that the MLR rebates are provided to all employees participating in a group health plan in the year the MLR rebates are paid (in these examples, 2012), regardless of whether an employee participated in the plan in the year the employees paid the premiums being rebated (in these examples, 2011).

Q8. In 2011, Doris participated in her employer's group health plan and received health coverage under the group health insurance policy purchased directly by her employer under the plan. The plan provides that Doris's employer pays for 60% of the premium for each employee, and the employee pays for 40% of the premium on an after-tax basis.

On July 1, 2012, Doris's employer receives an MLR rebate of part of the 2011 group health insurance policy premiums. The employer may distribute the MLR rebate in cash or in the form of a reduction in the current year premium for coverage under the group health insurance policy. In accordance with the terms of the group health plan and the applicable DOL guidance, the employer applies 60% of the MLR rebate to reduce the employer portion of the premium due for 2012 and 40% of the rebate to reduce the employee portion of the premium due for 2012 for all participants under the plan, regardless of whether the employee who receives the MLR rebate participated in the plan during 2011.

Because Doris participates in the plan during 2012, she is entitled to an MLR rebate. As a result of the rebate and the corresponding premium reduction, Doris's premium for 2012 coverage under the group health plan is reduced.

Is Doris's MLR rebate subject to federal income tax?

A8. No. Doris receives the MLR rebate due to her participation in her employer's group health plan during 2012 and would not have received the MLR rebate had she failed to participate in the plan during 2012. Therefore, the MLR rebate is a purchase price adjustment that reduces the cost of her 2012 insurance premiums and is not taxable regardless of whether Doris deducted the 2011 premium payments on her 2011 Form 1040. If Doris deducts the premiums she pays for health care coverage on her 2012 Form 1040, the amount of the MLR rebate reduces the amount of her deduction because she is paying less for premiums. If Doris had received the MLR rebate in cash, instead of as a premium reduction, Doris's rebate also would not be subject to federal income tax and would reduce the amount of any 2012 deduction for premiums paid by Doris on her Form 1040. In either case, Doris's rebate would not be wages subject to employment taxes.

Q9. In 2012, Edwin begins working for the same employer as Doris (and thus he did not participate in the plan during 2011). Edwin participates in the plan beginning on his first day of employment. When his employer distributes the MLR rebate as a reduction in Edwin's 2012 premiums, Edwin's premium for 2012 coverage under the group health plan is reduced.

Is Edwin's MLR rebate subject to federal income tax?

A9. No. The MLR rebate Edwin receives is a purchase price adjustment that reduces the cost of his 2012 insurance premiums and is not taxable. If Edwin deducts the premiums

he pays for health care coverage in 2012 on his Form 1040, the amount of the rebate reduces the amount of his deduction because he is paying less for premiums. If Edwin had received the MLR rebate in cash, instead of as a premium reduction, Edwin's rebate also would not be subject to federal income tax and would reduce the amount of any 2012 deduction for premiums paid by Edwin on his Form 1040. In either case, Edwin's rebate would not be wages subject to employment taxes.

D. Group Policies—Employee Pre-Tax Payments

In Questions 10 and 11, assume the MLR rebates are provided only to employees participating in a group health plan both in the year employees paid the premiums being rebated (in these examples, 2011) and the year the MLR rebates are paid (in these examples, 2012).

Q10. Frances participates in her employer's group health plan and receives health coverage under the group health insurance policy purchased directly by her employer under the plan. Frances pays her portion of premiums on a pre-tax basis under her employer's cafeteria plan. The plan provides that Frances's employer pays for 60% of the health insurance premium for each employee, and the employee pays for 40% of the premium.

On July 1, 2012, Frances's employer receives an MLR rebate of part of the 2011 group health insurance policy premiums. The MLR rebate is made in the form of a reduction in the current year's premium for coverage under the group health insurance policy. In accordance with the terms of the group health plan and consistent with applicable DOL guidance, the employer applies 60% of the rebate to reduce the employer portion of the premium due for 2012 and 40% of the rebate to reduce the employee portion of the premium due for 2012 but only for participants under the plan who also were participants under the plan during 2011.

Because Frances participates in the plan during 2011 and 2012, she is entitled to a rebate of \$X. As a result of the rebate and corresponding premium reduction, Frances's salary reduction contribution under the cafeteria plan for 2012 is reduced by \$X.

Is Frances's MLR rebate subject to federal income tax?

A10. Yes. Because the MLR rebate is distributed as a premium reduction, the amount Frances pays for premiums through a salary reduction contribution in 2012 is decreased by \$X. Consequently, in 2012, there is a corresponding increase of \$X in her taxable salary that is also wages subject to employment taxes.

Q11. Will Frances also have an \$X increase in taxable income during 2012 if the MLR rebate is provided in the form of a cash payment and the employer distributes the MLR rebate to Frances in cash (consistent with applicable DOL guidance) instead of reducing premiums for 2012 coverage?

A11. Yes. Frances will have \$X more taxable income in 2012. The amount that Frances paid for premiums for health insurance was subtracted from her salary on a pre-tax basis under her employer's cafeteria plan because it was used to pay for health insurance premiums. The MLR rebate is a return to Frances of part of that untaxed compensation that is no longer being used to pay for health insurance. Therefore, the MLR rebate that

Frances receives in 2012 is an increase in taxable income that is also wages subject to employment taxes.

In Questions 12 through 14, assume the MLR rebates are provided to all employees participating in a group health plan during the year the MLR rebates are paid (in these examples, 2012), regardless of whether the employee who receives the MLR rebate participated in the plan during the plan year covered by the MLR rebate (in these examples, 2011).

Q12. Fred participates during 2011 and 2012 in his employer's group health plan and receives health coverage under the group health insurance policy purchased directly by his employer under the plan. Fred pays his portion of premiums on a pre-tax basis under his employer's cafeteria plan. The plan provides that Fred's employer pays for 60% of the health insurance premium for each employee, and the employee pays for 40% of the premium.

On July 1, 2012, Fred's employer receives an MLR rebate of part of the 2011 group health insurance policy premiums. The MLR rebate is made in the form of a reduction in the current year's premium for coverage under the group health insurance policy. In accordance with the terms of the group health plan and consistent with applicable DOL guidance, the employer applies 60% of the rebate to reduce the employer portion of the premium due for July 2012 and 40% of the rebate to reduce the employee portion of the premium due for 2012 for all participants in the plan (regardless of whether a participant was also a participant in the plan during 2011).

Because Fred participates in the plan during 2012, he is entitled to a rebate of \$X. As a result of the rebate and corresponding premium reduction, Fred's salary reduction contribution under the cafeteria plan for 2012 is reduced by \$X.

Is Fred's MLR rebate subject to federal income tax?

A12. Yes. Because the MLR rebate is distributed as a premium reduction, the amount Fred pays for premiums through a salary reduction contribution in 2012 is decreased by \$X. Consequently, in 2012 there is a corresponding increase of \$X in his taxable salary that is also wages subject to employment taxes.

Q13. Will Fred also have an \$X increase in income during 2012 if the MLR rebate is made in the form of a cash payment and the plan distributes the MLR rebate to Fred in cash instead of reducing premiums for 2012 coverage?

A13. Yes. Fred will have \$X more taxable income in 2012. The amount that Fred paid for premiums for health insurance was subtracted from his salary on a pre-tax basis under his employer's cafeteria plan because it was used to pay for health insurance premiums. The MLR rebate is a return to Fred of part of that untaxed compensation that is no longer being used to pay for health insurance. Therefore, the MLR rebate that Fred receives in 2012 results in an increase in taxable income that is also wages subject to employment taxes.

Q14. George begins working for the same employer as Fred in 2012 (and thus he did not participate in the plan during 2011). He participates in the plan during 2012. As a result of the rebate and corresponding premium reduction, George's salary reduction contribution under the cafeteria plan for July 2012 is reduced by \$X.

Is George's MLR rebate income subject to federal income tax?

A14. Yes. Because the MLR rebate is distributed as a premium reduction, the amount George pays for premiums through a salary reduction contribution is decreased by \$X. Consequently, there is a corresponding increase of \$X in his salary and the additional salary is taxable income that is also wages subject to employment taxes.

If George receives an \$X cash payment, he will have \$X more taxable income in 2012. The amount that George paid for premiums for health insurance was subtracted from his salary on a pre-tax basis under his employer's cafeteria plan because it was used to pay for health insurance premiums. The MLR rebate is a return to George of part of that untaxed compensation that is no longer being used to pay for health insurance. Therefore, the MLR rebate that George receives in 2012 is an increase in taxable income that is also wages subject to employment taxes.