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Ambiguities in Calculating and Paying the COBRA Excise Tax

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November 16, 2012 — As important as the correction of COBRA violations is for ensuring qualified beneficiaries obtain the benefits to which they are entitled, there is another aspect to correction — the COBRA excise tax. This column will focus on some of the many issues that advisors and employers have been struggling with in applying the excise tax rules.

Background

When a plan sponsor or plan administrator commits a COBRA violation a number of things should be considered in correcting the violation. Depending on the specific failure, it might be necessary to re-send COBRA notices, allow a new election period, refund excess premium amounts or provide coverage that was not otherwise provided. Sometimes questions are raised about which entity caused the failure — was it the employer, the plan administrator (if not the employer), a third-party administrator or insurer? This can affect not only how the correction is effected but who needs to pay for the correction.

Since the late 1980s, the COBRA statute has included a tailored excise tax sanction for COBRA violations. However, until 2010, there were no effective implementing regulations telling those responsible for paying the tax how it was supposed to be paid. Effective Jan. 1, 2010, the IRS issued final regulations governing the excise tax rules as well as a form to use in paying the tax. (The rules governing the application of the excise tax issues are explained in *Mandated Health Benefits — The COBRA Guide*, ¶1511.)

Employers and administrators have had a couple years to deal with paying the COBRA excise tax. But based on the number of questions raised about this issue, a couple of years may seem like an eternity. Following are the most common questions.

Who Owes the Tax?

Many employers and plan administrators use the services of COBRA TPAs. These COBRA TPAs do not actually interpret or apply any plan benefits or benefit terms and they do not approve or deny coverage for any covered individual. Instead, they assist employers and plan administrators only with the administrative aspects of COBRA: sending completed notices, receiving election forms and transmitting enrollment selections to employers/plan administrators, collecting premiums for COBRA coverage and forwarding those premiums to employers/plan administrators.

From an excise tax perspective, the question is whether such a COBRA TPA is actually liable for the excise tax. Under COBRA's statutory terms, the party liable for the excise tax is the employer, if the plan *is not* a multi-employer plan, or the plan, if the plan *is* a multi-employer plan.

The statute further provides that "[e]ach person who is responsible (other than in a capacity as an employee) for administering or providing benefits under the plan and whose act or failure to act caused (in whole or in part) the failure" is liable for the excise tax if such person assumed, under a legally enforceable written agreement, responsibility for performing the act that resulted in the failure, and as a consequence, the excise tax.

The corresponding regulation re-states the statutory rule but in a slightly different manner. The regulation provides that the excise tax is also imposed on a person involved in providing plan benefits, such as a TPA that administers claims, if the person assumes, under a legally enforceable written agreement, the responsibility for performing the act to which the COBRA compliance failure relates.

The 1988 legislative history is not entirely conclusive but appears to suggest that the only third parties responsible for the excise tax should be health maintenance organizations, insurance companies and plan administrators. This would not include entities that only provide COBRA administrative services.

So the unclear question is whether the definition of the responsible party for excise tax purposes is broad enough to include a COBRA TPA. In the absence of any guidance, employers and administrators need to review and consider their contractual arrangements because these documents will outline COBRA responsibilities. In doing so, it is important to identify which party is responsible for which parts of COBRA administration. That way, if an excise tax is owed, the parties can identify the responsible party, as an effective matter, through the contractual undertaking.

To File or Not to File?

If a COBRA violation is identified, the excise tax provisions include several mitigation provisions. One that is particularly important is if a violation is corrected within 30 days of when a responsible party knew, or exercising reasonable diligence would have known, of the violation, no excise tax is owed. So if an error is fully corrected within the applicable 30-day period, should a form showing no excise tax be filed at all?

On the one hand, if no excise tax is owed, no form needs to be filed. However, the filing of the form starts the running of the statute of limitations period for the IRS to review the issue and decide whether the error was properly corrected. Generally, the tax rules provide for a three-year limitations period. Therefore, if an IRS audit is triggered more than three years after the violation and no excise tax form was filed (even showing no tax owed), the employer or plan administrator might have to justify its correction actions to the IRS.

Some advisors have advocated filing a Form 8928 showing no excise tax owed in any case when correction was made within 30 days. In fact, some advisors have even recommended filing the form every year even if there were no known violations in order to start the running of the limitations period for anything that happened in a given year.

On the other hand, what if a correction has been made so that no excise tax is owed, or the employer and administrator in good faith believe that no violations have been made? There is an argument in favor of not filing at all — the employer or administrator could always make the same arguments in support of no excise tax if the matter is ever identified by the IRS.

Regardless of the approach, if an employer or administrator believes that a COBRA violation was corrected (see the discussion below on correction), all actions should be carefully documented and retained for future reference.

Joint and Several Liability?

As explained earlier, in the context of a single-employer group health plan, it is possible that two parties could be liable for an excise tax for the same COBRA violation. The question that comes up is whether, if one party paid the excise tax, another party also could be responsible for the tax.

For example, suppose an administrator otherwise responsible for the tax causes a violation and an employer pays the excise tax. Could the administrator still be exposed for payment of the tax?

This is particularly important when, for example, one involved party (either the administrator or the employer) has argued successfully for a reduction in the excise tax because the error was due to reasonable cause and not willful neglect. In such a case, if the IRS were to audit the other involved party (either the administrator or the

employer), could the agency assess an additional penalty amount against that other party for the same COBRA violation for which a tax was paid (or for which a tax was abated due to reasonable cause and not willful neglect)?

COBRA's legislative history seems to be clear that employers and administrators should be jointly and severally liable for the excise tax. That is, the legislative history supports the view that if one party pays, the other party *should not be responsible* for additional payment. Pending further guidance, however, employers and administrators and their advisors should consider their filing and payment options and coordinate any excise tax payment.

What Is Correction?

The COBRA excise tax is generally $100 per day for each qualified beneficiary who is harmed by the violation during the "noncompliance period," which begins on the date of the COBRA violation and ends on the earlier of:

1. the date of "correction" for each qualified beneficiary who is harmed by a violation; or
2. the date that is six months after the last day of the otherwise applicable maximum COBRA coverage period (generally 18 or 36 months), without regard to the payment of a premium.

Correction occurs when a violation is retroactively undone and the qualified beneficiary (or his or her estate) is placed in a financial position that is as good as it would have been if the violation had not occurred. For these purposes, it is assumed that the qualified beneficiary would have elected to receive the maximum amount of benefits permissible under the group health plan in question.

The concept of correction of COBRA violations is very important whenever there is a COBRA error. However, no clear standard exists for what type of correction suffices in any given case and whether the facts will show that an error was "retroactively undone" so that the qualified beneficiary is placed in a financial position as good as if no error occurred. In making decisions on paying any excise tax in the absence of guidance, employers, administrators and their advisors need to consider the facts very carefully.

Initial Notice Quandary

For example, if the error involves a failure to have provided the initial COBRA notice to a group of covered employees and/or spouses, "correction" typically would involve furnishing the initial notice by sending it to the last known mailing address, to the extent possible. But what about placing an individual in the financial position that he or she would have been in had the error not occurred? What exactly does that mean in the vast majority of instances where the only violation is a failure to provide the initial notice?

Election Notice Quandary

Similarly, in the case of a failure to provide the COBRA election notice in a timely manner, the notion of retroactively undoing the violation and placing qualified beneficiaries in the financial position they would have been in had no error occurred is challenging without guidance on what that really means. Even when a qualified beneficiary wants to elect COBRA coverage, the election notice failure should, as a general rule, be corrected by the plan administrator that provides such notices to affected qualified beneficiaries and makes the COBRA coverage available if they elect and pay for it on a timely basis.

Quandary in Assessing Financial Position

In the context of notice violations, the problem in applying the statutory standard of retroactively undoing the violation is this: If correction does not occur until after a complete analysis of the affected individuals' financial position, then the statutory 30-day rule effectively would be meaningless. It is impossible for the plan administrator and/or COBRA TPA to know the exact financial position of everyone who could be affected by a notice failure. Why? Even basic violations involve multiple qualifying events, multiple qualified

beneficiaries who are not part of the same family, and/or multiple group health plans — either because a large employer offers more than one plan or because a COBRA administrator's computerized system creates the same error regarding the group health plans of multiple employers.

Also, as in the case of a failure to provide the initial notice, the likelihood is that most affected individuals will not have incurred significant financial harm because so many individuals who fail to receive the election notices do not even want to elect COBRA coverage (due to cost, the availability of other coverage or other reasons). In fact, it has been estimated that the percentage of qualified beneficiaries who elect COBRA coverage is typically between 18 percent and 26 percent. Therefore, a blanket rule requiring more than just making COBRA coverage available as proof of correction does not seem reasonable for all cases.

COBRA Premium Quandary

Instead of a notice violation, consider what happens if the error is overcharging COBRA premiums. Under COBRA, a group health plan may charge a qualified beneficiary no more than 102 percent (150 percent for disabled qualified beneficiaries after the first 18 months of COBRA coverage) of the applicable premium for coverage. Occasionally, a plan administrator will overcharge a qualified beneficiary for COBRA premiums. This can happen due to an inadvertent error of reporting new premium rates to various vendors or a simple error in programming the correct premium into a computerized administration system.

In connection with qualified beneficiaries who overpaid their applicable COBRA premiums due to mistaken information provided by the plan administrator, what is proper correction? Again, there is no clear answer. One approach might be to provide corrected information about the amount owed and offer to either refund the overpayment, plus interest at some reasonable interest rate or credit the overpayment toward the future premiums owed for COBRA coverage, as elected by the qualified beneficiary. For qualified beneficiaries who received incorrect premium information and failed to elect COBRA coverage, perhaps a reasonable correction could be made by providing correct premium information and giving them an additional reasonable period to elect COBRA coverage based on the correct premium amounts.

Of course, no clear standard exists on what it takes to correct these types of problems. The options above are merely suggestions and there is no indication on how the IRS would view these types of correction. Therefore, it is recommended that legal counsel be consulted before employers and plan administrators implement an appropriate correction for notice violations.

Waiver of the Excise Tax

The IRS has the authority to waive all or part of the excise tax if: (1) a COBRA violation is due to reasonable cause and not to willful neglect; and (2) paying the tax would be excessive relative to the seriousness of the violation. Although the instructions to Form 8928 indicate that a waiver is available, it is not clear what information a person liable for the tax must submit to the IRS to obtain such a waiver.

In seeking a waiver, taxpayers must decide whether to pay the full penalty and seek a waiver (in whole or in part) or pay a partial amount and explain that the waiver is being sought to support the amount paid. In any case, however, in the absence of any specific waiver form or procedure, taxpayers should prepare written explanations justifying the waiver and consider approaching the IRS directly (if possible) to negotiate an appropriate adjustment.

An important part of this explanation will be to show how the error in question was "due to reasonable cause and not to willful neglect." In evaluating a liable person's efforts to comply with COBRA, the IRS is supposed to consider the following factors:

1. The quality of the taxpayer's compliance program regarding, for example, the training of individuals responsible for operational compliance, and the preparation of written instructions for such individuals.

2. The extent to which the compliance program has been: (a) designed based on competent professional advice, such as legal and (where appropriate) actuarial counsel; and (b) updated, based on such advice, to reflect changes in the law or in other circumstances.
3. The extent to which the compliance program's operation is monitored by auditors, taking into account the safeguards established to ensure the auditors' independence.

Because these factors are specifically referenced in COBRA's legislative history, an explanation in support of a waiver should try to address each of these points.

On a matter related to obtaining an excise tax waiver, according to the statute, no excise tax is imposed during any period when no one who could be liable for the tax knew (or exercising reasonable diligence would have known) of a particular violation. Form 8928 and its instructions restate the statutory rule and provide that: (1) the noncompliance period begins on the violation date regardless of when the error was discovered; but (2) no excise tax applies if it is established to the IRS that no one liable for the tax knew, or exercising reasonable diligence would have known, the failure occurred.

However, in practice, Form 8928 and its instructions do not appropriately address this tax mitigation rule. As a result, careful consideration of how to fill out the form in the absence of clear guidance is needed.

How Many Forms to Fill Out?

When a COBRA violation occurs, it often occurs for multiple qualified beneficiaries who are not part of the same family, and perhaps multiple qualifying events. For large employers or administrators, this can result in potentially hundreds, if not thousands, of Forms 8928. The reason for this is that the Form 8928 does not provide flexibility to complete one form for separate affected qualified beneficiaries or for multiple qualifying events. Arguably, a single form with attachments can suffice to report all the violations for a specific period; but this is not entirely clear and a literal reading of the form and instructions does not make this clear.

As these examples show, although there is a mechanism and IRS tax form available for payment of the excise tax in cases of COBRA violations, employers, administrators and advisors must consider several unresolved questions. In some cases, a reasonable interpretation of the facts and guidance can help design a practical approach to paying the excise tax. But in all cases, consultation with a legal tax expert is recommended.

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