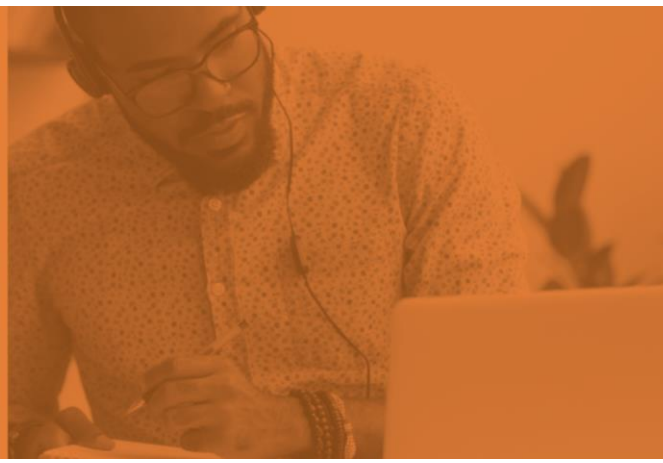
ABD Commentary

The Health Plan 401(k) Has Arrived



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January 1, 1980 was a momentous day in the employee benefits field. It was the day §401(k) went into effect, creating the first major opportunity for employers to offer defined contribution retirement plans. By 1982, many of the country's largest employers—including Johnson & Johnson, PepsiCo, JC Penney, and Honeywell—were in the process of offering 401(k) plans to their employees.[1]

January 1, 2020 marks both the 40th birthday of the 401(k) plan, as well as a fresh opportunity to celebrate the introduction of its spiritual successor. Effective January 1, 2020, employers finally have a viable pathway to establishing a legitimately defined contribution health plan approach.

The new defined contribution health plan vehicle available as of January 1, 2020 is referred to as the Individual Coverage Health Reimbursement Arrangement—or, more commonly, the "ICHRA".

What is an ICHRA?

An ICHRA (pronounced "ICK-rah") is an account-based health plan arrangement sponsored by employers to reimburse employees for the cost of their individual policy health insurance premiums on a tax-free basis.

The ICHRA as a 401(k)-Style Revolution for Employers

The pre-2020 model for employers has depended almost entirely on the traditional employer-sponsored group major medical plan as the predominant approach for employers to offer and for Americans to enroll in health coverage. These traditional group health plans are generally analogous to the traditional defined benefit pension plan on the retirement side.

The Dramatic Move from Defined Benefit to Defined Contribution in Retirement Plans

From the introduction of the 401(k) plan in 1980 to 2008, the percentage of private-sector workers participating in defined benefit plans fell from 38% to 28%.[2] By 2018, the percentage had dropped all the way to 13%.[3]

Meanwhile, 401(k) plans have seen a correlated dramatic increase in participation over the same 40-year period. From 1980 through 2008, the percentage of private-sector workers participating in defined contribution plans increased from 8% to 31%.[4] By 2018, the percentage had increased all the way to 47%.[5]

The Estimated Effect of ICHRAs Beginning in 2020

The Treasury Department projects that over 150 million persons under age 65 will be enrolled in employer-sponsored group health plans in 2020, compared to about 15 million in the individual market.[6]

However, the Departments of Labor, Health and Human Services, and the Treasury (collectively, the Departments) estimate that roughly 800,000 employers will offer an ICHRA to employees in the initial ten-year period from 2020 – 2029. In the first five years alone, the estimate is that roughly 11 million individuals will be covered by an ICHRA. That increase in ICHRA enrollment will cause a corresponding decrease in traditional group health plan coverage by roughly seven million individuals.[7]

In other words, there's a major health plan coverage shift brewing from the employer-sponsored group market to the ICHRA-driven individual market. Just as with the 401(k) plan's introduction in the 1980s, many employers will be driven by the desire to accomplish a pure defined-contribution alternative to their standard major medical plan.

The Estimated Effect of ICHRAs on the Individual Market

The small sliver of the American population in the individual market has not been an actuarially desirable risk pool for insurance carriers. Yet ICHRAs could make a major dent in that calculus.

The Departments estimate that 80% of individuals in employer-sponsored coverage are relatively healthy, and 20% are relatively unhealthy. Relatively healthy participants in employer plans have health costs that are only about a quarter of the average cost of the average individual market enrollee.[8]

As a result of the superior risk profile of the employer-sponsored group health plan, a shift of just five million individuals from employer-sponsored group health plans to the individual market (at the standard 4-to-1 ratio of healthy to unhealthy) would cause individual market premiums to fall by about 3%.[9] Given the Departments' estimate of roughly 11 million individuals covered by ICHRAs in the first five years alone, this movement has the potential to significantly stabilize the individual market.

The Defined Contribution Allure for Employers

Employers have long desired something truly akin to the 401(k) approach where the employee directs the funds to an underlying product that is not maintained by the employer. In most 401(k) plans, the employee's benefit is simply the result of the employee's investment decisions in third-party products (typically mutual funds). The employer's primary obligation with respect to those mutual funds is its fiduciary duty under ERISA to prudently select and monitor those designated investment alternatives.

The ICHRA similarly directs employees to choose their own underlying product in the form of an individual health insurance policy. The ICHRA actually is more advantageous to employers than the 401(k) in this regard because the rules explicitly provide that employers have no ERISA

fiduciary duties with respect to the underlying individual coverage as long as the employer meets a few basic requirements.

The result for the employer is a very streamlined offering in the form of the ICHRA with relatively few administrative or compliance requirements compared to a traditional group health plan. Plus, the employer cost is fixed at the amount of the employer's ICHRA allocation to each employee much (in the same manner as a 401(k) employer non-elective or matching contribution), and employee contributions can be made on a pre-tax basis (in the same manner as a 401(k) plan elective deferral).

The Defined Contribution Allure for Employees

While much of the focus on the ICHRA revolution is on employers, ICHRAs offer two significant advantages that have the potential to be a compelling recruiting and retention feature to attract employees.

1) Increased Plan Options

Most employers offer only a small handful of medical plan options to choose from. For example, a PPO high, PPO low, HMO, and HDHP. Employees looking to coverage on the individual market will have the full array of carriers and plan options available.

2) Portability

The ICHRA approach would permit employees to plausibly retain the same plan offering throughout their entire career. The ICHRA rules require that employees have the full individual market available to them.

The Individual Market: Why This Time It's Different

John Templeton is widely credited with the famous quote: "The four most dangerous words in the English language are '*This time it's different*.'"

However, changes made by the ACA and the ICHRA to unlock the individual market as a viable backbone for employer arrangements—and create the silver bullet of defined contribution, 401(k)-style disruption—should douse that healthy skepticism.

Why Employers Didn't Utilize the Individual Market Pre-ACA

Problem: Pre-Existing Condition Exclusions and Medical Underwriting

- **ICHRA Solution:** The ACA prohibits medical underwriting and pre-existing condition exclusions in the individual market.

Problem: No Tax Parity

- **ICHRA Solution:** ICHRAs permit tax-free reimbursement of employees' individual policy premiums, and employees can pay any remaining portion of the premium pre-tax through the Section 125 cafeteria plan. This addresses the "historical accident" since World War II-era wage controls led to the enactment of §106 to exclude the cost of coverage from employees' gross income—but with no comparable tax deduction on the individual tax turn.

Problem: Adverse Selection

- **ICHRA Solution**: The government estimates that each ICHRA shift of five million individuals from employer-sponsored group health plans to the individual market at the standard 4-to-1 ratio of healthy to unhealthy will cause individual market premiums to fall by about 3%.

Why Employers Didn't Utilize the Individual Market Under the ACA

Problem: ICHRAs Prohibited

- **ICHRA Solution:** President Trump's Executive Order 13813 was designed to override the 2013 "Friday the 13th Guidance" (IRS Notice 2013-54; DOL Technical Release 2013-03), the "ACA Potluck Guidance" (IRS Notice 2015-17; IRS Notice 2015-87), and related individual policy reimbursement prohibition guidance that created potential $100/day/employee excise taxes under §4980D. The result is the establishment of the ICHRA through the final regulations applicable January 1, 2020.

Problem: The Employer Mandate

- **ICHRA Solution:** Offering an ICHRA to employees will be treated as an offer of coverage for ACA employer mandate purposes beginning January 1, 2020 to avoid the §4980H(a) penalty ($2,570 annualized multiplied by all full-time employees (reduced by the first 30)). Further, regulations confirm that ICHRAs can be designed to avoid all potential ACA employer mandate penalties by providing minimum value and being affordable in reference to the lowest cost silver plan for self-only coverage offered by the Exchange.

Problem: Limited Choices and Narrow Networks

- **ICHRA Solution:** The Departments estimate that roughly 11 million individuals will be covered by an ICHRA within five years of its introduction in 2020. That increase in ICHRA enrollment will cause a corresponding decrease in traditional group health plan coverage by roughly seven million individuals. This injection of full-time employees into the individual marketplace is likely to drive demand for carriers to supply a wider variety of individual policy options that more closely resemble group health plans than Medicaid.

The ICHRA Horizon

In the same manner as the 401(k)'s introduction exactly 40 years earlier on January 1, 1980, ICHRAs have the potential to radically transform the current paradigm that is dominated by traditional employer-sponsored major medical group health plans.

Like 401(k) plans, ICHRAs will generally be less expensive, less administratively burdensome, and present less of a compliance challenge for employers than a traditional group health plan. Employees may also soon discover that they relish the broader field of underlying health coverage options and greatly enhanced portability that ICHRAs offer in the same way employees control the underlying investments and rollover opportunities of a 401(k) plan.

Over the past 40 years, participation in defined benefit pension plans has decreased from 38% of private sector workers to 13%. Meanwhile participation in defined contribution 401(k)-style plans has increased from 8% of private sector workers to 47%.

The health plan 401(k) has arrived in the form of the ICHRA on January 1, 2020, and the stars are aligned for the same defined contribution transformation on the health side over the next 40 years.

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[1] Employee Benefit Research Institute, "History of 401(k) Plans: An Update" (Nov. 5, 2018). Available at: https://www.ebri.org/docs/default-source/fast-facts/ff-318-k-40year-5nov18.pdf?sfvrsn=1b773e2f_6.

[2] Social Security Office of Retirement and Disability Policy, "The Disappearing Defined Benefit Pension and Its Potential Impact on the Retirement of Baby Boomers" (2009). Available at: https://www.ssa.gov/policy/docs/ssb/v69n3/v69n3p1.html.

[3] U.S. Department of Labor, Bureau of Labor Statistics, "National Compensation Survey: Employee Benefits in the United States, March 2018," Private Industry Tables, Table 2. Available at: https://www.bls.gov/ncs/ebs/benefits/2018/ownership/private/table02a.htm.

[4] See Note 2.

[5] See Note 3.

[6] 84 Fed. Reg. 28888, 28968 (June 20, 2019).

[7] *Id.* at 28965.

[8] 83 Fed. Reg. 54420, 54450 (October 29, 2018).

[9] *Id*.