Updated IRS COBRA Audit Guidelines—Employers Should Use COBRA Audit Guidelines as a Compliance Tool

Summer 2012 ***Authored by: Gabriel S. Marinaro and Amy M. Christen***

In March 2012, the IRS released updated COBRA audit guidelines, which can be found at the following link: http://www.irs.gov/businesses/small/article/0,,id=255893,00.html. These audit guidelines are intended to guide an IRS auditor in his or her review of an employer's COBRA compliance. These audit techniques also offer a useful guide for employers to assess whether or not their current COBRA practices and administration comply with COBRA requirements imposed by the IRS. While these COBRA audit guidelines and IRS requirements are an important and significant part of the Employer meeting its overall COBRA obligations, an employer also needs to review the additional notice and other obligations imposed under the Department of Labor's COBRA regulations under ERISA and also consider the caselaw surrounding COBRA denials and administration. The focus of this article is on the IRS COBRA audit guidelines only.

As you know, COBRA provides federal requirements for continuation of healthcare coverage following a "qualifying event" (e.g. a termination of employment). The COBRA requirements are complex and, if not carefully monitored, can often cause missteps even with the most well-intentioned employer. The employer should continually audit its COBRA administration, even if it outsources COBRA administration to a third party, not only to make sure it is in compliance but also to determine if it has self-reporting obligations for excise taxes under Code Section 4980B that would be reported on the IRS Form 8928, Return of Certain Excise Taxes Under Chapter 43 of the Internal Revenue Code.[1]

In the COBRA audit guidelines, the IRS instructs examiners to review the following to determine what types of COBRA procedures are in place:

- A copy of the COBRA procedures document
- Copies of the standard COBRA notices used by the employer
- Internal COBRA audit procedures
- Copies of the group health plans under which COBRA is offered
- Details of any past or pending lawsuits surrounding COBRA administration

In addition to documentary compliance, the IRS instructs the IRS auditor to review the employer's COBRA operational compliance. This type of review could include interviewing those individuals at the employer responsible for administering COBRA on a number of COBRA-related administration topics, including:

- The number of qualifying events occurring during the years being examined
- How COBRA qualified beneficiaries are notified with respect to their COBRA rights
- How the plan administrator is notified regarding a qualifying event
- Elections and premiums paid with respect to COBRA qualified beneficiaries

The COBRA audit guidelines go on to direct the IRS auditor to review personnel records to determine if individuals were properly notified of their COBRA rights. Importantly, the IRS notes that, in the event there was a failure to notify individuals of their COBRA rights in a timely manner, the personnel records will provide the beginning dates for any excise tax computation under Code Section 4980B. The personnel records that the IRS lists include the following:

- Name and address of each qualified beneficiary
- The date the qualifying event occurred

- Copies of the COBRA notices sent to the qualified beneficiaries (to determine when they were eligible to elect coverage, whether they were offered coverage, and to confirm they received their notice of rights under COBRA)
- Records of the COBRA premiums received from electing COBRA beneficiaries
- Copies of the employer's correspondence to the insurance company or plan administrator notifying them of a qualifying event
- Reasons for termination of the COBRA coverage (if elected)
- Reasons for employment termination

Based on these items included in the COBRA audit guidelines, employers should review their existing COBRA procedures and implement improvements and changes accordingly. For employers that outsource COBRA administration, an audit of their third-party administrator's COBRA procedures and a review of the service contract should be completed at least annually (which COBRA audit could be included as part of the employer's annual audit of all benefit service providers).

If, through an employer's audit of its COBRA procedures, it is determined that it has one or more COBRA compliance issues, the employer must take affirmative steps to fix the issue to avoid or reduce the employer's exposure to the excise tax under Code Section 4980B (and any other penalties (including ERISA penalties or liabilities) that could be imposed for non-compliance with COBRA obligations). Code 4980B provides an exception to its excise tax during the period where it has been established, to the satisfaction of the IRS, that a COBRA failure was not known or, by exercising reasonable due diligence, would not have been discovered, by the employer or other persons liable for the excise tax.[2]

In addition to the excise tax amnesty where the COBRA violation is not known (or would not have been discovered exercising reasonable due diligence), Code Section 4980B caps the excise tax liability for COBRA failures that are unintentional due to reasonable cause and not because of willful neglect. Importantly, the COBRA audit guidelines state that where the employer becomes aware of a COBRA failure and makes no effort to correct it, a failure that was originally not attributable to willful neglect turns into a failure due to willful neglect.

If the COBRA failure is due to reasonable cause and not willful neglect, and is corrected within 30 days after it is discovered, or would have been discovered in exercising reasonable due diligence, the excise tax under Code Section 4980B generally should be waived. Additionally, the IRS can waive all or part of the excise tax in the case of a COBRA failure that is due to reasonable cause and not to willful neglect, if the IRS determines that the excise tax would be unreasonably burdensome.[3] In determining whether to waive the excise tax, the IRS will examine certain factors, including the quality of the employer's COBRA administration, the training of individuals with respect to COBRA administration and the written instructions for those at the employer who are delegated the COBRA administration responsibilities. Other factors include whether an employer's COBRA documentation and administration has been reviewed by competent professional advisors, including legal counsel, and whether such documentation and administration have been updated for changes in the law.

With the IRS updating its COBRA audit guidelines, we anticipate that the IRS will increase its audits of an employer's COBRA compliance. Regardless of the IRS's intent, the IRS COBRA audit guidelines provide a good resource for employers to review their COBRA administration and make changes where appropriate. Please contact Gabe Marinaro at 313-568-6874 or gmarinaro@dykema.com, Amy Christen at 248-203-0760 or achristen@dykema.com, authors of this article, or your Dykema relationship attorney if you have questions regarding these IRS COBRA audit guidelines, or other general questions about COBRA.

For more information about Dykema's Employee Benefits practice, please visit http://www.dykema.com/services-practices-employee-benefits.html.

---

[1]Code Section 4980B provides for a nondeductible excise tax in an amount of $100 per qualified beneficiary (but not more than $200 per family) for each day of a period that the taxpayer is in violation of the COBRA requirements (subject to certain limitations and exceptions).

[2]The noncompliance period that would cause the imposition of the excise tax under Section 4980B would begin when an employer becomes aware or should have become aware of COBRA noncompliance. Also, this exception does not apply where the failure is not corrected before the IRS notifies the employer of an audit.

[3]The determination as to whether the Section 4980B excise tax is unreasonably burdensome is based on seriousness of the failure and not the employer's ability to pay.