



Health Reform

PPACA Requires Fully Insured Plans to Comply with Nondiscrimination Rules of IRC Section 105(h)

Updated January, 2011

Overview

In the past, fully insured group health plan administrators had great liberty to design benefit availability and eligibility as they desired, so long as such plans did not run afoul of the Title VII-type discrimination rules (i.e., discrimination based on age, gender, disability, pregnancy, etc.) and the cafeteria plan rules under section 125. For example, plans generally could discriminate outside of the cafeteria plan rules by allowing an employer to offer particular benefits only to highly compensated individuals (HCIs, as further defined below) or contribute a higher percentage of premiums for owners, officers, shareholders or the top 25 percent of its HCIs. Such liberty, however, has been greatly restricted by the Patient Protection and Affordable Care Act (PPACA).¹ The act requires fully insured group health plans to comply with Internal Revenue Code (IRC) section 105(h),² which generally prohibits discrimination in favor of HCIs.

Employers, human resource managers, plan administrators and company executives should be aware of this new requirement as they prepare to bring plans into compliance under PPACA. This paper examines the plans that are subject to the new PPACA nondiscrimination requirements, the definitions of relevant terms, the tests that must be satisfied under section 105(h) and the consequences associated with non-compliance.

Before examining the details of the new PPACA nondiscrimination requirements, it is important to note that on Dec. 22, 2010, the IRS issued Notice 2011-1, which delays the timing for compliance with the PPACA nondiscrimination requirements for fully insured non-grandfathered plans. The Notice delays compliance for fully insured non-grandfathered plans until after regulations or other administrative guidance has been issued. As a result, fully insured non-grandfathered group health plans are not required to report and pay excise taxes for nondiscrimination rule violations for plan years occurring prior to the release of this anticipated guidance.

It is also important to note that prior to PPACA's enactment, both self-insured and fully insured plans may have already been subject to certain nondiscrimination requirements. Namely, self-insured plans are already subject to the section 105(h) nondiscrimination rules, and both self-insured and fully insured plans are already subject to the IRC section 125 nondiscrimination rules (assuming that the plans were funded with pre-tax contributions). PPACA's enactment does not change these requirements, but rather makes the section 105(h) requirements applicable to fully insured non-grandfathered group health plans.

Plans Subject to the New PPACA Nondiscrimination Requirement

Generally, under PPACA, beginning at the first plan year on or after Sept. 23, 2010, a penalty will be imposed on all non-grandfathered fully insured group health plans that, on their face or in operation, provide higher benefit contributions or better benefits to HCIs than to rank-and-file employees (non-HCIs).⁵ The new requirement will generally apply to all group health plans that provide medical benefits, including plans covering both retirees and active employees, and dental and vision plans that are integrated with the medical plan.⁶ However, the preamble to the PPACA grandfathered health plan regulations provides that PPACA insurance provisions will not apply to HIPAA-exempt programs, such as limited scope dental and vision plans.⁷ In addition, such provisions will not apply to stand-alone retiree-only plans (i.e., those plans covering no active employees).

Definition of Highly Compensated Individual

Before examining the details of the section 105(h) nondiscrimination rules, it is helpful to define the term “HCI.” For purposes of the section 105(h) nondiscrimination rules, an HCI is defined as an individual who is:

- a. One of the five highest paid officers;
- b. A shareholder owning (or considered as owning within the meaning of the constructive ownership rules of section 318) more than 10 percent in value of the employer’s stock; or
- c. Among the highest paid 25 percent of all employees.⁸

For purposes of the above definition of HCI, the status of an employee as an officer or stockholder is determined on the basis of the employee’s officer status or stock ownership at the time during the plan year at which the benefit is provided.⁹ In other words, if an individual is an HCI anytime during the year, then that individual is considered an HCI for purposes of the above definition of HCI. Also, in calculating the highest paid 25 percent of all employees, the number of employees included is rounded to the next highest number, and the level of an employee’s compensation is determined on the basis of the employee’s compensation for the plan year.

Lastly, the definition of HCI under section 105(h) is different than such definition in section 125. The nondiscrimination requirements under section 125 are applicable to cafeteria plans when certain insurance premiums are paid on a pre-tax basis. Listed below are the differences in the term HCI for purposes of section 105(h) and section 125 nondiscrimination testing:

HCI Under Section 105(h)	HCI Under Section 125
One of the five highest paid officers	Any officer
More than 10 percent shareholder	More than 5 percent shareholder
Among highest-paid 25 percent of all employees	Salary greater than \$110,000 (for 2009/2010)

Thus, the definition of HCI under section 105(h) is typically broader than under section 125. Also, the rules for determining which employees are HCIs by virtue of their status as officers or shareholders differ between sections 105(h) and 125. Plan administrators should be aware of such differences in administering both sets of nondiscrimination testing.

Section 105(h) Nondiscrimination Testing

Under PPACA, a fully insured group health plan must now satisfy the nondiscrimination requirements of section 105(h). Namely, under section 105(h) such a plan must satisfy the so-called “eligibility” and “benefits” tests. An employer may aggregate two or more plans as a single plan or split one plan into separate plans for testing purposes.¹⁰ Also, the controlled group and affiliated service group rules of section 414(b), (c) and (m) are expressly applied to section 105(h) nondiscrimination testing.¹¹

Eligibility Test

With respect to the so-called eligibility test under section 105(h), a plan must not discriminate in favor of HCIs as to eligibility to participate.¹² A plan may actually satisfy any one of three tests to satisfy the eligibility test. The three tests are:

1. The plan must actually benefit 70 percent or more of all employees.
2. 70 percent or more of all employees must be eligible to participate in the plan, and of those eligible to participate, at least 80 percent must actually benefit under the plan.
3. The plan is set up to benefit a classification of employees that is found by the Secretary of the Treasury not to be discriminatory in favor of HCIs.¹³

With respect to tests (1) and (2), certain employees may be excluded for purposes of making the calculations. Such “excludable” employees include:

- Employees with less than three years of service
- Employees who have not attained age 25
- Part-time employees (generally, employees who work less than 25 hours per week, may be 35 hours per week in some circumstances)
- Seasonal employees (generally, employees who work less than seven months per year, may be nine months per year in some circumstances)
- Employees covered by a collective bargaining agreement (if health benefits have been a subject of good faith bargaining)
- Non-resident aliens with no U.S.-source income¹⁴

Exclusion of employees in any of these categories is optional, and excluded employees may be disregarded in applying the eligibility tests (and the benefits test, described below) even if they are actually covered by the plan.

With respect to test (3), the IRS regulations do not specify any mathematical test. Many practitioners believe that a plan will satisfy this test if it satisfies the two-step non-discriminatory classification test applied under IRC section 410(b). Under the first step, the classification of employees must be based upon a “bona fide” employment classification consistent with the employer’s usual business practice.¹⁵ Examples of such bona fide classifications include full-time versus part-time status, current versus former employee status, different geographic location, date of hire and length of service.¹⁶ Under the second step, the classification of employees must also be considered non-discriminatory based on a certain safe harbor percentage rate determined in IRS regulations.¹⁷ Since this test involves making a subjective determination based on the facts and circumstances of each particular case, outside counsel should be consulted by a plan seeking to satisfy test (3).

Also, while under the eligibility test a plan may not discriminate in favor of HCIs as to “eligibility to participate,” each of the three tests is phrased in terms of who benefits under the plan.¹⁸ This naturally leads to the question of what it means “to benefit.” To benefit, must the employee simply be eligible to participate or must the employee actually elect to participate? While both tests (1) and (2) clearly delineate whether the employee must be eligible or participate, test (3) is unclear. While both interpretations may find support in the regulations and other IRS guidance, cautious employers will likely take the approach that actual participation is required for an employee “to benefit” under the plan.

Eligibility Test Examples

As an example of test (1), consider the following. ABC Corp. has 10 employees; five are highly-paid consultants, two are office managers and three are secretaries. ABC Corp. establishes a fully insured medical plan and provides 100 percent coverage at no cost to all five consultants and the two office managers. The firm does not provide insurance for the secretaries. The plan satisfies the 70 percent test – test (1) – since 70 percent (seven out of 10 equals 70 percent), of the employees actually benefit from the plan.

As an example of test (2), consider the following. ABC Corp. has 10 employees; five are highly-paid consultants, two are office managers and three are secretaries. ABC Corp. establishes a fully insured medical plan. All five consultants and the two office managers (seven in total) are eligible to participate. However, only the five consultants and one office manager (six in total) elect coverage. The plan satisfies the 70 percent/80 percent test – test 2 – since 70 percent (seven out of 10 equals 70 percent) or more of all the employees are eligible to participate under the plan, and since 86 percent (six out of seven equals 86 percent) of those who are eligible actually elect coverage.

Benefits Test

With respect to the so-called benefits test under section 105(h), both the HCIs and the non-HCIs (and any dependents) must be provided with the same benefits.¹⁹ Generally, the benefits test has two components: (1) Testing for discrimination on its face; and (2) testing for discrimination in operation.

Generally, to pass the benefits test as it relates to discrimination on the plan's face, the following must be true:

1. The required employee contributions must be identical for each benefit level;
2. The maximum benefit level that can be elected cannot vary based on percent of compensation, age or years of service;
3. The type of medical expenses reimbursable must be identical for all participants; and
4. Disparate waiting periods cannot be imposed.²⁰

With respect to the nondiscrimination in actual operation, discrimination in operation may occur where the duration of a particular benefit coincides with the period during which an HCI would utilize such benefit. For example, if a medical plan or a benefit provided by a medical plan is amended or terminated such that the duration of the plan or benefit favors HCIs, the plan would be discriminatory²¹

Certain excludable employees (as defined above) may also be excluded for purposes of the benefits test. It is also important to remember that the benefits test is based on the actual receipt of benefits.²²

Penalties

With respect to consequences for non-compliance, the penalties generally include a civil action to compel the plan to provide non-discriminatory benefits and a civil monetary penalty of \$100 per day per individual discriminated against.²³ The penalties for fully insured plans are slightly different than for self-insured plans. For a self-funded plan, a discriminatory plan design results in adverse tax consequences (i.e., HCIs are generally taxed on their "excess reimbursements").²⁴ For a fully insured plan, the penalty is assessed based on each individual discriminated against (in the form of the \$100 per day per individual penalty), but no such excess reimbursement is taxed to the HCIs.

Summary

Now that fully insured group health plans must comply with the new PPACA nondiscrimination requirements, employers, human resource managers, plan administrators and company executives should be aware of the eligibility and benefits tests under section 105(h), as well as the possible consequences associated with non-compliance. Plans and plan administrators can bring fully insured plans into compliance with the new PPACA nondiscrimination requirements by considering how the section 105(h) requirements will apply to fully insured plans.

FAQs

Question 1: An employer has a fully insured, non-grandfathered policy and pays 75 percent of the premiums for all hourly employees and 90 percent of the premiums for all salaried employees. The premiums paid by the employees are all paid on a pre-tax basis. Will this plan design be considered discriminatory?

Answer: Possibly. An employer may have different eligibility criteria, waiting period or contribution levels for different employee classifications, if the employee classification is based on a "bona-fide employment classification." Under the regulation, bona fide employment classifications include full-time versus part-time status, current versus former employee status, different occupations, different geographic location, date of hire, length of service, and membership in a collective bargaining unit. Also, since the plan is allowing the payment of pre-tax premiums, the plan will be subject to nondiscrimination under both sections 105(h) and 125.

Question 2: Is a fully insured, supplemental “executive carve-out” plan, which offers benefits only to HCs, subject to the section 105(h) nondiscrimination requirements under PPACA?

Answer: The answer depends on whether the plan is grandfathered and whether the plan is considered “supplemental health coverage” and is therefore an “excepted benefit” under HIPAA. If the plan is grandfathered, the plan will not be subject to the section 105(h) nondiscrimination requirements under PPACA. If the plan is not grandfathered and provides “supplemental health coverage” that is considered an excepted benefit under HIPAA, the plan will not be subject to such requirements. However, in order for this exception to apply, the supplemental health coverage must:

- Be issued by an entity that does not provide primary coverage to the plan;
- Be designed to fill gaps in primary coverage, such as coinsurance and deductibles. The coverage should not become secondary or supplemental solely as a result of a coordination of benefits provision.
- Not exceed 15 percent of the cost of primary coverage, calculated in the same manner as the applicable COBRA premium; and
- Not differentiate among individuals as to eligibility, benefits, or premiums based on any health factor of an individual or dependent.

If the executive carve-out plan fails to meet any of these requirements, it will not be considered an excepted benefit under HIPAA and will be subject to the section 105(h) nondiscrimination requirements under PPACA.

Question 3: If a plan remains grandfathered, do the section 105(h) rules apply to it?

Answer: If the plan is fully insured and remains grandfathered, the section 105(h) rules will not apply. If the plan is self-insured, then the section 105(h) rules already apply under existing law. Finally, if the plan allows any portion of the premiums to be withheld on a pre-tax basis, the plan is subject to nondiscrimination testing under section 125, regardless of whether it is self-insured or fully insured.

Question 4: Company A owns Company B. Company A offers its employees a mini-med plan (with no annual limits). Company B offers its employees a fully insured medical plan. Are there any nondiscrimination issues?

Answer: Under PPACA, a company is not required to offer the same benefits to different geographic locations or different entities, or even offer benefits at all. Thus, Company A may offer a different plan than Company B. However, each different plan a company offers must still satisfy the nondiscrimination requirements of section 105(h).

Additional Resource

IRS Notice 2010-63: www.irs.gov/pub/irs-drop/n-10-63.pdf

Sources

1. Patient Protection and Affordable Care Act, Pub. L. No. 111-148 (2010) (PPACA), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152 (2010) (HCERA).
2. Public Health Service Act (PHSA) sec. 2716, 42 U.S.C. 300gg-16, as added and amended by PPACA, Pub. L. No. 111-148 (2010).
3. See IRC sec. 105(h).
4. See IRC sec. 125; Prop. Treas. Reg. 1.125-7.
5. PHSA sec. 2716.
6. PHSA sec. 2791(c); IRC sec. 9832(c); Treas. Reg. secs. 54.9831-1(c)(1) and (c)(3)(v).
7. Preamble to Interim Final Rules Relating to Status as a Grandfathered Health Plan Under PPACA, 75 Fed. Reg. 34537, 34539 (June 17, 2010).
8. IRC sec. 105(h)(5).
9. Treas. Reg. sec. 1.105-11(d).
10. See Treas. Reg. sec. 1.105-11(c)(4).
11. IRC sec. 105(h)(8).
12. IRC sec. 105(h)(2)(A).
13. IRC sec. 105(h)(3)(A).
14. IRC sec. 105(h)(3)(B).
15. Treas. Reg. sec. 1.410(b)-4(b).
16. See 26 CFR 54.9802-1(d)(1).
17. Treas. Reg. sec. 1.410(b)-4(c).
18. See IRC secs. 105(h)(2)(A) and (h)(3)(A).
19. IRC secs. 105(h)(2)(B), (h)(4); Treas. Reg. secs. 1.105-11(c)(3), (c)(3)(i).
20. Treas. Reg. sec. 1.105-11(c)(3)(i); PLR 8411051 (Dec. 13, 1983).
21. Treas. Reg. secs. 1.105-11(c)(3)(i) and (ii).
22. See Treas. Reg. sec. 1.105-11(c)(3).
23. See IRS Notice 2010-63, IRC sec. 4980D.
24. IRC sec. 105(h)(1); Treas. Reg. sec. 1.105-11(e)(1).

This material was created by National Financial Partners Corp., (NFP), its subsidiaries, or affiliates for distribution by their Registered Representatives, Investment Advisor Representatives, and/or Agents.

This material was created to provide accurate and reliable information on the subjects covered. It is not intended to provide specific legal, tax or other professional advice. The services of an appropriate professional should be sought regarding your individual situation. Neither NFP nor its affiliates offer legal or tax services.

56558 11/10

Copyright © 2010. All rights reserved.