NONDISCRIMINATION
PPACA Requires Employers to Reevaluate Compliance with Both New and Existing Nondiscrimination Requirements.

OVERVIEW

In the past, fully insured group health plan administrators had great flexibility 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 Internal Revenue Code (IRC) 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. Now, the Patient Protection and Affordable Care Act (PPACA) has greatly restricted how benefits plans are designed and to whom they must be offered. The act requires fully insured, non-grandfathered group health plans to comply with IRC Section 105(h), which generally prohibits discrimination that favors HCIs.

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

Before examining the nondiscrimination requirements in detail, it is important to note that the IRS has delayed the effective date for fully insured non-grandfathered plans until the IRS issues guidance on how Section 105(h) will apply in the fully insured context. As a result, those plans are not required to report and pay excise taxes for nondiscrimination 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 Section 125 nondiscrimination rules (assuming employees are allowed to pay their portion of the premium, if any, on a pretax basis through salary reduction). 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 PPACA NONDISCRIMINATION REQUIREMENT

Generally, under PPACA, 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). This requirement generally applies 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. However, the preamble to the PPACA grandfathered health plan regulations provides that PPACA insurance provisions do not apply to plans exempt from HIPAA, sometimes called “HIPAA-excepted” benefits, such as limited scope dental and vision plans and stand-alone retiree-only plans (i.e., those plans covering fewer than two active employees).
DEFINITION OF HIGHLY COMPENSATED INDIVIDUAL

For purposes of Section 105(h), an HCI is defined as an individual who is:

- One of the five highest paid officers
- 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
- Among the highest paid 25 percent of all employees

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. 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 that under Section 125. The nondiscrimination requirements under Section 125 are applicable to cafeteria plans when certain insurance premiums are paid on a pretax basis. Listed below are the differences in the term "HCI" for purposes of Section 105(h) and Section 125 nondiscrimination testing:

<table>
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<tr>
<th>HCl Under Section 105(h)</th>
<th>HCl Under Section 125</th>
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<tr>
<td>One of the five highest paid officers</td>
<td>Any officer</td>
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<tr>
<td>More than 10 percent shareholder</td>
<td>More than 5 percent shareholder</td>
</tr>
<tr>
<td>Among highest-paid 25 percent of all employees</td>
<td>Salary greater than $115,000 (for 2014)</td>
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The definition of HCI under Section 105(h) is generally 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 these differences in administering both sets of nondiscrimination testing.

SECTION 105(H) NONDISCRIMINATION TESTING

Under Section 105(h), such a plan must satisfy the so-called "eligibility" and "benefits" tests. 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, meaning that where two or more employers are under common ownership, all employees of all employers must be included in determining the HCI group and in running the nondiscrimination tests.

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. A plan may pass any one of three tests to satisfy the eligibility test:

- **Test 1:** The plan must actually benefit 70 percent or more of all employees (i.e., 70 percent or more of all employees must be enrolled in the plan).
- **Test 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.
- **Test 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.
With respect to tests 1 and 2, certain employees may be excluded when making the calculations. “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)
- Nonresident aliens with no U.S.-source income

Exclusion of employees in any of these categories is optional, and excluded employees may be disregarded when applying eligibility tests and the benefits test, described below. However, an otherwise excludable employee that is eligible for and participating in the plan must be included in the testing.

With respect to test 3, IRS regulations do not specify any mathematical test. Many practitioners believe a plan will satisfy this test if it satisfies the two-step nondiscriminatory classification test applied under Section 410(b). The first step requires that classification of employees is based upon a “bona fide” employment classification consistent with the employer’s usual business practice. Examples of such bona fide classifications include full-time versus part-time status, current versus former employee status, different geographic location, occupation type, business line, date of hire and length of service. The second step requires that classification of employees also be considered nondiscriminatory based on a certain safe harbor percentage rate determined in IRS regulations. 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.

Although the eligibility test prohibits a plan from discriminating in favor of HCIs as to “eligibility to participate,” each of the three tests is phrased in terms of who benefits under the plan. 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 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 generally be provided with the same benefits. The benefits test has two components: testing for discrimination on its face and 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:

- Employee contribution levels must not favor HCIs.
- Maximum benefit and employer contribution levels may not vary based on age, compensation or years of service.
- Types and amounts of reimbursable medical expenses must not favor HCIs.
- Waiting periods that favor HCIs may not be imposed.

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 discriminatory.

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.

**PENALTIES**

The penalties for non-grandfathered fully insured plans are slightly different than for self-insured plans. For a self-insured plan, a discriminatory plan design results in adverse tax consequences (i.e., HCIs are generally taxed on their “excess reimbursements”). For a fully insured plan, the penalty is assessed based on each individual discriminated against (in the form of a $100 per day penalty per individual discriminated against), but no such excess reimbursement is taxed to the HCIs.

**SUMMARY**

Although IRC Section 105(h) does not yet apply to non-grandfathered fully insured plans, it soon will. In addition, IRC Section 125 nondiscrimination may apply to both fully and self-insured plans, and IRC Section 105(h) currently applies to self-insured plans. Thus, employers, human resource managers, plan administrators, and company executives should be aware of both Sections 105(h) and 125, as well as the possible consequences associated with noncompliance.

**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 pretax basis. Will this plan design be considered discriminatory?

**Answer:** As long as the employer contribution strategy overall does not favor HCIs, the plan will not be considered discriminatory. An employer may have different eligibility criteria, waiting periods 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 pretax premiums, the plan will be subject to nondiscrimination under both Sections 105(h) and 125. While the variance here is based on a bona fide employment classification, testing would have to be performed to determine if the variance in employer contribution levels favors HCIs.

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

**Answer:** Possibly, depending on if the plan is exempt from PPACA and 105(h). If the plan is grandfathered, it 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.
- 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 do 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 pretax 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 very basic fully insured plan, and Company B offers its employees a much richer fully insured 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 RESOURCES**

**IRS Notice 2010-63**

**Nondiscrimination Calculator:** NFP has a nondiscrimination tool to assist our clients with Section 105(h) tests. Please ask your advisor for additional information.
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