



## **Health Care Reform – Special Edition**

### **Health Care Reform: Non-discrimination Testing for Insured Plans**

#### **LEGISLATIVE BRIEF**

**April 29, 2010**

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This memorandum is the fourth installment in our effort to address the critical and imminent changes brought about by the Patient Protection and Affordable Care Act ([H.R. 3590](#); Reform Bill) and the Health Care and Education and Affordability Reconciliation Act ([H.R. 4872](#); Reconciliation Bill), collectively referred to as the Health Care Reform Bills.

#### **The BIG Change**

For plan years beginning on or after September 23, 2010, insured health plans will be subject to the non-discrimination rules contained in the Internal Revenue Code Section 105(h) prohibiting a group health plan from discriminating in favor of highly compensated employees as to eligibility to participate in a plan or to the benefits provided under the plan. Please refer to the Attachment for a copy of the actual HCR provision. This new rule will not apply to grandfathered plans until and at such time the plan loses its grandfathered status (e.g. due to a change in plan design).

#### **Past Practices**

Historically, a number of employers purchased a special group health policy covering the employer's executive staff only. The policy provided benefits supplementing the underlying group health plan by covering deductibles, co-pays, and excess over plan limits, as well as qualifying benefits not available through the basic health (including dental and vision) plans. Non-highly compensated employees typically would be ineligible to participate in the plan. Since insured group health plans were exempt from the discrimination testing rules applicable to self-funded plans, the policy could be limited to executives without IRS scrutiny.

#### **Other Impacts**

This new rule also may impact multi-state employers who have different benefit levels, eligibility rules, and contribution requirements based on business location. For example, a company based

in Connecticut may have a rich health plan with no employee contributions for Connecticut employees and a plant in California with a modest health plan and high employee contributions achieving parity with what California employers offer as benefits in the same industry. The non-discrimination testing rules may require a more uniform level of benefits and contributions for all employees regardless of their business location, although there is some latitude here.

### **The Tax Effect**

Insured group health plans must pass the tests described below. If they do not, the actual benefits provided (claims paid) become ordinary income to the employee. For example, in a discriminatory plan, the actual dollars paid out in connection with a hospital stay, dental surgeries, or even the purchase of prescription lenses for the employee or covered family member would be income to the highly compensated employee in the year the benefit amount is paid. The non-highly compensated employees remain exempt from taxation of benefits paid out.

### **The Eligibility Tests**

A plan satisfies the eligibility requirements if the plan is available to:

1. 70% or more of all employees, or to
2. 80% or more of all the employees who are eligible to benefit under the plan if 70% or more of all employees elect to participate in the plan.

Alternatively, a plan meets the eligibility requirements if it covers a classification of employees that does not discriminate in favor of highly compensated individuals.

The 80/70 percentage test requires a minimum of 56% of employees (80% multiplied by 70%) participating in the plan. The non-discriminatory classifications test will allow reasonable classifications generally including specified job categories, compensation categories such as hourly or salaried, geographic location to some extent, and similar bona fide business criteria.

Certain non-participating employees may be excluded from the eligibility tests, including employees who have not completed three years of service; employees younger than age 25; part-time or seasonal employees; union employees; and employees who are nonresident aliens and who receive no U.S. earned income.

### **The Benefits Test**

In addition to the eligibility rules, all benefits provided to highly compensated employees must be provided to all other participants.

Please note: the controlled group rules specify that employees of controlled groups of corporations and partnerships and employees of affiliated service groups are to be treated as employees of a single employer.

### **Definition of Highly Compensated**

Using the same definition as for self-funded plans, a highly compensated individual is defined as one of the five highest paid officers, a shareholder who owns more than 10% in value of the stock of the employer, or among the highest paid 25% of all employees.

## Action Plan

1. If you are currently a grandfathered plan and if you are considering changes to your plan now or at the time of the policy renewal, and, if you have an executive type health plan or are a multi-state employer, seek the advice of your benefit plan consultant regarding the risk of failing the IRC Section 105(h) plan discrimination testing rules. The rule becomes applicable to your plan upon the implementation of the plan change or for plan years beginning on or after September 23, 2010, whichever is later.
2. If you do not have an executive type health plan and if you offer the same benefits to all employees with the same employee contribution requirements, and if you are considering a change in plan, weigh the value of the change against the risk of becoming subject to the discrimination testing rules.
3. Watch for further official guidance.
4. Contact your benefits consultant with any questions.

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