COMPLIANCE OVERVIEW

Section 105(h) Nondiscrimination Rules

Internal Revenue Code (Code) Section 105(h) contains nondiscrimination rules for self-insured health plans. Under these rules, self-insured health plans cannot discriminate in favor of highly compensated individuals (HCIs) with respect to eligibility or benefits.

- The **eligibility test** looks at whether a sufficient number of non-HCIs benefit under a self-insured health plan.
- The **benefits test** analyzes whether the plan provides HCIs with better benefits, either in terms of how the plan is designed or how it operates.

Benefits provided by a discriminatory self-insured health plan will be taxable to the HCI. Also, if the benefits are offered through a Section 125 cafeteria plan, the cafeteria plan nondiscrimination rules will impact whether contributions made by highly compensated employees are taxable.

The Section 105(h) nondiscrimination rules do not apply to fully insured group health plans. However, under the Affordable Care Act (ACA), nondiscrimination rules that are similar to the Section 105(h) rules may apply to non-grandfathered fully insured plans in the future.

LINKS AND RESOURCES

- Code Section 105(h)
- IRS Regulations under Code Section 105(h) – Treas. Reg. § 1.105-11

Highly Compensated Individual

An HCI is an individual who is:

- One of the five highest-paid officers;
- A shareholder who owns more than 10 percent in value of the employer's stock; or
- Among the highest-paid 25 percent of all employees.

Plan Design Issues

These plan designs may be discriminatory under Section 105(h) if:

- Only certain groups of employees are eligible to participate.
- There are different employment requirements for plan eligibility.
- Plan benefits or contribution rates vary based on employment classification, years of service or amount of compensation.

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Health Plan Design – Potential Problems

In general, a self-insured health plan will not have problems passing the Section 105(h) nondiscrimination tests when the employer treats all of its employees the same for purposes of health plan coverage (for example, all employees are eligible for the health plan, and the plan's eligibility rules and benefits are the same for all employees). This is the case even if HCIs use the plan's benefits more than non-HCIs. However, treating employees differently—either in terms of plan design or operation—may make it more difficult for a health plan to pass the applicable nondiscrimination tests.

Examples of plan designs that may cause problems with nondiscrimination testing include:

- ✓ Only certain groups of employees are eligible to participate in the health plan (for example, only salaried or management employees);
- ✓ The health plan has different employment requirements for plan eligibility (for example, waiting periods and entry dates) for different employee groups;
- ✓ Plan benefits or contribution rates vary based on employment classification, years of service or amount of compensation (for example, management employees pay a lower premium or receive additional benefits); or
- ✓ The employer maintains separate health plans for different groups of employees.

Fully Insured Health Plans – Because fully insured health plans are not subject to the Section 105(h) nondiscrimination rules, employers generally have more flexibility to treat employees differently under their fully insured group health plans. For example, some employers only make coverage available to management employees or make coverage available to all employees, but provide better benefits (or charge lower premiums) to management employees. Although the Section 105(h) rules do not apply to an employer's fully insured group health plan, the Section 125 nondiscrimination rules will apply if the health plan is offered through a cafeteria plan. If a cafeteria plan is discriminatory, highly compensated employees' health plan contributions will be taxable.

Self-Insured Health Plans

The Section 105(h) nondiscrimination rules apply to self-insured health plans. All self-insured health plans are subject to these nondiscrimination rules—no exceptions apply for small employers or plans that have grandfathered status under the ACA.

Self-insured benefits that are subject to the Section 105(h) nondiscrimination rules include:

- Medical benefits, including preferred provider organization (PPO) plans, health maintenance organization (HMO) plans and high deductible health plans (HDHPs);
- Dental and vision benefits;
- Health flexible spending accounts (FSAs); and
- Health reimbursement arrangements (HRAs).

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Some group health plans may include both insured and self-insured components. For example, an employer's health plan may include a fully insured medical benefit and an HRA that reimburses eligible medical expenses up to the fully insured benefit's deductible. Although the fully insured medical benefit is not subject to the Section 105(h) nondiscrimination rules, the self-insured portion of the plan—for example, the HRA benefit—would be subject to these rules.

A self-insured health plan is an accident or health plan that reimburses medical care expenses and does not provide this reimbursement through an insurance policy.

Section 105(h) Testing

Under Section 105(h), if an employer's self-funded health plan provides tax-free health benefits to employees, the plan cannot discriminate in favor of HCIs with respect to either **eligibility** or **benefits**. If a self-insured health plan fails either the eligibility or benefits test, HCIs will be taxed on their "excess reimbursements" from the plan.

A self-insured health plan should be tested for nondiscrimination at least annually before the start of each plan year. A self-insured health plan cannot correct a failed discrimination test by making corrective distributions after the end of the plan year. Thus, depending on the plan's design, an employer may wish to monitor its health plan's compliance with the Section 105(h) rules throughout the plan year to avoid adverse tax consequences for HCIs.

Because Section 105(h) testing is complex, employers with self-insured plans should work with their service providers when performing this nondiscrimination testing. There are some permitted ways to structure health plan benefits in a way that favors highly compensated employees (for example, a separate fully insured group health plan for HCIs offered outside of a cafeteria plan), but due to the complicated nature of the rules, employers may want to consult with legal counsel before implementing one of these designs.

Consequences of Discriminatory Plan: Fully Insured Versus Self-insured – If a self-insured group health plan is discriminatory, it will not impact non-HCIs and the overall plan will retain its tax-favored status. However, HCIs will lose a tax benefit under the plan. If the nondiscrimination rules become effective for fully insured group health plans and an insured group health plan is discriminatory, the plan is subject to an excise tax of $100 per day per individual discriminated against.

Eligibility Test

The eligibility test under Section 105(h) looks at whether a sufficient number of non-HCIs benefit under a self-insured health plan. If not enough non-HCIs are benefitting, the plan will fail this discrimination test.

An HCI is an individual who is:

- ✓ One of the five highest-paid officers;
- ✓ A shareholder who owns more than 10 percent in value of the employer's stock; or
- ✓ Among the highest-paid 25 percent of all employees.

Testing Group

With a few exceptions, all employees of the employer must be included in the testing group. For nondiscrimination testing purposes, the Code treats two or more employers as a single employer if there is sufficient common ownership or a

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combination of joint ownership and common activity. Thus, if companies are part of the same controlled group or affiliated service group under Code sections 414(b), (c) and (m), all employees of those companies must generally be included in the nondiscrimination testing.

The following employees (collectively referred to as "**excludable employees**") may be excluded from the eligibility test:

- Employees who have not completed three years of service;
- Employees who have not attained age 25;
- Part-time or seasonal employees;
- Employees covered by a collective bargaining agreement, provided that they are not eligible to participate in the plan; and
- Non-resident aliens with no U.S. source income from the employer.

It is not clear, however, whether excludable employees (other than collective bargained employees) may be excluded from nondiscrimination testing if they are eligible to participate in the plan.

Testing Requirements

Code Section 105(h) provides three different ways for a self-insured health plan to pass the eligibility test.

1	2	3
70 Percent Test:	**70 Percent/80 Percent Test:**	**Nondiscriminatory Classification Test:**
The plan benefits 70 percent or more of all non-excludable employees.	The plan benefits 80 percent or more of all non-excludable employees who are eligible to benefit under the plan, if 70 percent or more of all non-excludable employees are eligible to benefit under the plan.	The plan benefits a classification of employees that does not discriminate in favor of HCIs. A plan satisfies this test if it has: ✓ A bona fide business classification for any exclusions (for example, specified job categories, compensation categories or geographic location); and ✓ A sufficient ratio of benefitting non-HCIs to benefitting HCIs.

Federal tax law does not define what it means to "benefit" under a self-insured plan for purposes of Section 105(h) eligibility testing. Based on the wording of the test, it seems logical that "benefitting" means that an employee is actually covered under the plan (and not just merely eligible for coverage). Other interpretations may also be acceptable, but given the lack of IRS guidance, employers may want to work with their legal counsel if they want to use another interpretation.

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Also, if an employer offers an HMO option in addition to its self-insured health plan, there is a special rule that allows HMO participants to be considered for purposes of the eligibility test. This special rule may be used if the employer's contributions to the HMO equal or exceed those to the self-insured health plan.

Benefits Test

The benefits test under Section 105(h) is designed to prevent health plans from providing HCIs with better benefits, either in terms of how the plan is designed or how it operates.

Plan Design

A health plan does not satisfy Section 105(h) nondiscrimination testing unless ***all the benefits provided to participants who are HCIs are provided for all other participants*****.** In addition, all the benefits available for the dependents of HCIs must be available on the same basis for the dependents of all other employees who are participating in the plan.

This test analyzes the benefits that may be reimbursed under the plan's terms—it does not take into account actual benefit payments or claims. Also, employers may be able to aggregate or disaggregate benefit plans under IRS rules if necessary to pass the benefits test.

The IRS has provided the following guidance on specific plan design features:

Plan Design	IRS Guidance
Employee Contributions	The Section 105(h) rules suggest that employee contributions for HCIs and non-HCIs must be the same. These rules provide that a health plan that provides optional (elective) benefits to participants will satisfy the benefits test if: ✓ All participants are eligible to elect the optional benefits; and ✓ There are either no required employee contributions or the required employee contributions are the same amount.
Benefit Limits	As a permissible design option, a self-insured health plan may establish a maximum reimbursement limit for any single benefit or combination of benefits. However, any maximum limit attributable to employer contributions must be uniform for all participants (and for all dependents of employees who are participants) and may not be modified by reason of a participant's age or years of service. If a plan covers HCIs and the type or the amount of benefits subject to reimbursement under the plan are in proportion to employee compensation, the plan will fail the benefits test.
Waiting Periods	The IRS has suggested that having a **longer waiting period** for non-HCIs than HCIs will cause a self-insured health plan to fail the benefits test.

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The Section 105(h) rules include a special exception for medical diagnostic procedures for employees. This exception allows employers to provide free "**executive physicals**" to certain key employees (often, all HCIs) without violating the nondiscrimination rules. The medical diagnostic procedures include routine medical examinations, blood tests and X-rays.

Plan Operation

In addition to being nondiscriminatory in its design, a self-insured health plan must not discriminate in favor of HCIs in actual operation. Determining whether a health plan discriminates in operation involves a "facts and circumstances" analysis. A plan is not considered discriminatory merely because HCIs participating in the plan use a broad range of plan benefits to a greater extent than other employees participating in the plan. However, a plan may violate the benefits test if the plan's procedures for approving benefit claims are applied more favorable to HCIs than non-HCIs.

In addition, if a plan (or a particular benefit provided by a plan) is terminated, the termination would cause the plan's benefits to be discriminatory if the duration of the plan (or benefit) has the effect of discriminating in favor of HCIs. Prohibited discrimination may occur, for example, where the duration of a particular benefit coincides with the period during which an HCI uses the benefit.

Impact of Failed Testing

If a plan discriminates in favor of HCIs, HCIs will be taxed on excess reimbursements that would have otherwise been excluded from their income. The excess reimbursements should be included in the HCIs' gross income and reported on their Forms W-2. Although excess reimbursements are includible in gross income, these amounts are generally not subject to income tax or employment tax (FICA or FUTA) withholding.

The method for determining the amount of excess reimbursements depends on whether the health plan failed Section 105(h) testing due to discriminatory coverage or discriminatory benefits. Also, if an HCI pays for coverage on an after-tax basis (or has his or her cafeteria plan contributions taxed due to a failed Section 125 nondiscrimination test), the HCI will only be taxed on the proportion of the discriminatory coverage or benefit that is attributable to employer contributions.

Discriminatory Coverage	Discriminatory Benefit
When a health plan fails the eligibility test, the amount of excess reimbursement is determined by multiplying the total amount reimbursed to the HCI by a fraction. The numerator is the total amount reimbursed during that plan year for all HCIs. The denominator is the total amount reimbursed during that plan year for all participants. In computing this amount, any amount that is already included in the HCI's income as a discriminatory benefit is excluded.	In the case of a benefit available to HCIs, but not to all other participants (or which otherwise discriminates in favor of HCIs as opposed to other participants), the amount of excess reimbursement equals the total amount reimbursed to the HCI with respect to the benefit. If a discriminatory benefit is available to non-HCIs, the amount reimbursed to the HCI is offset by the amounts available to non-HCIs.

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