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Nondiscrimination Rules for Fully-Insured Group Health Plans

Under health care reform, **non-grandfathered, fully insured group health plans** will be required to comply for the first time with federal nondiscrimination rules related to compensation. These rules, which have historically applied only to self-insured health plans, prohibit discrimination in favor of highly compensated individuals (HCIs).

The nondiscrimination rules were set to be effective for plan years beginning on or after **Sept. 23, 2010**. However, they have been **delayed indefinitely**, pending the issuance of regulations. Once regulations are issued, they will specify the new effective date.

CAFETERIA PLAN NONDISCRIMINATION RULES

Because cafeteria plans offer tax advantages to employers and participants, these plans must meet certain nondiscrimination requirements to ensure HCIs do not receive a disproportionate amount of tax-advantaged benefit. Specifically, a cafeteria plan must not discriminate in favor of:

- HCIs as to eligibility to participate (the eligibility test);
- HCIs as to contributions and benefits (the contributions and benefits test); or
- Key employees as to concentration of benefits (the key employee concentration test).

If a cafeteria plan is discriminatory, all HCI or key employee participants will face adverse tax consequences.

NONDISCRIMINATION RULES FOR FULLY-INSURED GROUP HEALTH PLANS

Health care reform requires non-grandfathered, fully insured plans to follow many of the same nondiscrimination rules that, up until now, have applied only to self-funded plans. Because grandfathered plans are exempt from these rules, existing plans that are designed to favor HCIs may want to make the effort to retain grandfathered status. If grandfathered status is lost, discriminatory plans will have to be amended or face potential excise tax penalties.

Specifically, non-grandfathered, fully insured plans will have to satisfy the requirements similar to those of Internal Revenue Code (Code) section 105(h)(2), which prohibits discrimination in favor of HCIs. This section generally provides that plans must pass two separate nondiscrimination tests – the eligibility test and the benefits test.

An HCI for purposes of these rules is an individual who is:

- One of the five highest paid officers;
- A shareholder who owns more than 10 percent in value of the stock of the employer; or
- One of the highest paid 25 percent of all employees (other than an employee excludable as described below).

For nondiscrimination testing purposes, the Code generally treats two or more employers as a single employer if there is sufficient common ownership or a combination of joint ownership and common activity. The controlled group and affiliated service group rules of Code sections 414(b), (c) and (m) are expressly applied to nondiscrimination testing under Code section 105(h)(2).

Eligibility Test

To pass the eligibility test, a plan must benefit one of the following:

- At least 70 percent of all employees;
- At least 80 percent of all employees who are eligible to benefit under the plan (if at least 70 percent of all employees are eligible to participate in the plan); or
- A nondiscriminatory classification of employees.

In order to have a nondiscriminatory classification of employees, there must be a bona fide business reason for the classification and a sufficient ratio of non-HCIs must benefit. Examples of reasonable classifications generally include specified job categories, compensation categories (such as hourly or salaried) and geographic location.

In running the eligibility test, an employer may **exclude from consideration** employees who:

- Have not completed three years of service;
- Have not attained age 25;
- Are part-time or seasonal;
- Are collectively bargained; or
- Are non-resident aliens who do not receive U.S. earned income.

Benefits Test

To pass the benefits test, all benefits provided to the HCIs who participate in the plan must be provided to all other participants as well. Also, all the benefits available for the dependents of HCIs must be available on the same basis for dependents of all other participants. The regulations and IRS guidance indicate that the level of employer contributions should not discriminate in favor of HCIs.

A plan may have a maximum reimbursement limit for any single benefit or combination of benefits, but the maximum limit attributable to employer contributions must be uniform for all participants and their dependents. The limit may not be modified due to a participant's age or years of service.

There are two components to the benefits test. A plan must not:

- Discriminate on its face in providing benefits in favor of HCIs; or
- Discriminate in favor of HCIs in actual operation (determined on a facts and circumstances basis).

A plan will discriminate on its face if the plan document contains discriminatory provisions that favor HCIs. A plan could discriminate in operation if it is amended or terminated so that the duration of the plan (or benefit) favors HCIs, or if the plan approves certain claims for medical expenses for HCIs but denies them for non-HCIs without a permissible reason for treating them differently. However, a plan will not be considered discriminatory just because HCIs participating in the plan use a broad range of plan benefits to a greater extent than do other employees participating in the plan.

NONDISCRIMINATION RULES DELAYED PENDING REGULATIONS

As with many areas of health care reform, the law regarding nondiscrimination rules for fully insured plans is unclear. Recognizing the uncertainty surrounding these rules, the Internal Revenue Service (IRS) issued **Notice 2011-1**,

which became available on Dec. 22, 2010. Notice 2011-1 delays the application of the nondiscrimination rules to insured group health plans until after regulations are issued. The regulations will specify the new effective date.

In Notice 2011-1, the IRS acknowledged that employers would have difficulty complying with the nondiscrimination rules without regulatory guidance. In particular, one provision of the health care reform law states that insured plans must follow rules "similar to the rules" found in Code section 105(h)(3), (4) and (8). This reference means that guidance must specify how insured plans should follow those rules, since the law itself is unclear on this point.

Compliance with the nondiscrimination rules **will not be required until after regulations (or other administrative guidance) is issued**. In order to give employers time to implement any required changes, the guidance is expected to apply to plan years beginning a certain amount of time after the guidance is issued.

The IRS plans to include the effects of later health care reform changes in any guidance. Specifically, the IRS will take into account the operation of state health insurance Exchanges and the individual and plan sponsor requirements that go into effect in 2014. **The IRS has not yet released any further guidance on this issue.**