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TO: **Broker and TPA Clients**
FROM: **Christine P. Roberts**
RE: **Nondiscrimination Rules for Non-Grandfathered, Insured Group Health Plans**
DATE: **November 15, 2010**

Nondiscrimination rules apply to non-grandfathered, insured group health plans for the first time under health care reform. The effective date is January 1, 2011 for calendar year plans but the rules may already apply to plans with policy years beginning on or after September 23, 2010 (the six-month anniversary of health care reform legislation). Many of you are dealing with client questions on how the new rules will impact their plan design. The purpose of this memo is to provide some background on this issue, walk through the nondiscrimination test that "may" eventually apply to insured plans, and then provide some guidance on how to move forward.

Background on Nondiscrimination Rules for Health Plans

Below I compare "old" and "new" rules – with the proviso that the "new" rules are as yet set forth in statute only and will not be known in greater detail until regulations issue from the Treasury Department, the Department of Labor and the Department of Health and Human Services (collectively, the "Agencies").

Note: unless otherwise mentioned, the "New Rules" go into effect for plan or policy years beginning on or after September 23, 2010 (for calendar year arrangements, the effective date is January 1, 2011).

Old Rules: An insured group health plan could discriminate as to eligibility and benefits, in favor of highly paid employees and owners. Some restrictions apply under small group coverage laws, state-by-state.

Examples of permitted arrangements included:

- Limiting eligibility to executives/key employees and owners ("key group"), or to other classifications that primarily include this group (e.g., "Management Employees" or "Home Office Employees.")
- Shorter (or no) waiting periods for key group

- Lower deductibles/larger employer contributions for key group
- Benefit levels increase along with employee's age, compensation, or years of service
- For multiple option "menu" plan arrangements, one more options are limited to key group
- Richer employer contributions for key group, e.g. 100% coverage of dependents.

New Rules: Insured group health plans must meet nondiscrimination rules to be issued by the Agencies. The new rules will be patterned on nondiscrimination rules currently applicable to self-funded health plans under Internal Revenue Code ("Code") Section 105(h). They prohibit discrimination in favor of "highly compensated individuals," with regard to either eligibility or benefits.

Old Rules: The main consequence of a discriminatory plan is that the dollar value of discriminatory benefits is included in gross income of key group employees. The employer experiences no tax effect other than increased withholding and payroll taxes for affected employees. This is still the case with discriminatory self-funded health plans.

New Rules: The consequences of a discriminatory insured plan can be financially ruinous to employers: they will be subject to a $100 per day, per employee excise tax, up to a maximum that is equal to the lesser of 10% of health care costs paid by the employer in the preceding year, or $500,000. (The per-employee rule applies to employees who are disadvantaged by the discriminatory plan. Thus an employer with 100 employees and 10 key group members receiving extra benefits would owe an excise tax of $9,000 per day (90 x $100)).

Note: The excise tax, set forth in Code § 4980D, contains an exception for group health plans maintained by small employers (at least 2 but not more than 50 employees), however representatives of the Treasury Department have indicated that they will view this exception as applying only when the prohibited discrimination results from the underlying insurance policy, not when it is a result of employer plan design.

Other relief from the excise tax may be available if the failure evades detection despite the exercise of reasonable diligence, or if the failure is due to reasonable cause and is corrected within 30 days of discovery.

An employer maintain a discriminatory insured plan is also potentially exposed to civil penalties, and to ERISA litigation to enjoin discriminatory practices. Further, the employer can not just play "audit roulette" on this issue but must voluntarily disclose and pay the excise tax on IRS Form 8928. This means that

failure to report penalties, and interest on same, would accumulate along with the per-employee/per-day penalty tax.

Nondiscrimination Testing

Again, until regulations issue, all we have are existing testing rules under Code Section 105(h) that apply to self-funded plans. I walk through the existing testing rules below, highlighting issues specific to insured plans, wherever possible.

As mentioned, there are really two plan components that are tested: eligibility, and benefits.

Eligibility Nondiscrimination Tests

There are actually three alternative eligibility tests. I will only discuss the simplest two versions of the test. They are follows:

- A plan passes if at least 70% of all **non-excludable** employees "**benefit under"** the plan.
- A plan passes if at least 80% of all **non-excludable** employees who are eligible also "**benefit under**" the plan, provided that at least 70% of all **non-excludable** employees are eligible under the plan. (This means at least 56% of **non-excludable** employees must benefit – 70% x 80% = 56%).

Note that neither test requires universal coverage, and neither involves identification of "Highly Compensated Individuals." They do require you to understand who is "**non-excludable**," and what "**benefitting under**" a plan means, however.

"**Benefiting under**" a plan, for these purposes, is conservatively interpreted to mean actually enrolled in the plan. Regulations *may* define this term more liberally to include simply meeting eligibility requirements, regardless of enrollment status (akin to a 401(k) plan).

A "**non-excludable"** (or "includable") employee means an employee who falls within your "testing universe" of employees. Depending on the plan, your testing universe may be smaller than your total employee population.

Non-excludable can be further defined by reference to the terms of the plan, or by reference to regulations under Section 105(h).

The Section 105(h) rules allow employers to exclude the following groups from the testing universe: employees with fewer than 3 years of service, employees under age 25, part-time or seasonal employees (with part time meaning under 35 hours/week), and employees receiving no U.S. source income. Collectively bargained employees can also be excluded.

However, these excludable categories are much broader than most insurance carriers allow. Typically a carrier will not allow a waiting period of more than 6 months (and health care reform will disallow waiting periods longer than 90 days, starting in 2014.) Also, employee minimum ages generally are not higher than 21, and 30 hours rather than 35 usually suffice for part-time coverage.

When the carrier's exclusions are narrower than the exclusions permitted under Section 105(h), **the conservative approach is to perform nondiscrimination testing using only the carrier's exclusions**. An example is set forth below.

> **Example:** Burger Co. has 100 employees and offers an insured group health plan to its managerial and administrative employees who are at least age 21 and have worked for 6 months for the company. The plan currently has 20 managerial/administrative employees, all of whom participate in the plan. Of the 100 employee total, 50 have not met the minimum age and service requirements because Burger Co. employs many students and they have high turnover. That leaves 50 "non-excludable" employees.

70% Benefiting Test – Policy Exclusions Only

- Total employees: 100
- Non-excludable employees: 50
- "Benefitting" employees: 20
- 50 x 70% = 35
- Testing result: Plan needs to cover 15 more employees.

Note that if the "non-excludable employees" group was determined using the Section 105(h) exclusion categories (under age 25, under 3 years of service), it might be much smaller, given Burger Co.'s demographics (young, high turnover). For the sake of example, assume that 50 employees meet age 21 and 6 months, but only 30 employees meet the age 25 and 3 years of service requirements. The test would work this way:

70% Benefiting Test – 105(h) Exclusions

- Total employees: 100
- Non-excludable employees: 30

- "Benefitting" employees: 25
- 30 x 70% = 21
- Testing result: plan passes.

Under the second of three nondiscrimination-in-eligibility tests, a plan passes if it "benefits" at least 80% of all non-excludable employees who are eligible, provided that at least 70% of all non-excludable employees meet plan eligibility requirements. (This means at least 56% of **non-excludable** employees must benefit (be enrolled) – (70% x 80% = 56%).

> **Example:** Service Co. has 100 employees and offers an insured group health plan to all salaried employees who are at least age 21 and have worked for 6 months for the company. The plan currently has 70 salaried employees who have met age and service requirements. Of that group, 65 have enrolled in the plan. Of the 100 employee total, only 10 non-salaried employees fail to meet the age and service requirements under the plan.

80%/70% Test

- Total employees: 100
- Non-excludable employees: 90
- Eligible employees: 70
- "Benefitting" employees: 65
    - First element of test – 70% of non-excludable employees must be eligible. There are 90 non-excludable employees and 70 eligible employees; 90 x 70% = 63. This component of the test is passed.
    - The second element requires 80% of all eligible employees to actually benefit under (enroll) in the plan. There are 70 eligible employees. 80% x 70 = 56; there are 60 actual enrollees so the plan passes.

Again, those are only the simplest two versions of the eligibility nondiscrimination test. The third version can be passed with only 50% participation, but the complicated nature of the test makes it impractical for most employers to use.

Benefits Nondiscrimination Test

The benefits nondiscrimination test is quite simply stated as follows: a plan does not meet the test unless "all benefits provided for participants who are highly compensated individuals are provided for all other participants." (Code Section 105(h)(4)). For these purposes, a highly-compensated individual is:

- One of the company's five highest-paid officers.
- A shareholder owning more than 10 percent of the company's stock (ownership percentage is to be determined using "attribution" of share ownership from certain family members and business entities).*
- Among the top 25 percent highest-paid employees.

From the last category, note that even in a company with no shareholder employees, there will always be at least some HCIs due to the highest paid 25% rule.

A plan may be nondiscriminatory "on its face" (i.e., its written terms) or in operation, meaning actual utilization of benefits. It is hoped that, due to the likely expense and complication of analyzing benefit use, the new rules will allow insured plans to pass testing on the basis of benefit design rather than utilization of benefits.

What that means is that all of the plan features listed on pages 1-2 of this memo would be disallowed, as would any plan feature that gave highly compensated individuals access to benefits that non-HCIs do not have. On the other hand, a plan with different tiers of coverage which are equally available to all eligible employees would not fail nondiscrimination testing just because HCIs predominantly enrolled in the more expensive tier.

Further note – the nondiscrimination testing is applied on a "controlled group" basis such that parent-subsidiary companies and other businesses with shared ownership will be treated as a single employer for testing purposes, as will companies that are owned by the same five or fewer individuals. So, employers cannot create new entities simply to circumvent the testing rules. Under regulations that will issue, there may be some ways in which employers can "aggregate" and "disaggregate" plans for testing purposes, which would allow for more design flexibility.

I am participating in the drafting of comments on the new nondiscrimination regulations, to be submitted by the Tax Section of the American Bar Association. Based on comments I have reviewed to date I expect that several testing alternatives and "safe harbors" may eventually be available to employers, to help simplify the nondiscrimination testing process. There is no question that the days of almost complete design flexibility are over, but employers will still have some ability to limit insured group health plan access to selected sub-populations of

*In the case of partnerships or LLCs, use capital or profits interests.

employees. Within the covered population, however, it is likely that almost complete parity of benefits will be required.

What to Tell Clients

Despite the heading of this section, clients of Mullen & Henzell L.L.P. should keep in mind that I do not have attorney-client relationships with *your* clients (except in unusual circumstances) and thus that what I advise you should not be passed on verbatim to a client.

With that proviso out of the way, here are my thoughts on advising client with insured, discriminatory group health plans.

First, you should tell clients that, yes, nondiscrimination rules will apply to insured plans but that we do not yet have the specific details on how those rules will work. You should also suggest that the most conservative path forward, in the absence of clear guidelines, is to eliminate any plan design features that are exclusive to the highly paid group, whether it be accelerated or eliminated waiting periods, access to a special tier of coverage, larger employer contributions or "free" dependent coverage, and the like. You should also state that a good reason for a conservative approach is the very high penalty tax burden that an employer with 50 or more employees might possibly bear in the event it failed to eliminate discriminatory plan features.

If the client needs help determining which employees are "highly compensated individuals" and whether plan features are discriminatory or not, it is my opinion that analysis and conclusions in this regard constitutes the practice of law and should be carried out by an attorney. That said, it may not be practical or possible for every client to get the advice of outside benefits counsel. I can assist you in these instances, provided that your client is clearly informed that my attorney-client relationship is limited to your organization and does not encompass them. Alternatively I could represent the client directly pursuant to a mutual waiver of potential conflicts of interest by the client, and by you.