

# Health Care Reform Update

## Section 105(h) – Application to Insured Plans

Under the Patient Protection and Affordable Care Act (PPACA), a non-grandfathered insured group health plan will be required to satisfy the nondiscrimination requirements under Internal Revenue Code (Code) Section 105(h)(2), effective for the first plan year that begins on or after September 23, 2010.

While no guidance on this requirement has been issued, the statutory language does state that “rules similar to” the rules contained in Code Section 105(h) will apply to non-grandfathered group health plans. It is not clear whether this “similar to” language will result in a different application of Section 105(h) than what currently applies. The information in this summary assumes the same rules that exist under Section 105(h) today will apply to insured plans. However, the information contained in this summary is subject to change once regulations are issued.

### **HOW WILL A PLAN SATISFY CODE SECTION 105(H)(2)?**

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A plan will satisfy the requirements of Code Section 105(h)(2) only if:

- the plan does not discriminate in favor of highly compensated individuals (HCIs) as to eligibility to participate in the plan; and
- the benefits provided under the plan do not discriminate in favor of participants who are HCIs.

### **WHAT PLANS ARE SUBJECT TO 105(H)?**

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Self-insured group health plans are already subject to Code Section 105(h) (including self-insured medical, dental and vision plans, HRAs and health FSAs), and must continue to comply regardless of the plan’s grandfathered status.

Under Section 2716 of the PPACA, non-grandfathered insured group health plans are subject to the requirements of 105(h)(2), effective for the first plan year that begins on or after September 23, 2010.

Grandfathered insured plans are not subject to this requirement.

Excepted benefits that are insured (e.g. limited scope dental and vision plans) are not subject to this requirement.<sup>1</sup> Also, it appears that stand-alone insured retiree-only plans are not subject to this requirement.

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<sup>1</sup> Excepted benefits are (1) provided under a separate policy, certificate, or contract of insurance; or (2) otherwise not an integral part of the group health plan. This two-pronged exception applies only to:

- limited-scope dental benefits;
- limited-scope vision benefits;
- benefits for long-term care, nursing-home care, home care, or community-based care;
- other similar, limited benefits specified in the regulations.

For purposes of this exception, benefits are not considered to be an integral part of a plan, whether the benefits are provided through the same plan or a separate plan, if the following two conditions are met: (1) the participant has the

## **WHAT PLAN DESIGNS MAY BE PROBLEMATIC?**

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Among other things, a non-grandfathered insured group health plan subject to 105(h)(2) likely cannot:

- impose disparate waiting periods that favor HCIs;
- provide more favorable employer contributions on behalf of HCIs that are not available to non-HCIs;
- only provide coverage to HCIs;
- provide more favorable benefits to HCIs than what are provided to non-HCIs; and
- provide more favorable benefits to HCIs who are retired than what are provided to non-HCIs.

## **ARE THERE EXAMPLES OF DISCRIMINATORY TREATMENT?**

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Examples of plan designs that may violate the nondiscrimination requirement include plans that:

- impose no waiting period on HCIs, while non-HCIs must satisfy a 60-day waiting period;
- provide coverage to HCIs at no cost to the HCI, but require non-HCIs to pay 25% of the cost;
- only offer group health plan coverage to HCIs (i.e. management carve out plans);
- provide coverage to retired HCIs, but not to retired non-HCIs, unless the plan is a stand-alone insured retiree plan;
- the employer pays for COBRA for HCIs who terminate employment, but not for non-HCIs who terminate employment.

## **WHO ARE HIGHLY COMPENSATED INDIVIDUALS (HCIs)?**

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Code Section 105(h)(5) defines a highly compensated individual (HCI) to mean an individual who is:

- one of the 5 highest paid officers;
- a shareholder who owns (with application of Code Section 318 – *attribution rules*) more than 10% in value of the stock of the employer; or
- Among the highest paid 25% of all employees (other than employees who are excludable – *as defined below*).

## **WHAT ARE THE TESTS?**

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There are two sets of tests that must be satisfied in order to demonstrate that a plan is nondiscriminatory – the Eligibility Test and the Benefits Test.

All employees with common ownership (i.e., who are treated as employed by a single employer under Code Section 414 (b), (c), or (m)) shall be treated as employed by a single employer for purposes of these tests.

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right to elect not to receive the coverage; and (2) if the participant elects to receive the coverage, the participant must pay an additional premium or contribution for it.

## Eligibility Test

The Eligibility Test consists of three separate tests. A group health plan only needs to pass one of them.

Briefly, the tests are:

- **70% Test** – the plan must benefit 70% or more of all non-excludable employees.
- **70%/80% Test** – the plan must benefit 80% or more of all non-excludable employees who are eligible to benefit, if 70% or more of all non-excludable employees are eligible to participate under the plan.
- **Reasonable Classification Test** – the employees covered by the plan qualify under a classification that is nondiscriminatory under the requirements of Code Section 410(b). This requires that there be both a *Reasonable Classification* and a *Nondiscriminatory Classification* of employees.
  - Reasonable Classification. The employer must set up a reasonable classification of employees eligible for the benefits based on objective business criteria (e.g. salary/hourly, type of job, geographic location).
  - Nondiscriminatory Classification. This test is a ratio percentage test and requires certain calculations to ensure the required percentage is satisfied (known as the Safe Harbor and Unsafe Harbor Tests). As a general principle, a classification is more likely to be nondiscriminatory if the percentage of HCIs who benefit under the plan is not significantly more than the percentage of non-HCIs who benefit under the plan. In other words, the more non-HCIs that benefit versus HCIs, the easier it is to pass this test.

\*\* More information on the 410(b) Reasonable Classification Test is in the attached Appendix. \*\*

### *Excludable Employees*

For purposes of the Eligibility Test, certain employees that may be excluded from consideration:

- Employees who have not completed 3 years of service;
- Employees who have not attained age 25;
- Part-time or seasonal employees<sup>2</sup>;
- Employees covered by a collective bargaining agreement, and
- Employees who are nonresident aliens and receive no earned income from the employer which constitutes income from sources within the United States.

However, it would appear that if employees in the categories described above are eligible to participate in the group health plan, then a plan may not exclude these employees for purposes of non-discrimination testing. Further guidance on this issue would be helpful.

## Benefits Test

Once a plan satisfies the Eligibility Test, the next question is whether the benefits offered under the plan favor participants who are HCIs. Under the Benefits Test, all benefits provided to HCIs who are participating in the plan must be provided to all other participants. In addition, all benefits available for the dependents of HCIs must also be available on the same basis for the dependents of non-HCIs. There

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<sup>2</sup> Any employee whose customary weekly employment is less than 25 hours or any employee whose customary annual employment is less than 7 months may be considered as a part-time or seasonal employee.

Also, employees whose customary weekly employment is less than 35 hours are considered to work part-time if other employees in similar work with the same employer (or, if no employees of the employer are in similar work, in similar work in the same industry and location) have substantially more hours and, seasonal employees whose customary annual employment is less than 9 months are considered to be seasonal if other employees in similar work with the same employer (or, if no employees of the employer are in similar work, in similar work in the same industry and location) have substantially more months.

are two tests for benefits discrimination, *Discrimination on the Face of the Plan* and *Discrimination in Operation*.

#### *Discrimination on the Face of the Plan.*

This first test looks at whether the benefits under the plan are set up to favor HCIs.

A plan does not discriminate in favor of HCIs if:

- There are identical employee (and employer) contributions at each benefit level;
- The maximum benefit level and type of benefits available do not vary based on age, years of service or compensation;
- The same type of benefits available to HCIs are offered to non-HCIs; and
- Any waiting periods imposed do not favor HCIs.

#### *Discrimination in Operation.*

The second test prohibits discrimination in favor of HCIs in the actual operation of the plan. This is a facts and circumstances test based on each particular case. A plan will not be discriminatory merely because the HCI utilizes a broad range of benefits under the plan to a greater extent than the non-HCI. However, to the extent the plan operates to favor HCIs in its operation, the plan will be discriminatory. For example, a plan would discriminate in operation if the plan implements coverage for gastric bypass surgery for one HCI and then terminates the benefit without making it available to non-HCIs.

### **HOW DOES THIS REQUIREMENT INTERACT WITH THE SECTION 125 NONDISCRIMINATION RULES?**

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If the insured plan is offered under the cafeteria plan, the plan must comply with both the Section 105(h) and Section 125 nondiscrimination rules.

### **WHAT ARE THE PENALTIES FOR DISCRIMINATORY INSURED PLANS?**

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Unlike a discriminatory self-insured plan, where the excess reimbursement is taxable, a discriminatory insured plan may be subject to an excise tax of \$100 per day with respect to each individual to whom such failure relates.<sup>3</sup> A tax may not apply if the failure to comply was due to reasonable cause (and not willful neglect) and is corrected within 30 days after the plan knew, or should have known, the failure existed.

Enforcement procedures under ERISA may also apply.

### **WHAT SHOULD I DO NOW?**

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- Await further guidance.
- Determine whether or not the plan will retain grandfathered status.
- Review your current benefit plan design to determine potential exposure to a discrimination violation. A discriminatory insured plan will likely need to retain grandfathered status in order to avoid penalties.
- Self-funded plans should take this opportunity to review compliance with 105(h).

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<sup>3</sup> Code Section 4980D. However, certain small employers (2-50 employees) may avoid the tax if noncompliance with 105(h)(2) is based solely on the insurance policy issued by the insurance carrier. This exception appears to be very limited. More guidance is needed.



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601 Union St  
Suite 1000  
Seattle, WA 98101  
206.441.6300  
kpc.com

700 NE Multnomah  
Suite 1300  
Portland, OR 97232  
503.224.8390  
usinw.usi.biz

1255 Treat Boulevard  
Suite 300  
Walnut Creek, CA 94597  
925.472.6770  
usi.biz

2021 W March Lane  
3rd Floor  
Stockton, CA 95207  
209.957.6800  
usi.biz

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## Appendix

### Reasonable Classification Test

A plan satisfies the Reasonable Classification Test for a plan year if, for the plan year, the plan meets the *Bona Fide Employment Classification Test* and the *Nondiscriminatory Classification Test*.

#### 1. BONA FIDE EMPLOYMENT CLASSIFICATION TEST

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A classification is reasonable if, based on all the facts and circumstances, the classification is reasonable and is established under objective business criteria that identify the category of employees who benefit under the plan. Reasonable classifications generally include specified job categories, nature of compensation (i.e., salaried or hourly), geographic location, and similar bona fide business criteria.

#### 2. NONDISCRIMINATORY CLASSIFICATION TEST

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A classification is nondiscriminatory for a plan year if it satisfies the *Safe Harbor* or the *Unsafe Harbor – Facts and Circumstances Test*.

##### Safe Harbor

A plan satisfies the Safe Harbor for a plan year if the plan's ratio percentage is greater than or equal to 38.75%.

For a plan year, a plan's "ratio percentage" means the percentage (rounded to the nearest hundredth of a percentage point) determined by dividing the Non-HCI percentage<sup>4</sup> by the HCI percentage.<sup>5</sup>

##### Unsafe Harbor – Facts and Circumstances Test

A plan satisfies the Unsafe Harbor – Facts and Circumstances Test if:

- The plan's ratio percentage is greater than or equal to 28.75%, and
- Based on all the relevant facts and circumstances, the Internal Revenue Service finds that the classification is nondiscriminatory. No one particular fact is determinative. Included among the facts and circumstances relevant in determining whether a classification is nondiscriminatory are the following:
  - The underlying business reason for the classification. The greater the business reason for the classification, the more likely the classification is to be nondiscriminatory. Reducing the employer's cost of providing benefits is not a relevant business reason.
  - The percentage of the employer's employees benefiting under the plan. The higher the percentage, the more likely the classification is nondiscriminatory.
  - Whether the number of employees benefiting under the plan in each salary range is representative of the number of employees in each salary range of the employer's workforce. In general, the more representative the percentages of employees benefiting under the plan in each salary range, the more likely the classification is nondiscriminatory.
  - The difference between the plan's ratio percentage and the employer's safe harbor percentage. The smaller the difference, the more likely the classification is to be nondiscriminatory.

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<sup>4</sup> Determined by dividing the number of non-excludable non-HCIs benefiting under the plan by the total number of all non-excludable non-HCIs of the employer.

<sup>5</sup> Determined by dividing the number of non-excludable HCIs benefiting under the plan by the total number of non-excludable HCIs of the employer.

- The extent to which the average of the non-HCI benefit percentages exceeds 70 percent of the average of the non-HCI benefit percentages.<sup>6</sup>

### Example 1

There are 2,000 employees in the employer's controlled group.

500 are excludable due to age, years of service, etc. *See page 3 for a list of Excludable Employees.*

1,000 employees are eligible to participate in the health plan. Of those eligible, 375 are HCIs (top 25% of 1,500) and 625 are non-HCIs.

575 non-HCIs participate. 375 HCIs participate.

Under the safe harbor, the ratio percentage is 51.11%.<sup>7</sup> 51.11% is equal to or greater than 38.75% (Safe Harbor) so the plan passes.

### Example 2

Same facts as above except that only 300 non-HCIs benefit.

The ratio percentage is 26.67%.<sup>8</sup> 26.67% is not equal to or greater than 38.75% (Safe Harbor) or 28.75% (Unsafe Harbor) so the plan does not pass.

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<sup>6</sup> As determined under § 1.410(b)-5.

<sup>7</sup> Percentage of the non-HCIs who benefit under the plan (determined by dividing the number of non-excludable non-HCIs benefiting under the plan by the total number of non-excludable non-HCIs of the employer (575/1125)) by the percentage of the HCIs who benefit under the plan (determined by dividing the number of non-excludable HCIs benefiting under the plan by the total number of non-excludable HCIs (375/375)).

<sup>8</sup> Percentage of the non-HCIs who benefit under the plan (determined by dividing the number of non-HCIs benefiting under the plan by the total number non-HCIs of the employer (300/1125)) by the percentage of the HCIs who benefit under the plan (determined by dividing the number of HCIs benefiting under the plan by the total number of HCIs (375/375)).