

Non-discrimination Testing Still a Requirement for Self-insured Plans

Contributed by Adam Jensen, JD, CEBS, GBA, FLMI, Director of Compliance Services, Cottingham & Butler Consulting Services

Although fully-insured plan sponsors have been given at least a temporary reprieve from the health care reform requirement to conduct Section 105(h) testing, self-insured plans are still subject to non-discrimination testing.

What is Prohibited?

Self-insured medical reimbursement plans must comply with the discrimination tests found in Internal Revenue Code (IRC) Section 105(h). Under Section 105(h), a self-insured medical reimbursement plan satisfies the requirements of this test only if the plan does not discriminate in favor of highly compensated individuals (“HCIs”) as to eligibility to participate; and if the benefits provided under the plan do not discriminate in favor of participants who are highly compensated individuals. Self-insured plans subject to Section 105(h) include: medical plans, dental plans, flex spending plans, and health reimbursement arrangements (HRAs).

Who is Highly Compensated?

A key question is whether or not a plan discriminates in favor of HCIs. Under IRC Section 105(h)(5), the term “highly compensated individual” means an individual who is:

- (A) One of the 5 highest paid officers,
- (B) A shareholder who owns more than 10 percent in value of the stock of the employer, or
- (C) Among the highest paid 25 percent of all employees (other than excluded employees who are not participants).

As noted, certain employees can be excluded from consideration. Under IRC Section 105(h)(3)(B), plans may exclude from consideration:

- (i) Employees who have not completed 3 years of service;
- (ii) Employees who have not attained age 25;
- (iii) Part-time or seasonal employees;
- (iv) Employees not included in the plan who are included in a unit of employees covered by an agreement between employee representatives and one or more employers which the Secretary finds to be a collective bargaining agreement, if accident and health benefits were the subject of good faith bargaining between such employee representatives and such employer or employers; and
- (v) Employees who are nonresident aliens and who receive no earned income.

What Tests does my Plan have to Pass?

Self-insured plans must pass tests for eligibility and benefits. The eligibility tests consist of the “70% Test”, the “80% Test” and the Classifications Test. A plan need pass only one of the three tests to establish that it does not discriminate in favor of HCIs. The 70% Test requires that the plan provides benefits to 70% or more of all employees. If plans fail this test, then you must check to see if the plan provides benefits to 80% or more of all the employees who are eligible to benefit under the plan. If the plan cannot pass the 70% Test or 80% Test, you must test to see if the plan is providing benefits based classifications set up by the employer and found by the Secretary not to be discriminatory in favor of highly compensated individuals.

If a plan passes non-discrimination testing for eligibility, it must then show that it does not discriminate in favor of HCIs with respect to benefits. Reg. Section 1.105-11(c)(3)(i) states that in general benefits subject to reimbursement under a plan must not discriminate in favor of HCIs. Plan benefits will not satisfy the non-discrimination requirement unless all benefits provided to HCIs are provided to all participants. In addition, all the benefits available for the dependents of employees who are HCIs must also be available on the same basis for the dependents of all other employees who are participants.

If a plan discriminates in favor of highly compensated individuals as to eligibility to participate, then the eligibility criteria would have to be adjusted accordingly. Similarly, if the benefits provided under the plan

discriminate in favor of participants who were HCIs, then these benefits would have to be made available to the non-HCI participants as well.

Employer plan contributions can be a source of testing failure. This is especially true if owners and executives are provided with coverage at no cost. The easiest remedy for this sort of failure is to impute the value of the normal employee plan contribution in gross wages.

What if I Fail Testing?

The consequence of not correcting a discriminatory plan can entail problems for plan sponsors, because IRC Section 105(h)(2) does not permit discriminatory plans. There may be potentially serious income ramifications for the HCI participants in the plan. Amounts paid to highly compensated individuals under a discriminatory self-insured medical expense reimbursement plan may constitute an “excess reimbursement” to a highly compensated individual that could be taxable in whole or in part.

How Often Should I Test?

While there is not an annual testing requirement under Section 105(h), testing should be done regularly and any time there is a change in demographics, coverage, or plan design. Once your plan passes Section 105(h) testing, you should keep a copy of your testing with your plan records.

Adam Jensen is the Director of Compliance Services for Cottingham & Butler Consulting Services, has worked in the insurance and employee benefits industry since 1986. Adam specializes in providing regulatory compliance and plan design services for health and welfare plans.