

Health Care Reform— Discrimination Testing



NEW RULES

2.1 TIMETABLE

This begins on the plan anniversary that falls on or after September 23, 2010.

2.2 EMPLOYERS AFFECTED

All employers (if plan sponsors) but special provisions apply for collectively bargained plans.

2.3 EMPLOYEES AFFECTED

Discrimination rules can negatively affect “highly compensated employees” who are among the top five highest paid officers, own 10% or more of the company, or are among the top 25% paid employees. (Other rules apply.)

2.4 FULLY INSURED PLANS

Self-funded plans have had non-discrimination rules that apply for many years, under IRC §105(h). The health care reform legislation added the same rules to fully insured plans.

New rules for fully insured health plans

Health Plan Discrimination Testing

The health care reform legislation added Section 2716 to the Patient Protection and Affordable Care Act. This new section generally imposed on fully insured health plans the same non-discrimination rules that apply to self-insured plans under IRC §105(h) and potentially §410(b). Unfortunately these rules as written are ill-suited to be applied to the way health insurance is sold today, and this is likely one of many areas in the health care reform where we will need to see that regulations are written by the federal government to explain how the rules should be used in the current environment (where employers often offer multiple plans and small employers have age-based plans).

Intent

The federal government over the years has been concerned that employers would favor what they call “highly compensated employees” when providing health plans. Over twenty years ago the attempt was made by Congress to impose a series of complicated discrimination tests under a new section to the Internal Revenue Code, Section 89. Due to public outcry, Section 89 was repealed. Now with the new health care reform legislation the issue is back as employers or other plan sponsors will need to run tests to ensure that the plans do not discriminate in favor of those deemed highly compensated.

In general, a “highly compensated employee” (HCE) is one who meets any of the following criteria:

- a) is one of the five highest paid officers in the company;
- b) is a 10% or more owner of the employer (including §318 family attribution rules), OR
- c) was among the highest paid 25% of all employees (not including certain excluded employees who are not participants under the plan)

(The above list is a summary only and, while sufficient in most cases, is not complete. Note: §105(h) has its own definition of Highly Compensated Employee and does not use the §414(q) language.)

Key Points

The accompanying language illustrates the complexity of the testing. The net result is that if the employer contributes the same percentage for the HCEs as it does for other employees, and they have the same plan options as the other employees, the plan will likely be deemed to pass. *If the HCEs are S Corp 2% owners, partners, sole proprietors or LLC members, the issue will not affect them since the premiums are deemed taxable compensation to them.*

For other HCEs, the business could provide the same level of benefit and contribution to them, but it could then pay the HCE more money (i.e., “gross up) so that the person could

then use a salary reduction through a cafeteria plan to achieve the same results. (This option will not work if the owner has taken out all of the money so that there is no money left with which to gross up the owner. One important point is to make sure that the non-HCEs have access to the same plans as the HCEs at the same employer contribution. Another point to remember is that the discrimination tests only relate to discrimination in favor of HCEs: it appears generally all right to discriminate in favor of one non-HCEs over another (such as one employee who has worked for ten years versus one who has worked six months). Of course discrimination cannot be due to factors such as race, creed, national origin, etc.)

The actual language of the health care reform bill on prohibited discrimination reads as follows:

“SEC. 2716. PROHIBITION ON DISCRIMINATION IN FAVOR OF HIGHLY COMPENSATED INDIVIDUALS.

“(a) IN GENERAL.—A group health plan (other than a self-insured plan) shall satisfy the requirements of section 105(h)(2) of the Internal Revenue Code of 1986 (relating to prohibition on discrimination in favor of highly compensated individuals).

“(b) RULES AND DEFINITIONS.—For purposes of this section—

“(1) CERTAIN RULES TO APPLY.—Rules similar to the rules contained in paragraphs (3), (4), and (8) of section 105(h) of such Code shall apply.

“(2) HIGHLY COMPENSATED INDIVIDUAL.—The term ‘highly compensated individual’ has the meaning given such term by section 105(h)(5) of such Code.”

(e) Section 2717 of the Public Health Service Act, as added by section 1001(5) of this Act, is amended—

(1) by redesignating subsections (c) and (d) as subsections (d) and (e), respectively; and

(2) by inserting after subsection (b), the following:

“(c) PROTECTION OF SECOND AMENDMENT GUN RIGHTS.—

“(1) WELLNESS AND PREVENTION PROGRAMS.—A wellness and health promotion activity implemented under subsection (a)(1)(D) may not require the disclosure or collection of any information relating to—

“(A) the presence or storage of a lawfully-possessed firearm or ammunition in the residence or on the property of an individual; or

“(B) the lawful use, possession, or storage of a firearm or ammunition by an individual.

“(2) LIMITATION ON DATA COLLECTION.—None of the authorities provided to the Secretary under the Patient Protection and Affordable Care Act or an amendment made by that Act shall be construed to authorize or may be used for the collection of any information relating to—

“(A) the lawful ownership or possession of a firearm or ammunition;

“(B) the lawful use of a firearm or ammunition; or

“(C) the lawful storage of a firearm or ammunition.

“(3) LIMITATION ON DATABASES OR DATA BANKS.—None of the authorities provided to the Secretary under the Patient Protection and Affordable Care Act or an amendment made by that Act shall be construed to authorize or may be used to maintain records of individual ownership or possession of a firearm or ammunition.

“(4) LIMITATION ON DETERMINATION OF PREMIUM RATES OR

ELIGIBILITY FOR HEALTH INSURANCE.—A premium rate may not be increased, health insurance coverage may not be denied, and a discount, rebate, or reward offered for participation in a wellness program may not be reduced or withheld under any health benefit plan issued pursuant to or in accordance with the Patient Protection and Affordable Care Act or an amendment made by that Act on the basis of, or on reliance

upon—

“(A) the lawful ownership or possession of a firearm or ammunition; or

“(B) the lawful use or storage of a firearm or ammunition.

“(5) LIMITATION ON DATA COLLECTION REQUIREMENTS FOR

INDIVIDUALS.—No individual shall be required to disclose any information under any data collection activity authorized under the Patient Protection and Affordable Care Act or an amendment made by that Act relating to—

“(A) the lawful ownership or possession of a firearm or ammunition; or

(B) the lawful use, possession, or storage of a firearm or ammunition.”

The IRC §105(h) non-discrimination language is as follows:

§ 105. Amounts received under accident and health plans

[Current as of January 5, 2009]

(a) Amounts attributable to employer contributions

Except as otherwise provided in this section, amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts

- (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or
- (2) are paid by the employer.

(b) Amounts expended for medical care

Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include amounts referred to in subsection (a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by him for the medical care (as defined in section 213(d)) of the taxpayer, his spouse, and his dependents (as defined in section 152, determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B) thereof). Any child to whom section 152 (e) applies shall be treated as a dependent of both parents for purposes of this subsection.

(c) Payments unrelated to absence from work

Gross income does not include amounts referred to in subsection (a) to the extent such amounts—

- (1) constitute payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement, of the taxpayer, his spouse, or a dependent (as defined in section 152, determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B) thereof), and
- (2) are computed with reference to the nature of the injury without regard to the period the employee is absent from work.

[(d) Repealed. Pub. L. 98–21, title I, § 122(b), Apr. 20, 1983, 97 Stat. 87]

(e) Accident and health plans

For purposes of this section and section 104—

- (1) amounts received under an accident or health plan for employees, and
- (2) amounts received from a sickness and disability fund for employees maintained under the law of a State or the District of Columbia, shall be treated as amounts received through accident or health insurance.

(f) Rules for application of section 213

For purposes of section 213 (a) (relating to medical, dental, etc., expenses) amounts excluded from gross income under subsection (c) or (d) shall not be considered as compensation (by insurance or otherwise) for expenses paid for medical care.

(g) Self-employed individual not considered an employee

For purposes of this section, the term “employee” does not include an individual who is an employee within the meaning of section 401 (c)(1) (relating to self-employed individuals).

(h) Amount paid to highly compensated individuals under a discriminatory self-insured medical expense reimbursement plan

(1) In general

In the case of amounts paid to a highly compensated individual under a self-insured medical reimbursement plan which does not satisfy the requirements of paragraph (2) for a plan year, subsection (b) shall not apply to such amounts to the extent they constitute an excess reimbursement of such highly compensated individual.

(2) Prohibition of discrimination

A self-insured medical reimbursement plan satisfies the requirements of this paragraph only if—

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

(3) Nondiscriminatory eligibility classifications

(A) In general

A self-insured medical reimbursement plan does not satisfy the requirements of subparagraph (A) of paragraph (2) unless such plan benefits—

- (i) 70 percent or more of all employees, or 80 percent or more of all the employees who are eligible to benefit under the plan if 70 percent or more of all employees are eligible to benefit under the plan; or
- (ii) such employees as qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of highly compensated individuals.

(B) Exclusion of certain employees

For purposes of subparagraph (A), there may be excluded 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 (within the meaning of section 911 (d)(2)) from the employer which constitutes income from sources within the United States (within the meaning of section 861 (a)(3)).

(4) Nondiscriminatory benefits

A self-insured medical reimbursement plan does not meet the requirements of subparagraph (B) of paragraph (2) unless all benefits provided for participants who are highly compensated individuals are provided for all other participants.

(5) Highly compensated individual defined

For purposes of this subsection, the term “highly compensated individual” means an individual who is—

(A) one of the 5 highest paid officers,

(B) a shareholder who owns (with the application of section 318) 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 employees described in paragraph (3)(B) who are not participants).

(6) Self-insured medical reimbursement plan

The term “self-insured medical reimbursement plan” means a plan of an employer to reimburse employees for expenses referred to in subsection (b) for which reimbursement is not provided under a policy of accident and health insurance.

(7) Excess reimbursement of highly compensated individual

For purposes of this section, the excess reimbursement of a highly compensated individual which is attributable to a self-insured medical reimbursement plan is—

(A) in the case of a benefit available to highly compensated individuals but not to all other participants (or which otherwise fails to satisfy the requirements of paragraph (2)(B)), the amount reimbursed under the plan to the employee with respect to such benefit, and

(B) in the case of benefits (other than benefits described in subparagraph (A) paid to a highly compensated individual by a plan which fails to satisfy the requirements of paragraph (2), the total amount reimbursed to the highly compensated individual for the plan year multiplied by a fraction—

(i) the numerator of which is the total amount reimbursed to all participants who are highly compensated individuals under the plan for the plan year, and

(ii) the denominator of which is the total amount reimbursed to all employees under the plan for such plan year.

In determining the fraction under subparagraph (B), there shall not be taken into account any reimbursement which is attributable to a benefit described in subparagraph (A).

(8) Certain controlled groups, etc.

All employees who are treated as employed by a single employer under subsection (b), (c), or (m) of section 414 shall be treated as employed by a single employer for purposes of this section.

(9) Regulations

The Secretary shall prescribe such regulations as may be necessary to carry out the provisions of this section.

(10) Time of inclusion

Any amount paid for a plan year that is included in income by reason of this subsection shall be treated as received or accrued in the taxable year of the participant in which the plan year ends.

(i) Sick pay under Railroad Unemployment Insurance Act

Notwithstanding any other provision of law, gross income includes benefits paid under section 2(a) of the Railroad Unemployment Insurance Act for days of sickness; except to the extent such sickness (as determined in accordance with standards prescribed by the Railroad Retirement Board) is the result of on-the-job injury.

(j) Special rule for certain governmental plans

(1) In general

For purposes of subsection (b), amounts paid (directly or indirectly) to the taxpayer from an accident or health plan described in paragraph (2) shall not fail to be excluded from gross income solely because such plan, on or before January 1, 2008, provides for reimbursements of health care expenses of a deceased plan participant’s beneficiary.

(2) Plan described

An accident or health plan is described in this paragraph if such plan is funded by a medical trust that is established in connection with a public retirement system and that—

(A) has been authorized by a State legislature, or

(B) has received a favorable ruling from the Internal Revenue Service that the trust’s income is not includible in gross income under section 115.

The additional rules under §410(b) are as follows:

§ 410(b)

(b) Minimum coverage requirements

(1) In general

A trust shall not constitute a qualified trust under section 401 (a) unless such trust is designated by the employer as part of a plan which meets 1 of the following requirements:

(A) The plan benefits at least 70 percent of employees who are not highly compensated employees.

(B) The plan benefits—

(i) a percentage of employees who are not highly compensated employees which is at least 70 percent of

(ii) the percentage of highly compensated employees benefiting under the plan.

(C) The plan meets the requirements of paragraph (2).

(2) Average benefit percentage test

(A) In general

A plan shall be treated as meeting the requirements of this paragraph if—

(i) the plan benefits such employees as qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of highly compensated employees, and

(ii) the average benefit percentage for employees who are not highly compensated employees is at least 70 percent of the average benefit percentage for highly compensated employees.

(B) Average benefit percentage

For purposes of this paragraph, the term “average benefit percentage” means, with respect to any group, the average of the benefit percentages calculated separately with respect to each employee in such group (whether or not a participant in any plan).

§ 1.410(b)-5 Average benefit percentage test.

(a) *General rule.* A plan satisfies the average benefit percentage test of this section for a plan year if and only if the average benefit percentage of the plan for the plan year is at least 70 percent. A plan is deemed to satisfy this requirement if it satisfies paragraph (f) of this section for the plan year.

(b) *Determination of average benefit percentage.* The average benefit percentage of a plan for a plan year is the percentage determined by dividing the actual benefit percentage of the nonhighly compensated employees in plans in the testing group for the testing period that includes the plan year by the actual benefit percentage of the highly compensated employees in plans in the testing group for that testing period. See paragraph (d)(3)(ii) of this section for the definition of testing period.

(c) *Determination of actual benefit percentage.* The actual benefit percentage of a group of employees for a testing period is the average of the employee benefit percentages, calculated separately with respect to each of the employees in the group for the testing period. All nonexcludable employees of the employer are taken into account for this purpose, even if they are not benefiting under any plan that is taken into account.

(d) *Determination of employee benefit percentages—(1) Overview.* This paragraph (d) provides rules for determining employee benefit percentages. See paragraph (e) of this section for alternative methods for determining employee benefit percentages.

(2) *Employee contributions and employee-provided benefits disregarded.* Only employer-provided contributions and benefits are taken into account in determining employee benefit percentages. Therefore, employee contributions (including both employee contributions allocated to separate accounts and employee contributions not allocated to separate accounts), and benefits derived from such contributions, are not taken into account in determining employee benefit percentages.

(3) *Plans and plan years taken into account—(i) Testing group.* All plans included in the testing group under §1.410(b)-7(e) (1), and only those plans, are taken into account in determining an employee's employee benefit percentage.

(ii) Testing period. An employee's employee benefit percentage is determined on the basis of plan years ending with or within the same calendar year. These plan years are referred to in this section as the relevant plan years or, in the aggregate, as the testing period.

(4) *Contributions or benefits basis.* Employee benefit percentages may be determined on either a contributions or a benefits basis. Employee benefit percentages for any testing period must be determined on the same basis (contributions or benefits) for all plans in the testing group.

(5) *Determination of employee benefit percentage—(i) General rule.* The employee benefit percentage for an employee for a testing period is the rate that would be determined for that employee for purposes of applying the general test for nondiscrimination in §§1.401(a)(4)–2, 1.401(a)(4)–3, 1.401(a)(4)–8 or 1.401(a)(4)–9, if all the plans in the testing group were aggregated for purposes of section 410(b). Thus, if employee benefit percentages are determined on a contributions basis, each employee's employee benefit percentage is the aggregate normal allocation rate that would be determined for the employee under §1.401(a)(4)–9(b)(2)(ii)(A) (if the plans in the testing group include both defined benefit and defined contribution plans), the allocation rate that would be determined for the employee under §1.401(a)(4)–2(c)(2) (if the plans in the testing group include only defined contribution plans), or the equivalent normal allocation rate that would be determined for the employee under §1.401(a)(4)–8(c)(2) (if the plans in the testing group include only defined benefit plans). Similarly, if employee benefit percentages are determined on a benefits basis, each employee's employee benefit percentage is the aggregate normal accrual rate that would be determined for the employee under §1.401(a)(4)–9(b)(2)(ii)(B), the normal accrual rate that would be determined for the employee under §1.401(a)(4)–3(d), or the equivalent accrual rate that would be determined for the employee under §1.401(a)(4)–8(b)(2), depending on whether the plans in the testing group include both defined benefit and defined contribution plans, only defined benefit plans, or only defined contribution plans.

(ii) *Plans with differing plan years.* If not all the plans in the testing group share the same plan year, §1.410(b)–7(d)(5) would ordinarily prohibit them from being aggregated for purposes of section 410(b). In such a case, employee benefit percentages are determined by applying the rules of paragraph (d)(5)(i) of this section separately to each subset of plans in the testing group that share the same plan year (or the same accrual computation period) and aggregating the results for all plans in the testing group. Thus, an employee's employee benefit percentage is determined as the sum of these separate employee benefit percentages that are determined consistently for all the plans in the testing group (except for differences attributable solely to the differences in plan years).

(iii) *Options and consistency requirements.* In determining employee benefit percentages under this paragraph (d)(5), any optional or alternative methods or rules available for determining rates in §§1.401(a)(4)–2, 1.401(a)(4)–3, 1.401(a)(4)–8, or 1.401(a)(4)–9, whichever is applicable, may be applied. Thus, for example, employee benefit percentages may generally be calculated using any of the alternative methods of determining average annual compensation or plan year compensation under §1.401(a)(4)–12, and using any underlying definition of compensation that satisfies section 414(s). Except as otherwise specifically permitted, the determination of employee benefit percentages must be made on a consistent basis for all employees and for all plans in the testing group as required by §§1.401(a)(4)–2(c)(2)(vi), 1.401(a)(4)–3(d)(2)(i), 1.401(a)(4)–8(b)(2)(iv), 1.401(a)(4)–8(c)(2)(iv) or 1.401(a)(4)–9(b)(2)(iv).

(6) *Permitted disparity—(i) In general.* Permitted disparity may be imputed in determining employee benefit percentages as provided in §§1.401(a)(4)–2, 1.401(a)(4)–3, 1.401(a)(4)–8, or 1.401(a)(4)–9, whichever is applicable. When separate employee benefit percentages are determined for individual plans under paragraph (e)(2) of this section (or for subsets of plans that have the same plan year as described in paragraph (d)(5)(ii) of this section), permitted disparity may be imputed for an employee only in one individual plan (or subset of plans) and may not be imputed for the same employee in another individual plan (or subset of plans). However, if the same average annual compensation or plan year compensation is used to determine employee benefit percentages in more than one plan, the employee's employee benefit percentages for those plans may be summed prior to imputing permitted disparity.

(ii) *Plans which may not use permitted disparity.* Permitted disparity may be reflected in the determination of rates only to the extent that the plans for which rates are being determined are plans for which the permitted disparity of section 401(l) is available. Thus, for example, if a section 401(k) plan is included in the testing group and permitted disparity is imputed under §1.401(a)(4)–2(c)(iv), then employee benefit percentages are determined by first calculating an adjusted allocation rate (within the meaning of §1.401(a)(4)–7(b)(1)) without regard to the amount of allocations under the section 401(k) plan and adding to it the allocation rate for the section 401(k) plan. See §1.401(l)–1(a)(4) for a list of types of plans for which permitted disparity is not available.

(7) *Requirements for certain plans providing early retirement benefits—(i) General rule.* If any defined benefit plan in the testing group provides for early retirement benefits in addition to normal retirement benefits to any highly compensated employee, and the average actuarial reduction for any one of these benefits commencing in the five years prior to the plan's normal retirement age is less than four percent per year, then the aggregate most valuable allocation rate, equivalent most valuable allocation rate, aggregate most valuable accrual rate, or most valuable accrual rate must be substituted for the related normal rates in paragraph (d)(5) of this section.

(ii) *Exception.* Paragraph (d)(7)(i) of this section does not apply if early retirement benefits with average actuarial reductions described in that paragraph are currently available, within the meaning of §1.401(a)(4)–4(b), under plans in the testing group

to a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees to whom these benefits are currently available.

(e) *Additional optional rules*—(1) *Overview*. This paragraph (e) contains various alternative methods for determining employee benefit percentages for a testing period.

(2) *Determination of employee benefit percentages as the sum of separately determined rates*—(i) *In general*. Employee benefit percentages may be determined as the sum of separately determined employee benefit percentages for each of the plans in the testing group that are aggregated under paragraphs (d)(5) (i) or (ii) of this section, provided that these employee benefit percentages are determined on a consistent basis for all of these plans pursuant to paragraph (d)(5)(iii) of this section.

(ii) *Exception from consistency requirement*. The consistency requirement of paragraph (e)(2)(i) of this section is not violated merely because employee benefit percentages are not determined in a consistent manner for all of the plans in the testing group and the inconsistencies in determination of rates among plans are described in paragraph (e)(2)(iii) of this section. The exception in this paragraph (e)(2)(ii) applies only if it is reasonable to believe that the inconsistencies do not result in an average benefit percentage that is significantly higher than the average benefit percentage that would be determined had employee benefit percentages been determined on a consistent basis pursuant to paragraph (d)(5)(iii) of this section.

(iii) *Permitted inconsistencies*. The following inconsistencies between plans are permitted under this paragraph (e)(2)—

(A) Use of different underlying definitions of section 414(s) compensation in the determination of rates;

(B) Use of different definitions of average annual compensation;

(C) Use of different testing ages;

(D) Use of different fresh-start dates;

(E) Use of different actuarial assumptions for normalization; or

(F) Disregard of actuarial increases after normal retirement age and QPSA charges without regard to any requirement for uniformity in the actuarial increases or QPSA charges.

(3) *Determination of employee benefit percentages without regard to plans of another type*—(i) *General rule*. Employee benefit percentages may be determined under plans of one type (i.e., defined benefit plans or defined contribution plans) by treating all plans of the other type (i.e., defined contribution plans or defined benefit plans, respectively) as if they were not part of the testing group, using the method provided in this paragraph (e)(3). If this method is used to determine whether a defined contribution plan satisfies the average benefit percentage test, employee benefit percentages under all defined contribution plans in the testing group must be determined on a contributions basis, and benefits under any defined benefit plans may not be included in the employee benefit percentage. Similarly, if this method is used to determine whether a defined benefit plan satisfies the average benefit percentage test, employee benefit percentages under all defined benefit plans in the testing group must be determined on a benefits basis, and allocations under any defined contribution plans may not be included in the employee benefit percentage.

(ii) *Restriction on use of separate testing group determination method*. A plan does not satisfy the average benefit percentage test using the method provided in this paragraph (e)(3) unless each of the plans in the testing group of the other type (i.e., defined benefit plan or defined contribution plan) than the plan being tested satisfies the average benefit test of §1.410(b)–2(b)(3) using the method in this paragraph (e)(3) or satisfies the ratio percentage test of §1.410(b)–2(b)(2).

(iii) *Treatment of permitted disparity*. Although under the general rule of this paragraph (e)(3) plans of another type are disregarded in determining employee benefit percentages, the permitted disparity used by those plans (including any permitted disparity that is used by those plans to satisfy §1.401(a)(4)–1(b)(2)) is nonetheless taken into account in determining the extent to which permitted disparity may be used in determining employee benefit percentages.

(iv) *Example*. The following example illustrates the rules of this paragraph (e)(3):

Example. Employer A maintains two defined benefit plans, neither of which covers a group of employees that satisfies the ratio percentage test of §1.410(b)–2(b)(2), and a profit-sharing plan and a section 401(k) plan, each of which benefits a group of employees that satisfies the ratio percentage test of §1.410(b)–2(b)(2). The defined benefit plans will satisfy the average

benefit percentage test if the actual benefit percentage of all nonexcludable nonhighly compensated employees, computed on a benefits basis without regard to contributions under the profit-sharing plan or the section 401(k) plan, is at least 70 percent of the actual benefit percentage of all nonexcludable highly compensated employees, computed on a benefits basis without regard to contributions under the profit-sharing plan or the section 401(k) plan.

(4) *Simplified method for determining employee benefit percentages for certain defined benefit plans*—(i) *In general.* An employee's employee benefit percentage with respect to a plan may be determined under the simplified method of paragraph (e)(4)(ii) of this section, provided the following conditions are satisfied:

(A) The only plans included in the testing group are defined benefit plans, and employee benefit percentages under these plans are determined on a benefits basis.

(B) Employee benefit percentages under the plans in the testing group are not required to be determined by taking into account early retirement benefits under paragraph (d)(7) of this section.

(C) The plan is a safe harbor defined benefit plan described in §1.401(a)(4)–3(b).

(ii) *Simplified method*—(A) *Section 401(l) plans.* Under the simplified method of this paragraph (e)(4)(ii), an employee's employee benefit percentage with respect to a section 401(l) plan described in §1.401(a)(4)–3(b)(3) (i.e., a unit credit plan) may be deemed equal to the employee's excess benefit percentage or gross benefit percentage (as defined in §1.401(l)–1(c)(14) or (18), respectively), whichever is applicable under the plan's benefit formula in the plan year. In the case of a section 401(l) plan described in §1.401(a)(4)–3(b)(4) (i.e., a fractional accrual plan), an employee's employee benefit percentage with respect to that plan may be deemed equal to the rate at which the excess or gross benefit, whichever is applicable, accrues for the employee in the plan year, taking into account the plan's benefit formula and the employee's projected service at normal retirement age. The use of this simplified method will be treated as an imputation of permitted disparity. See paragraph (d)(6) of this section for a restriction on multiple use of permitted disparity.

(B) *Other plans.* Under the simplified method of this paragraph (e)(4)(ii), an employee's employee benefit percentage with respect to a plan described in §1.401(a)(4)–3(b)(3) that is not a section 401(l) plan and that is not imputing permitted disparity may be deemed equal to the employee's benefit rate in the plan year under the plan's benefit formula. In the case of a plan described in §1.401(a)(4)–3(b)(4) that is not a section 401(l) plan and that is not imputing permitted disparity, an employee's employee benefit percentage with respect to that plan may be deemed equal to the rate at which the benefit accrues for the employee in the plan year, taking into account the plan's benefit formula and an employee's projected service at normal retirement age.

(5) *Three-year averaging period.* An employee's employee benefit percentage may be determined for a testing period as the average of the employee's employee benefit percentages determined separately for the testing period and for the immediately preceding one or two testing periods (referred to in this section as an averaging period). Employee benefit percentages of a particular employee that are averaged together within an averaging period must be determined on a consistent basis for all testing periods within the averaging period.

(6) *Alternative methods of determining compensation.* Employee benefit percentages may be determined on the basis of any definition of compensation that satisfies §1.414(s)–1(d) (without regard to whether the definition satisfies §1.414(s)–1(d)(3)), provided that the same definition is used for all employees and it is reasonable to believe that the definition does not result in an average benefit percentage that is significantly higher than the average benefit percentage that would be determined had employee benefit percentages been determined using a definition of compensation that also satisfies §1.414(s)–1(d)(3).

(f) *Special rule for certain collectively bargained plans.* A plan (as determined without regard to the mandatory disaggregation rule of §1.410(b)–7(c)(5)) that benefits both collectively bargained employees and noncollectively bargained employees is deemed to satisfy the average benefit percentage test of this section if—

(1) The provisions of the plan applicable to each employee in the plan are identical to the provisions of the plan applicable to every other employee in the plan, including the plan benefit or allocation formula, any optional forms of benefit, any ancillary benefit, and any other right or feature under the plan, and

(2) The plan would satisfy the ratio percentage test of §1.410(b)–2(b)(2), if §§1.410(b)–6(d) and 1.410(b)–7(c)(5) (the excludable employee and mandatory disaggregation rules for collectively bargained and noncollectively bargained employees) did not apply.

[T.D. 8363, 56 FR 47646, Sept. 19, 1991; 57 FR 10817, 10954, Mar. 31, 1992, as amended by T.D. 8487, 58 FR 46840, Sept. 3, 1993]

A 1997 letter from the IRS helps give the IRS view on how they look at the discrimination testing (in this case for a 501(c)(9) trust, which uses the same rules). That letter, with redactions, is reproduced on the following pages.

Following that letter is the text for §125 of the Internal Revenue Code, which includes the discrimination language for health plans. Such discrimination tests will likely have to be run in addition to the §105(h) tests.

NO PROTEST RECEIVED
Release Notes to District
Date 10/6/97
Signed [redacted]

[redacted]
[redacted]
[redacted]

[redacted]
[redacted]

CP:E:EO:R

JUL 31 1997

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax as an organization described in section 501(c)(9) of the Internal Revenue Code.

You were created [redacted] to provide self-funded medical benefits to employees of [redacted]. Full-time employees with [redacted] service are eligible to participate. Benefits are funded by employee and employer contributions, and the required contributions vary by job classification and type of coverage selected. For self-only coverage, professionals [redacted] contribute [redacted] % of the premium cost, or \$ [redacted]. Nonprofessionals contribute [redacted] % of the premium cost, or \$ [redacted]. For family coverage, professionals pay [redacted] % of the premium cost, or \$ [redacted]. Nonprofessionals selecting family coverage pay the entire premium cost in excess of the employer's contribution for self-only coverage, or \$ [redacted]. Thus, some employees receive a partial premium waiver benefit that is not available to all other employees.

You have provided the following data with respect to compensation and plan participation (as of [redacted])

	Eligible Employees	Number Participating	Compensation	
			Low	High
Professionals	[redacted]	[redacted]	\$ [redacted]	\$ [redacted]
Non-professionals	[redacted]	[redacted]	\$ [redacted]	\$ [redacted]

[redacted] other employees are excluded from participation because they are part-time employees. There are [redacted] persons employed by the plan sponsor.

Section 501(c)(9) of the Internal Revenue Code describes voluntary employees' beneficiary associations providing for the payment of life, sick,

[REDACTED]

accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

Section 505(a)(1) of the Code provides, in relevant part, that an organization described in section 501(c)(9) will not be exempt unless it meets the requirements of section 505(b).

Section 505(b)(3) of the Code provides that in the case of any benefit for which some other Code section provides nondiscrimination rules, section 505(b) will be satisfied only if the nondiscrimination rules so provided are satisfied with respect to such benefit.

Section 105(h) of the Code and the regulations thereunder provide nondiscrimination rules for self-funded medical benefits.

Section 105(h)(2) of the Code provides that a self-insured medical plan satisfies the requirements of section 105(h) only if (A) it does not discriminate in favor of highly compensated individuals as to eligibility to participate; and (B) the benefits of the plan do not discriminate in favor of participants who are highly compensated individuals.

Section 105(h)(4) of the Code provides that a self-insured medical plan does not meet the requirements of section 105(h)(2)(B) unless all benefits provided for participants who are highly compensated individuals are provided for all other participants.

Section 105(h)(5) defines the term "highly compensated individual" to mean an individual who is one of the 5 highest paid officers, a shareholder who owns more than 10% of the employer, or among the highest paid 25% of all employees (other than employees described in section 105(h)(3)(B) who are not participants).

Section 1.105-11(c)(3)(i) of the Income Tax Regulations provides that benefits must not discriminate in favor of highly compensated individuals. Plan benefits will not satisfy the requirements of this subparagraph unless all the benefits provided for participants who are highly compensated individuals are provided for all other participants.

[REDACTED]

Nondiscriminatory Benefits Test

Treated as a single plan, your plan does not meet the requirement of section 105(h)(2)(B) of the Code and section 1.105-11(c)(3)(i) of the regulations because the highly compensated professional employees who are participating in the plan receive a partial premium waiver that is not available to the [REDACTED] nonprofessional employees who are participating in the plan. However, if your plan is treated as two separate plans, one for professional employees and one for nonprofessional employees, the employer and employee contribution would be the same for the participants of each individual plan. Accordingly, each plan could meet the nondiscriminatory benefits requirements if tested separately.

Nondiscriminatory Classification Tests

a. Percentage Tests

Section 105(h)(3)(A) of the Code provides that a self-insured medical plan meets the requirements of section 105(h)(2)(A) if it benefits 70% or more of all employees (the 70% test), or 80% or more of all the employees who are eligible to benefit if 70% or more of all employees are eligible to benefit (the 70/80% test); or benefits such employees as a qualify under a classification set up by the employer and found not to be discriminatory in favor of highly compensated individuals (the classification test). One of these three tests must be satisfied, or the plan will be considered discriminatory as to eligibility for participation.

Section 105(h)(3)(B) permits certain categories of employees to be excluded from consideration. These are, in relevant part, employees who have not completed 3 years of service, employees who have not attained age 25, and part-time or seasonal employees.

Since we have already established that this plan, if treated as a single plan, provides discriminatory benefits, it is unnecessary to test as a single plan with respect to eligibility. Therefore, we will treat it as two separate plans for purposes of determining whether it is discriminatory with respect to its eligibility requirements.

If the plan is considered to be two separate plans, one for professionals and one for nonprofessionals, each plan must meet the eligibility requirements of section 105(h)(3)(A)(i). The largest number of employees participating under either plan is [REDACTED]. Accordingly, each plan fails the 70% test under section 105(h)(3)(A)(i). Of the [REDACTED] excludable employees, [REDACTED] are eligible to participate in the plan for

professionals. Thus, less than 70% of nonexcludable employees are eligible to participate and the plan for professionals could not meet the 70% part of the 70/80% test.

Because nonprofessional employees are eligible to participate in the plan for nonprofessionals, the plan meets the 70% part of the 70/80% test. However, 80% of the eligible employees (employees) would have to participate in order to qualify under the 80% part of the test, and only nonprofessional employees actually participated. Accordingly, if tested separately, neither plan could satisfy the percentage tests of section 105(h)(3)(A)(i) of the Code.

b. Alternative Classification Test

Therefore, if the plan is considered to be two separate plans, in order to satisfy the section 105(h) eligibility test, each plan must satisfy the classification test of section 105(h)(3)(A)(ii) of the Code. Section 1.105-11(c)(2)(ii) of the regulations provides that the existence of discrimination inherent in a plan's participation requirements may be judged on a facts-and-circumstances basis, using the same standards as are applied under Code section 410(b)(1)(B). Each plan could satisfy the eligibility requirements if it could meet either the current or prior law nondiscriminatory classification requirements of section 410(b).

As amended by the Tax Reform Act of 1986 (P.L. 99-514), section 410(b)(1) of the Code provides that a trust shall not be considered a qualified trust under section 401(a) unless it is designated by the employer as part of a plan which satisfies at least one of three requirements. These requirements are set forth in subparagraphs (A), (B), and (C) of section 410(b)(1). One of these requirements is the "average benefits test" described in section 410(b)(2). The latter is a two-fold test. One aspect of the test, described in paragraph (A)(i), requires that the plan benefit such employees as qualify under a classification that is not discriminatory in favor of highly-compensated employees.

Section 1.410(b)-4 of the regulations (entitled *Nondiscriminatory classification test*) provides rules for satisfying the requirements of Code section 410(b)(2)(A)(1). Any such classification must be both reasonable and nondiscriminatory. A classification, to be reasonable, must be established under "objective" and "bona fide" business criteria. Your classification appears to be objective. Under some circumstances, a classification between professionals and non-professionals might constitute a bona fide business criterion. On the other hand, the nature of your wage structure causes this classification to be, in effect, a

[REDACTED]

classification based on compensation. We therefore find that this classification is not "reasonable" within the meaning of section 1.410(b)-4(b) of the regulations.

Because a classification must be both reasonable *and* nondiscriminatory, your failure to satisfy the "reasonableness" standard makes it unnecessary to consider in detail whether the plan is also discriminatory. Furthermore, you have not provided sufficient information regarding the composition of the employer's work force to enable us to make this calculation with certainty. However, even using assumptions most favorable to the employer, the plan for professional employees is discriminatory under the standards of Code section 410(b)(2)(A)(i) and section 1.410(b)-4(c) of the regulations.

As noted above, we will also test your plan under the "old" requirements of Code section 410(b)(1)(B) as it existed prior to the enactment of the Tax Reform Act of 1986. These "old" nondiscrimination standards are set forth in section 1.410(b)-1(d)(2) of the regulations. A classification will satisfy these standards only if it is nondiscriminatory both on its face and in actual operation. Furthermore, a satisfactory classification will provide coverage to employees in all compensation ranges, with the lower and middle ranges being covered in more than nominal numbers.

In view of the fact that your classification is, in effect, a classification based on compensation, it does not cover employees in all compensation ranges. Accordingly, your classification does not satisfy the requirements of section 410(b)(1)(B) of the Code as it existed prior to the Tax Reform Act of 1986 (and as modified by section 105(h)).

Whether tested as a single plan, or as two separate plans, your plan does not meet any of the relevant nondiscrimination standards. Therefore, you do not meet the nondiscrimination requirements of section 505(b) of the Code and you are not exempt from federal income tax as an organization described in section 501(c)(9) of the Code.

You have the right to protest our ruling if you believe that it is incorrect. To protest, you should submit a statement of your views, with a full explanation of your reasoning. This statement must be submitted within 30 days of the date of this letter and must be signed by one of your officers. You also have a right to a conference in this office after your statement is submitted. If you want a conference, you must request it when you file your protest statement. If you are to be represented by someone who is not one of your officers, he/she must file a

[REDACTED]
proper power of attorney and otherwise qualify under our Conference and Practice Requirements.

If we do not hear from you within 30 days, this ruling will become final and copies will be forwarded to your key District Director. Thereafter, if you have any questions about your federal income tax status, including questions concerning reporting requirements, please contact your key District Director.

You will expedite our receipt of your reply by using the following address:

Internal Revenue Service
CP:E:EO:T:4, Room 6236
1111 Constitution Ave., NW
Washington, DC 20224

Sincerely,

Gerald V. Sack
Chief, Exempt Organizations
Technical Branch 4

cc:

[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

Code	CP:E:EO:T:4	CP:E:EO:R			
Surname	[REDACTED]	[REDACTED]			
Date	[REDACTED]	[REDACTED]			

“§ 125. Cafeteria plans

(a) General rule

Except as provided in subsection (b), no amount shall be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan.

(b) Exception for highly compensated participants and key employees

(1) Highly compensated participants

In the case of a highly compensated participant, subsection (a) shall not apply to any benefit attributable to a plan year for which the plan discriminates in favor of—

- (A)** highly compensated individuals as to eligibility to participate, or
- (B)** highly compensated participants as to contributions and benefits.

(2) Key employees

In the case of a key employee (within the meaning of section [416 \(i\)\(1\)](#)), subsection (a) shall not apply to any benefit attributable to a plan for which the statutory nontaxable benefits provided to key employees exceed 25 percent of the aggregate of such benefits provided for all employees under the plan. For purposes of the preceding sentence, statutory nontaxable benefits shall be determined without regard to the second sentence of subsection (f).

(3) Year of inclusion

For purposes of determining the taxable year of inclusion, any benefit described in paragraph (1) or (2) shall be treated as received or accrued in the taxable year of the participant or key employee in which the plan year ends.

(c) Discrimination as to benefits or contributions

For purposes of subparagraph (B) of subsection (b)(1), a cafeteria plan does not discriminate where qualified benefits and total benefits (or employer contributions allocable to qualified benefits and employer contributions for total benefits) do not discriminate in favor of highly compensated participants.

(d) Cafeteria plan defined

For purposes of this section—

(1) In general

The term “cafeteria plan” means a written plan under which—

- (A)** all participants are employees, and
- (B)** the participants may choose among 2 or more benefits consisting of cash and qualified benefits.

(2) Deferred compensation plans excluded

(A) In general

The term “cafeteria plan” does not include any plan which provides for deferred compensation.

(B) Exception for cash and deferred arrangements

Subparagraph (A) shall not apply to a profit-sharing or stock bonus plan or rural cooperative plan (within the meaning of section [401 \(k\)\(7\)](#)) which includes a qualified cash or deferred arrangement (as defined in section [401 \(k\)\(2\)](#)) to the extent of amounts which a covered employee may elect to have the employer pay as contributions to a trust under such plan on behalf of the employee.

(C) Exception for certain plans maintained by educational institutions

Subparagraph (A) shall not apply to a plan maintained by an educational organization described in section [170 \(b\)\(1\)\(A\)\(ii\)](#) to the extent of amounts which a covered employee may elect to have the employer pay as contributions for post-retirement group life insurance if—

- (i)** all contributions for such insurance must be made before retirement, and
- (ii)** such life insurance does not have a cash surrender value at any time.

For purposes of section [79](#), any life insurance described in the preceding sentence shall be treated as group-term life insurance.

(D) Exception for health savings accounts

Subparagraph (A) shall not apply to a plan to the extent of amounts which a covered employee may elect to have the employer pay as contributions to a health savings account established on behalf of the employee.

(e) Highly compensated participant and individual defined

For purposes of this section—

(1) Highly compensated participant

The term “highly compensated participant” means a participant who is—

- (A)** an officer,
- (B)** a shareholder owning more than 5 percent of the voting power or value of all classes of stock of the employer,
- (C)** highly compensated, or
- (D)** a spouse or dependent (within the meaning of section [152](#), determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B) thereof) of an individual described in subparagraph (A), (B), or (C).

(2) Highly compensated individual

The term “highly compensated individual” means an individual who is described in subparagraphs [11](#) (A), (B), (C), or (D) of paragraph (1).

(f) Qualified benefits defined

For purposes of this section, the term “qualified benefit” means any benefit which, with the application of subsection (a), is not includible in the gross income of the employee by reason of an express provision of this chapter (other than section [106 \(b\)](#), [117](#), [127](#), or [132](#)). Such term includes any group term life insurance which is includible in gross income only because it exceeds the dollar limitation of section [79](#) and such term includes any other benefit permitted under regulations. Such term shall not include any product which is advertised, marketed, or offered as long-term care insurance.

(g) Special rules

(1) Collectively bargained plan not considered discriminatory

For purposes of this section, a plan shall not be treated as discriminatory if the plan is maintained under an agreement which the Secretary finds to be a collective bargaining agreement between employee representatives and one or more employers.

(2) Health benefits

For purposes of subparagraph (B) of subsection (b)(1), a cafeteria plan which provides health benefits shall not be treated as discriminatory if—

(A) contributions under the plan on behalf of each participant include an amount which—

(i) equals 100 percent of the cost of the health benefit coverage under the plan of the majority of the highly compensated participants similarly situated, or

(ii) equals or exceeds 75 percent of the cost of the health benefit coverage of the participant (similarly situated) having the highest cost health benefit coverage under the plan, and

(B) contributions or benefits under the plan in excess of those described in subparagraph (A) bear a uniform relationship to compensation.

(3) Certain participation eligibility rules not treated as discriminatory

For purposes of subparagraph (A) of subsection (b)(1), a classification shall not be treated as discriminatory if the plan—

(A) benefits a group of employees described in section [410 \(b\)\(2\)\(A\)\(i\)](#), and

(B) meets the requirements of clauses (i) and (ii):

(i) No employee is required to complete more than 3 years of employment with the employer or employers maintaining the plan as a condition of participation in the plan, and the employment requirement for each employee is the same.

(ii) Any employee who has satisfied the employment requirement of clause (i) and who is otherwise entitled to participate in the plan commences participation no later than the first day of the first plan year beginning after the date the employment requirement was satisfied unless the employee was separated from service before the first day of that plan year.

(4) Certain controlled groups, etc.

All employees who are treated as employed by a single employer under subsection (b), (c), or (m) of section [414](#) shall be treated as employed by a single employer for purposes of this section.

(h) Special rule for unused benefits in health flexible spending arrangements of individuals called to active duty

(1) In general

For purposes of this title, a plan or other arrangement shall not fail to be treated as a cafeteria plan or health flexible spending arrangement merely because such arrangement provides for qualified reservist distributions.

(2) Qualified reservist distribution

For purposes of this subsection, the term “qualified reservist distribution” means,^[2] any distribution to an individual of all or a portion of the balance in the employee’s account under such arrangement if—

(A) such individual was (by reason of being a member of a reserve component (as defined in section [101](#) of title [37](#), United States Code)) ordered or called to active duty for a period in excess of 179 days or for an indefinite period, and

(B) such distribution is made during the period beginning on the date of such order or call and ending on the last date that reimbursements could otherwise be made under such arrangement for the plan year which includes the date of such order or call.

(i) Cross reference

For reporting and recordkeeping requirements, see section [6039D](#).

(j) Regulations

The Secretary shall prescribe such regulations as may be necessary to carry out the provisions of this section.”

[1] So in original. Probably should be “subparagraph”.

[2] So in original. The comma probably should not appear.

Outstanding questions:

The nondiscrimination tests above were written at a time that presumed the plan sponsored offered only one plan, and some of the language was geared more to retirement plans. Thus trying to use the tests in an environment of multiple plan options, and in the case of smaller employers, age-based rates, can be very difficult. Without further guidance from the federal government it is not clear how to run the above tests on a variety of real-world examples. Here are some questions that need further guidance:

- How are the tests run when the employer offers a great many plan options, which is especially common in the Small Group health market? If each plan option is a separate plan, the percentage tests would not be able to be met.
- In an age-based rating plan, will older Highly Compensated Employees with higher rates cause a plan to be considered discriminatory?
- Will executive benefit plans, such as plans from Exec-U-Care, be deemed automatically discriminatory? If so, may such plan existing on March 23, 2010, be grandfathered and avoid having to include those plans in any test?