



BENEFIT *Advisor*

In This Issue

In this ninth issue of the McGraw Wentworth Benefit Advisor for 2006, we will discuss the non-discrimination requirements for self-funded medical plans. Section 105(h) of the Internal Revenue Code addresses medical plan requirements to ensure your organization does not discriminate in terms of eligibility or benefits in favor of your highly compensated employees.

It is important to make sure your plan operates in a non-discriminatory manner. If your plan does discriminate in favor of highly compensated employees, those employees will be assessed what could be a substantial tax penalty.

We welcome your comments and suggestions regarding this issue of our technical bulletin. For more information on this Benefit Advisor, please contact your Account Manager or visit the McGraw Wentworth web site at www.mcgrawwentworth.com.

“Self-Funded Medical Non-Discrimination Rules”

Non-discrimination rules affect many employer-sponsored benefit plans. Unfortunately, different non-discrimination rules apply to different employer-sponsored benefit plans. The next several *Benefit Advisors* explain the various non-discrimination rules that affect different aspects of employee benefit plans, including:

- Section 105(h) non-discrimination rules for self-funded medical plans.
- Section 125 non-discrimination rules for cafeteria plans.
- Section 79 non-discrimination rules for employer-sponsored life plans.



This Advisor discusses the 105(h) non-discrimination requirements. These rules are intended to ensure the employer does not favor highly compensated employees in the eligibility provisions or benefits paid under a self-funded medical program.

This Advisor:

- Defines *self-funded medical plan*.
- Defines *highly compensated employees*.
- Examines the eligibility tests.
- Outlines the benefits tests.

- Offers concluding thoughts.

The Section 105(h) non-discrimination rules apply only to self-funded medical plans. Employers who fully insure their medical benefit plans can offer a higher level of benefits to their key employees.

The medical insurance carrier would need to approve the benefit structure of the employer’s plan, but these Section 105(h) non-discrimination rules do not apply to fully insured medical plans.

Definition of Self-Funded Medical Plan

To determine if your medical plan is self-funded and needs to be concerned with Section 105(h), consider these two questions:

1. What is considered a medical plan?
2. What is considered self-funded?

A medical plan is an arrangement for paying amounts to employees for personal injury or illness expenses. If the plan pays benefits for an Internal Revenue Code Section 213(d) medical expense, it is considered a

medical plan. Many different types of plans can pay medical expenses including major medical, hospital indemnity, HMOs, PPOs, health FSAs (flexible spending accounts) and any other supplemental health benefits. Dental and vision benefits are also considered medical benefits for these purposes.

The first step to meeting Section 105(h) non-discrimination requirements is to determine whether your plan qualifies as self-funded. A plan is considered self-funded if the employer sponsors the medical plan and reimburses medical expenses. The funds to pay for medical expenses generally come from the employer's general

assets or in some cases, a trust. The employer has no insurance directly covering the health plan claims. Also, the plan must be described in writing. If a reimbursement is made not subject to a written plan document, the reimbursement is considered income to the employee.

A self-funded medical plan can be subject to the non-discrimination requirements of Section 105(h) and Section 125. If the plan is part of a cafeteria plan and it is funded or partially funded with employee contributions, both Section 125 and Section 105(h) apply. If the medical plan is self-funded and not part of a cafeteria plan, it must meet only Section 105(h) non-discrimination requirements. An HRA (health reimbursement arrangement) is considered outside a cafeteria plan because only the employer can contribute to the HRA. The base medical plan can be offered under the cafeteria plan, just not the HRA component.

The Section 105(h) non-discrimination rules do not apply to fully insured plans. A fully insured plan shifts sufficient risk to an unrelated third party. If the plan is underwritten by an insurance policy or pre-paid medical plan that **does not** shift risk to an unrelated third party, it is considered a self-funded medical plan.

What if a plan combines elements of a self-funded and a fully insured plan? For example, in a minimum premium arrangement, the employer pays claims up to a certain amount, and the health insurance carrier fully insures the claims that exceed that amount. The

status of these plans is not particularly clear; however, the consensus is they should be considered self-funded.

Another example is a plan where the employer requires a deductible for a hospital stay but reimburses the employee for that deductible. The reimbursement plan is subject to Section 105(h) because it is considered a self-funded medical plan. If the base medical plan is fully insured, the base plan is not subject to Section 105(h).

A third example is employer-purchased stop loss coverage. The base medical plan is considered self-funded, but what is the nature of the claims that hit the specific or aggregate stop loss limits that are reimbursed by a stop carrier? It is generally believed even claims that hit the attachment point remain self-funded. The employer remains liable for the claims under the plan. Stop loss coverage is designed to reimburse the employer for losses

under the health plan that exceed the expected claim threshold. Since the plan generally pays these claims and the stop loss carrier reimburses the employer, claims that hit the attachment factors are still considered paid by the employer's self-funded medical plan.

Highly Compensated Employees

Section 105(h) states self-funded medical plans cannot favor highly compensated employees with respect to eligibility or benefits. Which employees should be considered highly compensated?

Section 105(h) refers to a prohibited group of highly compensated employees defined as:

- One of the five highest paid officers.
- A shareholder who owns more than 10% of the value of the employer's stock.
- One of the highest-paid 25% of all employees (with the exception of employees who are not considered participants).

These requirements are not mutually exclusive. The five highest paid officers may also be among the highest paid 25% of all employees. However, if one of the top five officers is not in that pay range, that officer still needs to be included in the highly compensated individual category. The Section 105(h) definition of highly compensated employees differs from the Section 125 definition.

The Internal Revenue Code does not define *officer*. Generally, an officer is an administrative executive in regular and continuous service. For



these tests, an employee's status as an officer depends on the particular benefit plan and the officer's status during the plan year. Generally, whether or not an employee is considered an officer is determined by facts and circumstances, including the source of the individual's authority, the term of appointment, and the nature and extent of the individual's duties.

The Code also does not formally define *highest paid*. Consider only the current plan year when you determine the level of compensation. If a plan operates on a fiscal year, consider the employee's compensation for the calendar year that ends within the fiscal year.

The more than 10% shareholder requirement applies to corporations where employees own stock in the company. If the employer is a partnership or another business, consider capital benefits or company profits. Count anyone with more than a 10% share in the company during the benefit plan year in non-discrimination testing.

The regulations do not formally define the term "compensation." To determine the highest paid 25% of employees, an employer should use a reasonable definition and consider the employee's compensation only for the current plan year. The following employees can be excluded from the top 25% highest-paid group:

- Employees who have not completed three years of service.
- Employees under age 25.
- Part-time or seasonal employees.
- Collectively bargained employees.

- Nonresident aliens who receive no U.S. source of earned income.

Once an employer determines a medical plan is self-funded, the next step in Section 105(h) testing is determining which employees are *prohibited* because they are highly compensated. These employees need to be segregated from the other employees for the eligibility and benefits tests.

Tests for Eligibility

The Section 105(h) eligibility test is designed to make sure the plan does not favor highly compensated individuals. The tests are designed to ensure enough non-highly compensated employees also benefit from the plan. A plan is considered non-discriminatory if it can pass any one of the following eligibility tests:

- The 70% test
- The 70%/80% test
- The nondiscriminatory classification test

The 70% Test

The first test is to determine whether the self-funded medical plan benefits 70% or more of all employees excluding:

- Employees that have not completed three years of service.
- Employees under age 25.
- Part-time or seasonal employees.

- Collectively bargained employees.
- Nonresident aliens with no U.S. source of income.

If 70% of all eligible employees participate in the plan (with the exception of the above employees), the plan passes the 70% test.

The 70%/80% Test

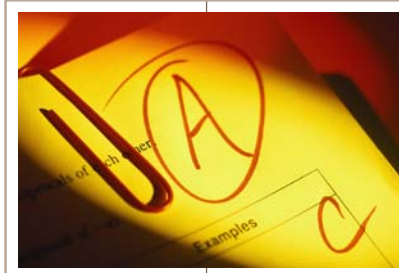
If a plan does not pass the 70% test, it might pass the 70%/80% test. A plan passes this test if the plan benefits 80% or more of all eligible employees providing that at least 70% of all includible employees can participate. The 70% test applies to all eligible employees. If at least

70% of includible employees can participate, the 70% portion of this test is met. If at least 80% of eligible employees enroll for plan coverage, the 80% portion of

this test is met. In other words, a plan passes this test if at least 70% of includible employees are eligible for plan benefits and at least 80% of those eligible employees elect coverage.

The Nondiscriminatory Classification Test

If a plan cannot pass the 70% or the 70%/80% test, the plan may still pass the eligibility test if it can meet the nondiscriminatory classification test. This test shows the plan does not favor highly compensated employees. In this test, the determination depends on the facts and circumstances of each case.



The plan must pass one of the following two tests:

- **Post-TRA Nondiscriminatory Classification Test:** A plan will satisfy this test for the plan year only if it meets the following requirements:

- The plan benefits employees who qualify under a reasonable classification test the employer establishes. A reasonable classification is established if, based on facts and circumstances, the classification uses objective business criteria to establish the category of employee that will benefit from the plan. These categories may include job category, location of office, nature of compensation and so on.

- The classifications established do not favor highly compensated employees.

The rules adopt a safe harbor percentage test and a subjective facts and circumstances test to determine

whether the classifications favor those employees. These tests are fairly complicated and require an understanding of specific Internal Revenue Code provisions. If your plan is left with this test as an only option, ask your tax advisor for help.

- **Pre-TRA Fair Cross Section Test:** This test is more subjective; its key concepts are really related to qualified

plans. A plan can pass this test, even when most plan participants are in the *prohibited group* if it meets the following requirements:

- Compensation of the plan participants is substantially the same as the excluded employees.
- The plan covers employees in all compensation ranges.
- Individuals in the middle and lower compensation classes are covered in more than nominal numbers.
- The classification on its face does not favor officers, shareholders or highly compensated employees.

It makes sense to ask your tax advisor for help with this test as well.

A special rule applies to organizations that offer a self-funded medical plan (for example, a PPO plan) and a fully insured HMO plan to their employees. For Section 105(h) non-discrimination testing, if the employer funding for the HMO plan equals or exceeds the funding for the self-funded plan

option, HMO participants can be counted as covered under the self-funded plan for the purposes of non-discrimination testing. The IRS allows this special rule because some employers were concerned about whether they could pass the eligibility tests if a number of their non-highly compensated employees elected the HMO plan and their highly compensated employees selected the self-funded PPO coverage. This special HMO rule has had the practical effect of allowing certain

self-funded plans to pass the eligibility test that might have otherwise failed because non-highly compensated employees are more likely to select the HMO option.

If a plan fails to pass any of the three eligibility tests, the plan is considered discriminatory. If the plan is discriminatory, employees in the *prohibited group* must pay income tax on the benefits they receive. This tax penalty could be substantial.

Benefits Test

The benefits test determines whether all participants are eligible for the same level of benefits under the plan. To determine whether the same level of benefits is offered, an employer needs to consider a number of questions:

- Are all participants eligible for the same benefits under the plan?
- Are all benefits offered under the same conditions to all plan participants?
- If optional benefits are offered, can all participants elect each benefit option for the same additional premium?
- Are waiting periods the same for all employees?
- Do the benefits vary based on age, years of service or compensation?

The benefits test is designed to determine whether benefits offered under a self-funded medical plan favor employees in the *prohibited group*. The *prohibited group* is the same group of employees identified for the eligibility tests.



The benefits test has two parts:

1. Testing for discrimination on the face of the plan.
2. Testing for discrimination in operation.

Discrimination on the Face of the Plan

In order for the plan to be considered non-discriminatory on its face, the plan must include these important parameters:

- Required employee contributions must be identical for each benefit level. This implies contributions should be uniform; however, it is not directly stated in the regulations.
- The maximum benefit level cannot vary based on age, years of service, or compensation.
- The same benefits available to highly compensated employees must also be made available to the non-highly compensated employees.
- Different waiting periods cannot be imposed. This requirement causes the most concern because employers often have different new hire waiting periods for different classes of employees. If your highly compensated employees have a shorter new hire waiting period than all other employees, the plan benefits are considered discriminatory on their face. In this case, the highly compensated employees must pay income tax on any benefits they receive during the extra time covered.

Discrimination in Operation

Discrimination in operation concerns situations where a type of

benefit is covered for a period of time that coincides with the time a highly compensated employee uses that benefit. The IRS understands that frequently the decision-makers associated with a plan are often members of the *prohibited group* (the highly compensated employees).

For example, the president of an organization may choose to amend the group health plan to cover infertility treatment because his family needs these services. These services can be very expensive. Adding this benefit is not considered discriminatory, because the president amended the plan for all plan participants. However, suppose the president decides to drop this coverage after his wife becomes pregnant and no longer needs the benefit. Dropping this coverage is considered discrimination in how the plan operates.

Plans can also be found discriminatory in operation if the self-funded plan makes a habit of making extra-contractual benefit payments for highly compensated employees for benefits not covered for non-highly compensated employees. Extra-contractual benefit payments were more common five years ago. When the Department of Labor revised the required claims and appeal procedures for ERISA group health plans, issuing extra-contractual benefit payments became less practical. Since the revised regulations took effect, very few plans have made it a practice to make extra-contractual benefit payments.

If a self-funded medical benefit plan fails the benefit tests, the value of the additional benefits paid for the

highly compensated employees are considered taxable income. This could be a substantial tax penalty to your highly compensated employees.

Concluding Thoughts

If you are confused, you are in good company, the Section 105(h) non-discrimination requirements are difficult to understand. However, the tax penalties to your highly compensated employees may be substantial. It is in your organization's best interest to offer a non-discriminatory self-funded medical plan.

That goal may be hard to achieve because organizational issues may force different benefit levels for different groups of employees. This situation occurs frequently in mergers and acquisitions. If your company offers a self-funded medical plan with different benefits for different employees, be sure to conduct Section 105(h) non-discrimination tests.

While the eligibility tests are not too difficult to perform in-house, the benefit tests may be more complicated. Most third party administrators will conduct non-discrimination tests for a reasonable fee. Your organization should conduct these tests every couple of years to make sure your plan does not favor highly compensated employees.

If you have any questions regarding Section 105(h) non-discrimination requirements, please contact your McGraw Wentworth Account Director. **MW**



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