Health Care Reform Non-discrimination Testing Requirements

Health care reform extends the Internal Revenue Service (IRS) non-discrimination requirements that previously only applied to self-insured plans to all fully insured, non-grandfathered plans beginning as plans renew on or after September 23, 2010. According to the IRS rules, plans cannot discriminate in favor of highly compensated employees. Below is an overview of what this provision of health care reform means for employers.

Q: Which types of plans are most likely to be impacted by this new requirement?
A: All fully insured non-grandfathered plans must comply. Generally, plans that may have issues with compliance are those that offer different health plan options or benefits to different classes of employees. Employers should consult with their tax or legal advisors about their specific plan design.

Q: Who is responsible for testing?
A: It is the responsibility of the employer to monitor non-discrimination compliance throughout the plan year.

Q: What are the tests?
A: The plan must satisfy two non-discrimination tests. If a plan fails either test, the favorable tax treatment for highly compensated individuals is lost. Under Section 105(h) of the tax code the two tests a plan is required to meet are:

1. **Eligibility test**
   The plan cannot discriminate in favor of highly compensated individuals as to eligibility to participate. Highly compensated individuals consist of the five highest paid officers, more than 10 percent shareholders and the highest paid 25 percent of all employees.

   There are 3 alternative ways to pass the eligibility test:

   1. **70 percent test**
      The plan benefits 70 percent or more of all non-excludable employees
   2. **70/80 percent test**
      The plan benefits 80 percent or more of all non-excludable employees who are eligible to benefit, if 70 percent or more of all non-excludable employees are eligible to benefit under the plan. First, determine whether 70 percent of employees are eligible under the plan. Then determine whether at least 80 percent of those eligible employees actually participate in the plan.
   3. **Non-discriminatory classification test**
      The plan benefits a non-discriminatory classification of employees. This requires a bona fide business classification for any exclusion and
a sufficient ratio of benefiting non-highly compensated individuals to benefiting highly compensated individuals.

A plan may pass the eligibility test by excluding permitted categories of excludable employees. In running the eligibility tests, an employer may exclude the following employees:

- Employees who have not completed three years of service
- Employees under age 25
- Part-time or seasonal employees
- Non-resident aliens with no U.S. source income.

2. The benefits test

The benefits provided under the plan must not discriminate in favor of highly compensated individuals. The benefits test has two components: testing for discrimination on the face of the plan and testing for discrimination in operation.

The plan must include several design features in order to be non-discriminatory:

1. The required employee contributions must be identical for each benefit level.
2. The plan may establish a maximum reimbursement limit for any single benefit or combination of benefits. The maximum benefit level that can be elected cannot vary based on percent of compensation, age or years of service.
3. All the benefits provided/available for participants who are highly compensated individuals must also be provided/available for all other participants.
4. The plan cannot impose disparate waiting periods.

A plan must also not discriminate in favor of highly compensated individuals in actual operation. For example, discrimination in operation could arise if a plan administrator approves certain claims for medical expenses for highly compensated individuals while denying them for non-highly compensated individuals.

Q: What if the plan does not pass the test?

A: If a fully insured plan does not pass the tests, there is a $100 per day penalty for the plan per incident, and there is a possibility that amounts considered to be excess reimbursements to highly compensated individuals could be taxable to them.