HONIGMAN ALERT

Health Care Reform April 25, 2011

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Application of Nondiscrimination Rules for Insured Health Plans Delayed

One of the more "seemingly innocuous, but very significant" benefit changes enacted in the Affordable Care Act (ACA) was the extension of the Code Section 105(h) rules prohibiting nondiscrimination in favor of highly compensated individuals (HCIs) to insured plans. Up to now, these rules applied only to self-funded group health plans. The nondiscrimination rules for self-funded plans, however, are not well understood, not entirely clear and not consistently enforced, and so extending these rules to insured plans creates a new level of uncertainty.

Aware of this consequence, the Internal Revenue Service (IRS) has recently issued guidance that delays the application of these nondiscrimination rules to fully insured group health plans. In Notice 2011-1, the IRS stated that compliance with these nondiscrimination requirements by fully insured plans will not be required, and the excise tax penalties for violations will not be imposed, until plan years beginning some time after final regulations or other definitive guidance has been issued. The Department of Labor (DOL) and the Department of Health and Human Services (DHHS) have also agreed to this delay.

What Are the Current Rules?

Under the current Section 105(h) nondiscrimination rules, self-funded group health plans cannot discriminate in favor of HCIs as to eligibility and benefits. HCIs are anyone who is (i) one of the five highest paid officers, (ii) a 10% or more shareholder, or (iii) among the highest paid 25% of all employees. Employees with less than three years service, who are under age 25, who are seasonal, who work part-time less than 35 hours per week, who are non-resident aliens, or who are union members whose contract does not provide for coverage can be excluded from this calculation.

To pass the eligibility test, either (i) 70% of the non-excludible employees must benefit under the plan, (ii) 80% of non-excludible employees must be eligible to benefit and 70% of those must actually benefit, or (iii) the employees who benefit are in a classification approved by the IRS. The benefits test is straightforward — HCIs can only be entitled to the same benefits to which non-HCIs are entitled.

Importantly, the penalties for violating these rules fall on the HCI, and not on the plan or the sponsoring employer. If the violation is for eligibility, the value of the coverage available to the HCI becomes taxable income to him or her. If the benefits test is failed, the value of the excess benefits available to the HCI become taxable income.

What Has the ACA Added?

The ACA, by its terms, simply extends these rules to fully insured health plans, with the exception of insured plans that are grandfathered under the ACA, and plans that provide HIPAA "excepted benefits" (*e.g.*, limited scope dental or vision benefits provided under separate contracts or which are not otherwise an integral part of the plan). The ACA also charged the IRS, DOL and DHHS (the Agencies) with drafting rules "similar" to those under Code Section 105(h). These agencies are having a difficult time deciding what "similar" means in this context, especially since the rules under Section 105(h) were first promulgated in 1981, have not been modified since, and are themselves somewhat unclear. It is as much to clarify the rules as they apply to self-funded plans, as well as figuring out how to apply them to insured health plans, that prompted the IRS to delay enforcement. In short, the Agencies need to determine how this new scheme will work before they can begin enforcing it.

The most significant change wrought by the ACA, however, is in the penalty scheme for insured plans. Unlike the penalties for self-funded plans, the penalties for insured plans are excise tax penalties, which fall on the plan sponsor. The excise tax penalty is $100 per day for each day of noncompliance with respect to each affected participant (*i.e.*, each participant who has been discriminated against, which likely amounts to the pool of non-excludible, non-HCIs). These penalties are subject to certain caps, and small employers (*i.e.*, those who employ less than 50 employees during the preceding calendar year) may be exempt. This penalty scheme can get quite expensive. For example, if a company employs 55 people, and five are HCIs and the violation continues for 10 days, the excise tax would be $100 times 10 days times 50 non-HCIs = $50,000. The IRS, however, does have the authority to modify or waive the penalties.

Why Is This Change Important?

Many companies want to provide key employees, officers, and/or high ranking executives with significant medical benefits, either while employed, as part of their retirement package, or as part of a severance arrangement. With insured benefits not being subject to these nondiscrimination rules, the solution was simple — provide these benefits as part of an insured program. When the promised guidance is issued, it will remove this safe harbor option for providing additional executive medical coverage, special retiree medical coverage for executives and owners, two-tiered health plan structures favoring HCIs, or creating differing medical benefit programs for different geographical locations or facilities if HCIs are concentrated in those areas or locations with greater benefits. This change will also have a significant impact on how benefits can be structured in mergers and acquisitions.

Unfortunately, it is impossible to determine how these arrangements might need to be restructured until after the promised guidance is issued, but it is important that this change be on the radar screen and monitored. The traditional insured arrangements for providing medical benefits for both active and retired executives and owners that avoided the non-discrimination rules for self-funded arrangements will no longer be available, but what kind of flexibility there will be with respect to these arrangements remains to be seen.

Action Steps

It is important to begin reviewing your current medical benefit arrangements for HCIs, including employment contracts, severance plans and other compensation arrangements. For these, Code Section 409A may no longer be the only complicating factor. If you have any questions about these nondiscrimination rules, complying with any other aspect of the ACA, or have any other employee benefit questions for which you need answers, please contact either of the Honigman attorneys listed on this Alert.

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