

Welfare Plan Nondiscrimination Testing

Tulsa Employee Benefits Group

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The nondiscrimination rules applicable to welfare benefit plans are, in some respects, very detailed. In many other respects, though, we do not have clear guidance about how to apply these rules. These slides provide a very general summary of certain rules. There are many details that are not included and that would impact how a plan sponsor applies these rules.

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Why Does it Matter?

- Nondiscrimination rules are the “price” plan sponsors pay to obtain tax-favored treatment for certain employee benefits.
- Failure to satisfy nondiscrimination rules can result in taxable income to “highly compensated” or “key” employees.

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Related Employers

- Generally, nondiscrimination tests are performed on a “controlled group” basis.
- Very generally, a controlled group can exist when:
 - One entity owns at least 80% of the voting power/equity value of another entity; or
 - Five or fewer persons own 80% of the voting power/equity value of two or more entities.
- The “affiliated service group” rules also apply to combine otherwise unrelated entities for testing purposes.

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Code § 105(h) – Self-Funded Medical Plans

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Code § 105(h) – Self-Funded Medical Plans

- Applicable to self-funded health plans.
 - Includes major medical plans, HRAs and health care FSAs.
 - ACA also applied nondiscrimination rules to insured plans, but not effective until regulations are issued.
- The rules prohibit discrimination in favor of highly compensated individuals (HCIs).
 - 5 highest paid officers.
 - More than 10% shareholders.
 - Highest paid 25% of all employees.

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Code § 105(h) – Self-Funded Medical Plans



- Eligibility Test: The plan must *benefit*:
 - 70% or more of all employees, or
 - 80% or more of all employees who are eligible to benefit if 70% or more of all employees are eligible to benefit, or
 - A classification of employees which is found by the IRS not to be discriminatory in favor of HCs (the “nondiscriminatory classification test”).

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Code § 105(h) – Self-Funded Medical Plans



- Eligibility Test: Two options for the “nondiscriminatory classification test”:
 - The nondiscriminatory classification test described in Code § 410(b)(2)(A)(i) and Treasury Regulation § 1.410(b)-4, or
 - The “old” fair cross-section test that applied under Code § 410(b) prior to the changes made by the Tax Reform Act of 1986.

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Code § 105(h) – Self-Funded Medical Plans



- Eligibility Test: The following employees may be excluded (not clear if can be excluded if eligible to participate) :
 - Have not completed 3 years of service.
 - Have not attained age 25.
 - Part-time employees (generally < 35 hours/week).
 - Seasonal employees (generally < 9 months/year).
 - Certain collectively bargained employees.
 - Nonresident aliens with no U.S. earned income.

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Code § 105(h) – Self-Funded Medical Plans



- Benefits Test: Benefits provided under the health plan must not discriminate in favor of participants who are HCIs.
- A plan generally passes the Benefits Test if all the benefits provided for participants who are highly compensated individuals are provided to all other participants.

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Code § 105(h) – Self-Funded Medical Plans



- Benefits Test: A plan that provides optional benefits is treated as providing a single benefit if:
 - All eligible participants may elect any of the benefits covered by the option, and
 - There are either no required employee contributions or the required employee contributions are the same amount.

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Code § 105(h) – Self-Funded Medical Plans



- A plan must not discriminate on its face in providing benefits, but also must not discriminate in favor of HCLs in actual operation.
- A plan is *not* considered discriminatory merely because HCLs participating in the plan utilize a broad range of plan benefits to a greater extent than other employees participating in the plan.

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Code § 105(h) – Self-Funded Medical Plans



- Retiree coverage will generally not be considered discriminatory if the type and dollar limitations of benefits provided to retired employees who were HCIs are the same as those provided for all other retired participants.

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Code § 105(h) – Self-Funded Medical Plans



- An employer may designate two or more plans as constituting a single plan for Code § 105(h) testing purposes.
- A single plan document may be utilized if the employer designates the plans that are to be considered separately and the applicable provisions of each separate plan.

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Code § 105(h) – Self-Funded Medical Plans



- A plan will be deemed to benefit an employee who has enrolled in an HMO that is offered on an optional basis if:
 - The employer's contributions to the HMO plan equal or exceed those that would be made to the self-funded plan, and
 - The HMO plan is designated with the self-funded plan as a single plan.

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Code § 105(h) – Self-Funded Medical Plans



- In a discriminatory plan, HCIs lose the exclusion from taxable income for health care benefits attributable to employer contributions.
 - Eligibility Test failure: A percentage of the health benefits (not premiums) paid to an HCI is included in the HCI's income. The percentage is based on the total benefits paid to the HCIs relative to total benefits paid to all employees.
 - Benefits Test failure: The amount paid to the HCI with respect to any benefit to the HCI not available to non-HCIs is includable in the HCI's income.

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Code § 105(h) – Self-Funded Medical Plans



- Diagnostic Procedure Exception:
 - Reimbursements paid for medical diagnostic procedures for an employee, *but not a dependent*, are not considered to be part of a plan for Code § 105(h) purposes.
 - Diagnostic procedures include routine medical exams, blood tests, and X-rays.
 - Diagnostic procedures do not include treatment, cure or testing of a known illness or disability or a physical injury, complaint or specific symptom of a bodily malfunction.

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Code § 105(h) – Self-Funded Medical Plans



- Diagnostic Procedure Exception:
 - The diagnostic procedures must be performed at a facility which provides no services (directly or indirectly) other than medical and ancillary services.
 - Transportation expenses primarily for an allowable diagnostic procedure are included within the exception, but only to the extent that they are ordinary and necessary.

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Code § 105(h) – Self-Funded Medical Plans

- Features / practices that might implicate Code § 105(h):
 - Cost-plus insurance policies or other insurance arrangements that do not shift risk.
 - Executive medical programs.
 - More favorable employer contributions.
 - Additional coverage options.
 - Shorter waiting periods.
 - Employer payment of COBRA premiums.

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125 Plans

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125 Plans

- A cafeteria plan must satisfy three nondiscrimination tests:
 - Eligibility test.
 - Contributions and benefits test.
 - Key employee concentration test.

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125 Plans

These slides discuss the 125 plan nondiscrimination rules generally and also discuss the nondiscrimination rules described in regulations that were proposed in 2007. Those proposed regulations – which taxpayers can rely on – change how the nondiscrimination rules are applied in significant ways.

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125 Plans – Eligibility Test

- Plans must not discriminate in favor of HCIs as to eligibility to participate.
- “Highly compensated individuals” (HCIs) are:
 - Officers.
 - More-than-5% shareholders.
 - Individuals who are “highly compensated” (generally using the same compensation limit as 401(k) plans).
 - Spouses or dependents of the above.

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125 Plans – Eligibility Test

- The plan must benefit a “reasonable classification” of employees (i.e., geographic location, hourly v. salaried).
- The group of employees in the “reasonable classification” must satisfy a numerical test that compares the percentage of HCIs that are eligible to the percentage of NHCI that are eligible.
 - Generally, coverage of > 50% of NHCI will satisfy this test.

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125 Plans – Eligibility Test

- The proposed regulations permit the following to be excluded from the eligibility test:
 - Employees (except key employees) covered by a collectively bargained plan.
 - Nonresident aliens with no U.S. source income.
 - Employees participating in the cafeteria plan under a COBRA continuation provision.

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125 Plans – Eligibility Test

- Red flags for potential eligibility test failure:
 - Exclusion of part-time employees.
 - Exclusion of other controlled group entities.

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125 Plans – Eligibility Test

- Example from proposed regulation:
 - Employer A has one health insurance plan. The cost to participants electing the plan is \$10,000 per year for single coverage. All employees have the same opportunity to salary reduce \$10,000 for accident and health plan.
 - The plan satisfies the eligibility test.

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125 Plans – Eligibility Test

- Example from proposed regulation:
 - Same facts, except the plan provides \$8,000 employer flex-credit to HCIs to pay a portion of the premium, and provides an election to them to salary reduce \$2,000 to pay the balance of the premium. (NHCI's pay 100%)
 - The plan fails the eligibility test.

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125 Plans – Eligibility Test

- Example from proposed regulation:
 - Plan offers 2 coverages:
 - Plan X for HCIs only; premium = \$15,000
 - Plan Y for NHCI only; premium = \$8,000
 - HCIs can elect \$15,000 salary reduction to pay for coverage
 - NHCI can elect \$8,000 to pay for coverage
 - The plan fails the eligibility test.

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125 Plans – Eligibility Test

- Example from proposed regulation:
 - Same facts, except that the amount of salary reduction for HCIs to elect Plan X is \$8,000.
 - The plan fails the eligibility test.

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125 Plans – Eligibility Test

- Ramifications of proposed regulation:
 - Eligibility test now looks to underlying benefit, not just opportunity to participate.
 - Appears to be an attempt to apply nondiscrimination rules to insured benefits.

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125 Plans – Eligibility Test

- Additional eligibility requirements:
 - No employee can be required to complete more than 3 years of employment with the employer as a condition of participation in the plan.
 - The employment requirement for each employee must be the same.
 - Employees must be entitled to participate no later than the first day of the plan year after all service requirements are met.

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125 Plans - Contributions & Benefits Test



- A plan may not discriminate in favor of highly compensated participants as to contributions and benefits.
- Under the proposed regulation, there are two components to this test:
 - Availability
 - Utilization
- The proposed regulation provides a new quantitative test that did not exist under prior guidance.

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125 Plans - Contributions & Benefits Test



- Under the proposed regulation:
 - Benefits and contributions must be available on a nondiscriminatory basis.
 - A plan must give each similarly situated participant a uniform opportunity to (i) elect qualified benefits, and (ii) elect to receive employer contributions for qualified benefits.

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125 Plans - Contributions & Benefits Test

- Under the proposed regulation:
 - Benefits and contributions must be utilized on a nondiscriminatory basis.
 - The actual election of (i) qualified benefits, and (ii) employer contributions for qualified benefits through the plan must not be disproportionate by highly compensated participants
 - The benefits elected by HCPs, as a percentage of compensation, is compared to the benefits elected by NHCPs as a percentage of compensation.

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125 Plans - Contributions & Benefits Test

- Under the proposed regulation:
 - The utilization test is represented by the following:

$$\frac{\text{NHCP Aggregate Benefit Election}}{\text{NHCP Aggregate Compensation}} \geq \frac{\text{HCP Aggregate Benefit Election}}{\text{HCP Aggregate Compensation}}$$

- Example from Proposed Regulation: HCPs elect aggregate qualified benefits equaling 5% of aggregate compensation; NHCPs elect aggregate qualified benefits equaling 10% of aggregate compensation. The plan passes the contribution and benefits test.

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125 Plans - Contributions & Benefits Test



- Health Benefits Safe Harbor: A plan that provides health benefits is not treated as discriminatory as to benefits and contributions if contributions on behalf of each participant include an amount that:
 - Is equal to 100% of the cost of the health benefit coverage of the majority of the HCPs, or
 - Equals or exceeds 75% of the cost of the health benefit coverage of the participant having the highest cost coverage under the plan.
- Any additional contributions or benefits under the plan must bear a uniform relationship to compensation.

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125 Plans – Concentration Test



- Benefits provided to “Key Employees” may not exceed 25% of the aggregate benefits provided to all employees.
- A “Key Employee” is a participant who, at any time during the preceding plan year, was:
 - An officer with annual compensation greater than \$180,000 (for 2019; indexed);
 - A more-than-5% owner; or
 - A more-than-1-percent owner with annual compensation greater than \$150,000 (not indexed).

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125 Plans – POP Plan Safe Harbor (Proposed Regulation)



- New safe harbor provided under proposed regulation
- Premium only plan: A cafeteria plan that offers as its sole benefit an election between cash and payment of the employee share of the employer-provided accident and health insurance premium.
- A “premium only plan” that satisfies the eligibility test will (it appears) be deemed to also satisfy the Contributions and Benefits Test and the Key Employee Concentration Test.

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125 Plans – POP Plan Safe Harbor (Proposed Regulation)



- Example from proposed regulation.
 - Plan offers one health plan and offers all employees the election to salary reduce the same amount or same percentage of the premium for self-only or family coverage.
 - All key employees and HCEs elect salary reduction, but only 20% of NHCEs elect the plan.
 - Plan satisfies the Contributions and Benefits Test and Key Employee Concentration Test despite disproportionate utilization by HCEs and Keys.

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125 Plans – Aggregation (Proposed Regulation)



- Under proposed regulation, employers may choose to aggregate multiple plans for testing purposes.
- However, aggregated plans must satisfy tests as though they were a single plan.
- Combined plan must give uniform opportunity to elect qualified benefits and actual election of qualified benefits by HCEs must not be disproportionate.

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125 Plans – Disaggregation (Proposed Regulation)



- A plan may disaggregate for testing purposes into two groups:
 - Employees with < 3 years of employment.
 - Employees who have completed 3 years of employment.
- Relevance: Are plans not permitted to disaggregate based on different criteria?
 - Same result can be achieved through multiple plans if eligibility test is satisfied by each plan.

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125 Plans – Consequences of Noncompliance (Proposed Regulation)

- HCPs or Key Employees (depending on the test that is failed) are taxed on the value of the taxable benefit with the greatest value that the employee could have elected to receive.
 - Generally, employee is taxed on any amounts that were originally contributed on a pre-tax basis.
- Employee must recognize tax in the tax year within which ends the cafeteria plan year in which the election could have been made.
 - Example: If the cafeteria plan year ends on December 31, 2008, the affected HCP/Key will need to recognize income for 2008.

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Dependent Care Assistance Plans

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Dependent Care Assistance Plans



- DCAPs must satisfy the following four tests:
 - Eligibility test.
 - Contribution or benefits test.
 - Concentration test.
 - 55% average benefits test.
- Failure to satisfy the tests will result in the inclusion of discriminatory reimbursement amounts in the gross income of the “highly compensated employees.”

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Dependent Care Assistance Plans



- Eligibility Test: Essentially the same test as applied to cafeteria plans, except that “highly compensated employee” is defined using the same definition as applies to 401(k) plans.
- Contributions or Benefits Test: Relatively little guidance on how to apply this test. Generally, are HCEs entitled to any dependent care benefits that are not available to NHCEs?
- Concentration Test: More-than-5% shareholders may not receive more than 25% of the benefits paid under the DCAP.

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Dependent Care Assistance Plans



- 55% Average Benefits Test: The average DCAP benefits provided to employees who are not HCEs under all plans of the employer must be at least 55% of the average DCAP benefits provided to HCEs under all plans of the employer.
 - This test is based on *utilization not just availability*.
 - Requires annual monitoring of elections.
 - Plan may need to be designed to exclude HCEs.

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Dependent Care Assistance Plans



- The following employees may be excluded for purposes of applying the DCAP eligibility test and the 55% average benefits test:
 - Employees with less than 1 year of service.
 - Employees who are under age 21.
 - Certain collective bargaining employees.
- For purposes of the 55% average benefits test, any employee whose compensation is less than \$25,000 may also be excluded.

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Group Term Life Insurance

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Group Term Life Insurance

- Employer contributions for group term life insurance benefits up to \$50,000 are generally not taxable to the employee.
- If a group term life insurance plan is discriminatory, “key employees” must include the value of the first \$50,000 in taxable income.

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Group Term Life Insurance

- “Key employees” include:
 - An officer with annual compensation greater than \$180,000 (for 2019; indexed);
 - A more-than-5% owner; or
 - A more-than-1-percent owner with annual compensation greater than \$150,000 (not indexed).
- Current plan year used to determine key employees (unlike 125 plan testing).

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Group Term Life Insurance

- Code § 79 requires the following two nondiscrimination tests for a group term life insurance plans:
 - Eligibility test.
 - Benefits test.

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Group Term Life Insurance



- Eligibility Test: The plan must benefit:
 - 70% or more of all employees, or
 - At least 85% of all employees who are participants who are not “key employees”, or
 - Employees who qualify under a classification set up by the employer that is not discriminatory in favor or “key employees.”
- The plan will also satisfy the eligibility test if it is part of a cafeteria plan and the Code § 125 nondiscrimination requirements are met.

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Group Term Life Insurance



- For purposes of applying the eligibility test, the following employees may be excluded:
 - Employees with less than 3 years of service.
 - Part-time or seasonal employees.
 - Certain collective bargaining employees who are not included in the plan.
 - Non-resident aliens with no U.S. source income.

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- Benefits Test:
 - All benefits available to participants who are key employees must also be available to all other participants.
 - The test will not fail merely because benefits bear a relationship to total compensation.

Educational Assistance Programs

Educational Assistance Programs



- EAP must not discriminate in favor of highly compensated employees and their spouses or dependents.
 - Same definition of HCE as for 401(k) plans, plus spouses and dependents.
- EAP must benefit those employees who qualify under a classification of employees that does not discriminate in favor of the HCEs.
- Nondiscrimination failure results in taxation for all participants – not just HCEs.

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Educational Assistance Programs



- Code § 410(b) coverage rules are applied to determine whether an EAP is discriminatory.
 - These are the coverage rules applicable to qualified retirement plans.
 - Two possible options for applying this test, similar to Code § 105(h) eligibility test.
 - Though unclear, it appears that only collectively bargained employees are excludable.

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Educational Assistance Programs

- Factors not considered in evaluating discrimination:
 - Higher utilization by the prohibited group.
 - Whether the EAP requires successful completion of the course or attaining a particular grade, or continued employment for a reasonable period.
- If the EAP restricts benefits to certain courses (such as graduate level courses), then only those who employees who could benefit are treated as eligible.

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Educational Assistance Programs

- No more than 5% of the EAP benefits during a year may be provided to more than 5% shareholders/owners and their spouses or dependents.
- Some employers exclude 5% owners from the EAP (or provide after-tax benefits) to avoid violating this rule.

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Adoption Assistance Programs

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Adoption Assistance Programs

The nondiscrimination rules applicable to educational assistance programs are also applicable to adoption assistance programs.

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The foregoing presentation is a summary of various statutes, regulations, guidance items and cases. As with any summary, some details are omitted.

This summary should not be relied upon for legal or tax advice for particular situations.