

CHAPTER 28

NONDISCRIMINATION AND HEALTH BENEFITS

Introduction

Internal Revenue Code (IRC) Sec. 105 and Sec. 106 permit employers to offer certain health benefits on a tax-free basis. However, these rules can be different for highly compensated employees (HCEs) if the health plan is self-insured and eligibility for benefits or benefits payable to the HCE is discriminatory. For purposes of IRC Sec. 105(h), an HCE (determined in the plan year for which the reimbursement was made) is:

- One of the five highest-paid officers.
- A shareholder owning (actually or constructively) more than 10 percent of the company's stock.
- Among the highest paid 25 percent of all employees.

IRC Sec. 105(h) applies to all employment-based health plans (medical, dental, and vision) in which the risk has not been shifted to an insurance company, including administrative services only (ASO) and cost-plus arrangements, possibly minimum premium plans, and medical reimbursement plans provided through an IRC Sec. 125 plan (collectively referred to as “self-insured health plans”). If such a self-insured health plan discriminates in favor of HCEs, the affected HCEs must include some or all of the value of the benefits received in their taxable income. This *imputed* income is subject to federal income taxes (but not to Social Security or Medicare taxes), and state tax liability if such liability is calculated pursuant to federal rules. Although employers are required to report such amounts on the HCEs' W2s, they are not required to withhold any taxes on these amounts. Obviously, discrimination in favor of an HCE in a self-insured health plan can result in large income tax liability exposure for the HCE. This tax liability can be avoided if the self-insured health plan is designed to avoid discrimination.

The IRC Sec. 105(h) discrimination rules do not apply to fully insured plans. When IRC Sec. 105(h) was enacted in 1978, most employee benefit programs were fully insured. Congress was concerned that self-insured health plans could potentially be used as devices for the benefit of shareholders, officials, or highly paid employees. Fully insured plans are able to protect employees from such discrimination because of the requirements imposed by state insurance laws. However, the Employee Retirement Income Security Act of 1974 (ERISA) prohibits states from regulating self-insured health plans. Accordingly, had Congress not acted to prohibit discrimination in

self-insured health plans, state law could not curtail discrimination in favor of HCEs.

The provisions of IRC Sec. 105(h) are only applicable to self-insured plans; thus the key indicator in determining applicability of IRC Sec. 105(h) is how the program is funded. The provisions also affect only persons who are current or retired HCEs. Accordingly, it is necessary to define: (1) which medical programs are subject to the discrimination rules of IRC Sec. 105(h), (2) when a program does in fact discriminate in favor of current or former HCEs, and (3) what amount of the benefit received by the HCE needs to be included in his or her income.

Programs Subject to IRC Sec. 105(h)

In essence, the IRC Sec. 105(h) requirements apply to all employment-based health plans (including health reimbursement arrangements) in which risk is not shifted to an unrelated third party. Thus, if the employer retains any of the financial risk of paying for the medical expenses incurred by employees or retirees (or their families), Sec. 105(h) may apply. An employment-based medical program is considered fully insured when the employer shifts the entire risk of medical expenses provided under the program to an unrelated third party (e.g., a state licensed insurance company). However, a plan that reimburses employees for premiums paid for fully insured plan health coverage is not subject to the nondiscrimination rules of IRC Sec. 105(h).

Discrimination—IRC Sec. 105(h) provides that a self-insured health plan may not discriminate in favor of HCEs with respect to either eligibility to participate or to benefits.

Eligibility Test—For a plan to be considered nondiscriminatory with respect to eligibility to participate, it must pass one of the three coverage tests:

- Seventy percent of all employees benefit under the plan.
- The plan benefits 80 percent of eligible employees and 70 percent of all employees are eligible.
- The plan benefits a nondiscriminatory classification of employees.

Employers who offer multiple medical options are unlikely to be able to pass either the first or the second test because employees are likely to be dispersed among the various medical options. This leaves the third test, which requires that the plan benefit a nondiscriminatory classification of employees. The IRS regulations indicate the test is conducted on the basis of plan participation (not merely eligibility to participate).

Although the IRS has not provided a definition of a nondiscriminatory classification for health plans, it would seem appropriate to use a methodology similar to the nondiscriminatory classification test that applies to qualified retirement plans (IRC Sec. 410(b) sets forth the minimum coverage requirements for qualified pension, profit-sharing, and stock-bonus plans).

Benefits Test—The IRS regulations indicate that the plan must provide the same benefits for both highly compensated and non-highly compensated employees. If a plan provides different benefits to different groups of employees (e.g., differences in waiting periods), each benefit structure is treated as a separate plan for purposes of the eligibility test described above.

A self-insured health plan discriminates as to benefits unless all benefits provided for participants who are HCEs are also provided to all other participants. All benefits for dependents of HCEs must also be available on the same basis for the dependents of all other employees. The self-insured health plan will also be considered discriminatory as to benefits if it covers HCEs and the type or amount of benefits subject to reimbursement is offered in proportion to compensation. The nondiscrimination test is applied to the benefits subject to reimbursement under the medical program and not to the actual payments or claims made. Further, a self-insured plan is not considered discriminatory just because HCEs utilize benefits to a greater extent than other participants.

If there are optional benefits available (e.g., vision and dental), these benefits will also be considered nondiscriminatory if all eligible employees can elect any of the benefits and either there is no required premium by the employee or the premium charged is the same for all employees.

An exception to the IRC Sec. 105(h) discrimination rules exists for programs that provide reimbursement for employee (but not for dependent) medical diagnostic procedures. Medical diagnostic procedures include routine medical examinations, blood tests, and X-rays; they do not include procedures for treatment, cure, or testing of a known illness or treatment or testing for an injury or symptom. Accordingly, an employer may provide for an executive “check-up” program without having to consider imputing its value to the HCE’s gross income.

Excludable Employees

In applying the rules set forth in the paragraph above, IRC Sec. 105(h)(3)(B) allows the employer to exclude the following groups of employees:

- Those who have less than three years of service at the beginning of the plan year.
- Those who are younger than age 25 at the beginning of the plan year.

- Part-time or seasonal employees.
- Those who are covered under a collective bargaining agreement.
- Nonresident aliens who receive no income from a U.S. source.

When applying the nondiscrimination test, all employees of a controlled group or affiliated service group, as defined in IRC Sec. 414, are treated as employed by a single employer.

Benefits Received and Taxable Income

If a benefit under the self-insured health plan is available to HCEs but not to other employees, the total amount of reimbursement to the HCE with respect to that benefit is an “excess reimbursement” and must be included in the HCE’s income taxes as imputed income. For example, if a self-insured dental program provides benefits only for HCEs, the value of the dental benefits paid to an HCE is imputed income to that HCE. In addition, if a plan provides maximum benefit limits subject to either the employee’s status as an HCE or based on a proportion of his or her compensation, the total value of the benefits provided to the HCE that is not provided to all other participants is an excess reimbursement subject to inclusion in the HCE’s wages as imputed income.

If the self-insured health plan discriminates in favor of HCEs as to eligibility to participate, the amount of the “excess reimbursement” that is taxable to the HCE who receives such reimbursement is computed as follows:

$$\frac{\text{Total reimbursement to HCE} \times \text{Total reimbursement to all HCEs in plan year}}{\text{Total reimbursement to all employees in plan year}}$$

For example, assume an HCE participates in a self-insured health plan that discriminates as to eligibility to participate. The HCE receives a reimbursement of \$120,000 for an open-heart surgery during the plan year. If the self-insured health plan made reimbursements of \$1 million to all HCEs in the plan year, and reimbursed all employees \$2 million in the plan year, the excess reimbursement to the HCE is \$60,000. This amount must be included on the HCE’s W-2 as imputed income (\$120,000 x \$1 million/\$2 million).

If a self-insured health plan is contributory, only that portion of the reimbursement attributable to employer contributions is subject to inclusion in the HCE’s income. All current and former employees, including current and former HCEs, are allowed to exclude benefits attributable to their own contribution under IRC Sec. 104(a)(3). Amounts attributable to employer contributions are determined in the ratio that employer contributions bear to total contributions over the three-year period prior to the year in which

the benefit was received (or, if the plan has been in effect for less than three years, the number of years the plan has been in effect). Note that the IRS treats pre-tax employee contributions like employer contributions. Thus, apportioning the taxable benefit amount for the HCE (including application of the three-year rule) applies only if the employee has made after-tax contributions to the health plan—which is unusual.

Personal Taxation Issues for the HCE

To cushion the tax liability blow slightly, HCEs may be able to deduct some of the value of qualified unreimbursed medical expenses from federal income tax on their individual tax returns, subject to IRC Sec. 213. To deduct a medical expense under IRC Sec. 213, taxpayers must determine their net unreimbursed medical expenses for the year by subtracting all reimbursements for medical expenses received from the total medical expenses paid for the year. They must then subtract 7.5 percent of his adjusted gross income from the net unreimbursed medical expenses and may deduct the balance, if any. IRC Sec. 68, which limits the overall amount of itemized deductions allowed for high-income taxpayers may also serve to reduce the HCEs' taxable income.

Taxation Issues for the Employer

The employer can deduct the full cost of medical treatment provided to employees and retirees through a program that is not fully insured as a business expense under IRC Sec. 162(a). Additional requirements apply to health programs that are provided through a welfare benefit fund, such as an IRC Sec. 501(c)(9) trust.

Conclusion

Employment-based health plans that are self-insured should be structured to avoid discrimination in favor of HCEs. The self-insured health plan must not discriminate as to eligibility to participate or as to benefits available to the HCE. Any discrimination in favor of an HCE will lead to tax consequences, specifically the inclusion of all or some part of the value of the benefits in the HCE's taxable income.

Bibliography

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Additional Information

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(866) 444-3272
www.dol.gov/ebsa/regs/fedreg/final/2001000106.htm