

Grandfathered Plans and the Section 105 Non-discrimination Rules

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Introduction

As employers have begun to sort through the grandfathered plan regulations released June 14th, many have begun to ask a simple question. Is it worth trying to maintain grandfathered status? When comparing the limitations imposed on plans to retain grandfathered status, with the additional requirements that must be followed if this status is lost, many employers are deciding that it is simply not worth retaining grandfathered status. The requirement causing the most employers to consider retaining grandfathered status is the rule that non-grandfathered, fully insured plans must comply with the Section 105 nondiscrimination rules.

The Section 105 nondiscrimination rules are complex; however, there are a number of common benefit strategies that result in a plan being in compliance with, or in violation of, the rules. A quick review of these common strategies will likely answer the question for most employers as to whether they need to worry about the detailed nondiscrimination rules. If an employer has a more complicated situation or wishes to maintain a benefits strategy that may be discriminatory, a more detailed analysis must be conducted, and expert or legal advice should be sought.

It is also important to remember that employers are free to provide highly compensated employees with additional taxable income which the employee could use to pay for extra benefits. The Section 105 testing exists to assure that benefits provided to employees on a tax free basis are limited to plans that are non-discriminatory.

Background

The Section 105 nondiscrimination rules prohibit employers from offering health benefits in a manner that discriminates in favor of highly compensated employees. These rules have applied to self-funded employer sponsored health plans for many years.

The Affordable Care Act applies the 105 nondiscrimination rules to non-grandfathered, fully-insured health plans. The rule goes into effect on the first plan year which begins after September 23, 2010. If a fully-insured plan is found to be discriminatory, a penalty will be imposed on the employer/plan sponsor. The potential penalty is discussed in detail below.

To pass the 105 nondiscrimination rules an employer must meet two separate tests:

1. The Benefits Test
2. The Eligibility Test

The names of the tests have long been the source of confusion, and subject to some criticism, since the “benefits test” considers a number of factors including eligibility, and the “eligibility test” principally measures who actually benefits under the plan!

Penalty for Non-compliance

Self-funded employers who fail the Section 105 non-discrimination rules are required to treat benefits received by highly compensated employees as taxable income. However, for discriminatory fully insured plans it appears the employer will pay a penalty of at least \$100 per day per highly compensated participant. Regulations are needed to define exactly how the employer penalty will be applied.

Highly Compensated Employees

The first thing an employer must determine is which employees are considered highly compensated individuals (HCI). Section 105 defines an HCI as:

- One of the five highest-paid officers
- A shareholder who owns more than 10% of the employer's stock

- An individual who is among the highest-paid 25% of all employees

Certain individuals can be excluded from the group of the highest 25% of paid employees and disregarded from the testing as long as they do not participate in the plan. Excluded individuals include:

- Employees who have not completed three years of service;
- Employees who have not attained age 25;
- Part-time (defined as less than 35 hours per week) or seasonal employees;
- Collectively bargained employees; and
- Nonresident aliens who receive no U.S. source earned income.

Step 1 – Perform a Quick Check

Before analyzing the 105 requirements in detail, an employer can consider these “quick check” criteria.

The Quick Check #1 – Employer Passes

Barring special circumstances, such as a plan being part of a common control group according to the IRS 414 rules, an employer who offers benefits in the following way would not violate the 105 nondiscrimination rules.

- An employer offers the identical health benefits to all full-time employees, with the same contribution requirements regardless of age, years of service, or compensation.
- Employees covered by a collective bargain agreement, and not covered by the plan, can be ignored for testing purposes. These employees can be offered a separate plan with different benefits and different contribution requirements.

It is possible for an employer to offer health benefits in a manner that varies in terms of eligibility, coverage or contribution for different employees, but then it must consider and pass the Section 105 tests.

Quick Check #2 – Employer Fails

If an employer offers health benefits that clearly favor individuals in the highly compensated group (defined above) in terms of benefits, eligibility or contribution, the plan will likely fail the 105 rules based on the “benefits test” described below.

Step 2 – Perform the Section 105 Tests

This summary will provide enough detail for most employers to perform an analysis of how the rules apply to their plan. However, there are additional strategies (i.e. combining multiple plans into one plan or creating complex classifications of employees) that have been used by some employers wishing to offer dissimilar benefits to separate groups of employees. Any employer considering one of these more complex approaches should seek the advice of a qualified advisor or legal counsel.

1 - The Benefits Test

The benefits test has two components;

- Is the plan offered in a manner that is discriminatory on its face?
- Is the plan operated in a discriminatory manner?

The statute requires that “all benefits provided for [HCIs]...are provided for all other participants” ... and that “all the benefits available for the dependents of HCIs must also be available on the same basis for dependents of all non-HCI participants.”

“Discriminatory on its face”

A plan must meet the following four requirements to be considered nondiscriminatory on its face.

1. Required employee contributions must be the same for HCIs and non-HCIs for each benefit level.

2. The same type of benefits that are available to HCIs must be available to non-HCIs.
3. The maximum benefit level cannot vary based on age, years of service, or compensation.
4. HCIs and non-NHCIs must have the same waiting periods.

Differences can exist in these areas between different classes of employees as long as the requirements of the eligibility test are met (discussed below). For example, an employer could have different contribution requirements for salaried employees vs. hourly employees, but not for “executives” vs. other employees.

“Discriminatory in operation”

A less common reason for a plan to be deemed discriminatory is in its actual operation. For example, if a plan added a benefit for a particular treatment for one plan year during which an HCI received coverage for that treatment, then terminated the benefits as soon as the HCI no longer needed the treatment, the plan would be discriminatory.

2 - The Eligibility Test

An employer passes the eligibility test if it passes any one of three different tests.

- The 70% Test – At least 70% of employees must benefit from the plan.
- The 70%/80% Test - If at least 70% of all non-excludable employees are eligible, the plan benefits at least 80% of the eligible employees.
- The Nondiscriminatory Classification Test - The plan benefits a nondiscriminatory classification of employees. This test requires (1) eligibility based on a bona fide business classification, and (2) a sufficient ratio of benefiting non-HCIs to benefiting HCIs.

The first two tests provide a method to pass the eligibility test using a clear measure of participation rates. If the employer does not meet either of these tests it may still pass based on the more subjective classification test. There is some debate whether employees need to actually enroll in, or simply be eligible for, the plan to be counted in the eligibility test. The more conservative approach, and the approach we recommend, is to count only the employees who actually enroll in a benefit.

The 70% test example

XYZ Company has 100 employees

- All employees are eligible for the health benefits
- 30 employees are considered highly compensated individuals
- 10 employees have less than 3 years of service and excluded from testing
- 65 non-excludable employees (counting both HCIs and NHCIs) actually participate in the plan

The employer passes the 70% test - Participation equals 72% ($65 \div 90$)

The 70%/80% test example

XYZ Company has 100 employees

- 70 employees are eligible for the health benefits
- 30 employees are considered highly compensated individuals
- 56 non-excludable employees (counting both HCIs and NHCIs) actually participate in the plan

The employer passes the 70%/80% test - 70 % are eligible (70 of 100) and 80% of the eligibles participate ($56 \div 70$).

The Classification Test

Employers need to consider this test if it offers different benefits to different groups of employees and cannot meet either of the first two eligibility tests. There are a number of strategies employers can consider when attempting to pass the classification test. This summary describes a common approach most employers can use to determine if they offer benefits in a non-discriminatory manner. If an employer fails to meet the requirements described below, it may still be possible to pass the test using a

more complex strategy such as combining multiple plans into a single plan. If an employer wants to consider other alternatives they should retain a qualified advisor or legal counsel.

To meet the classification test the employer must show two things:

1. Benefits are offered based on reasonable classifications
2. The classifications are not discriminatory in favor of highly compensated employees

Benefits must be offered to employees based on reasonable classifications.

The rules allow an employer to offer different benefits to different “reasonable” classifications of employees. Reasonable classifications generally include specified job categories, nature of compensation (i.e., salaried or hourly), geographic location, and similar bona fide business criteria.

Classifications are not discriminatory

The IRS will consider the “facts and circumstances” of the classifications to determine if classifications are discriminatory. If the employer is not confident their classifications will be deemed non-discriminatory the employer may be able to meet the safe harbor test described below. The subjective criteria considered include:

- The underlying business reason for the classification. The greater the business reason for the classification, the more likely the classification is to be nondiscriminatory.
- The percentage of the employer's employees benefiting under the plan. The higher the percentage, the more likely the classification is to be nondiscriminatory;
- Whether the number of employees benefiting under the plan in each salary range is representative of the number of employees in each salary range of the employer's workforce.

As stated above, the classifications are also not discriminatory if the employer can meet an objective “safe-harbor” test. The test compares ratio of the % of NHClS to HClS who participate in the plan

The safe-harbor test involves comparison of participation rate to a table included in the regulations. The results of a simple formula may answer the question for most employers.

- Compare the % of NHClS who participate in the plan to the % of HClS who participate.
- If the NHClS participant rate is at least 50% of the rate HClS participate, the plan passes.

This is a fairly low bar to meet. An employer would have to have very low NHCl participation to fail this test. Obviously an example will best illustrate this concept!

- Employer XYZ has 150 non-excludable employees - 100 NHClS, 50 HClS
- All 50 of the 50 HClS participate (100%)
- Only 50 of the 100 NHClS participate (50%)
- The ratio equals 50% ($50\% \div 100\%$) and the employer meets the safe harbor.

It is possible to pass the safe harbor with even lower participation of NHClS. For the sake of simplicity this more complex calculation is described in the appendix at the end of this paper.

Summary

As described in the introduction, many employers will pass the Section 105 non-discrimination rules simply because they offer the same benefits and contributions to all employees. Employers who vary their benefits or contributions for different groups of employees need to carefully consider the Section 105 non-discrimination rules to avoid paying what could be a significant penalty.

Appendix 1 – Safe Harbor Test

Step 1: *Determine the Plan's Ratio Percentage.* A plan's Ratio Percentage means the percentage determined by dividing the percentage of the non-HCIs who benefit under the plan by the percentage of HCIs who benefit under the plan. Again – consider the example used in summary above:

- Employer XYZ has 150 non-excludable employees - 100 NHCI, 50 HCIs
- All 50 of the 50 HCIs participate (100%)
- Only 50 of the 100 NHCI participate (50%)
- The ratio equals 50% (50% ÷ 100%)

Step 2: *Determine the Plan's Non-HCI Concentration Percentage.* A plan's Non-HCI Concentration Percentage means the percentage of all employees of the employer who are non-HCIs. Employees who can be excluded are not taken into account.

Step 3: *Determine the Safe Harbor Percentage from the Nondiscriminatory Classification Table.* Next, the employer must determine the applicable Safe Harbor Percentage for the plan by consulting the Code §410(b) Nondiscriminatory Classification Table published by the IRS. The Non-HCI Concentration Percentage determined in step 1 dictates the applicable Safe Harbor Percentage. The test is easier to pass as the percentage of non-highly compensated employees increases.

Examine the Nondiscriminatory Classification Table, find the applicable Non-HCI Concentration Percentage in left column, and match that with the corresponding Safe Harbor Percentage. For example, if the Non-HCI Concentration Percentage is 75%, the applicable Safe Harbor Percentage is 38.75%.

Nondiscriminatory Classification Table

Non-HCI Concentration Percentage	Safe Harbor Percentage
0-60	50.00
61	49.25
62	48.50
63	47.75
64	47.00
65	46.25
66	45.50
67	44.75
68	44.00
69	43.25
70	42.50
71	41.75
72	41.00
73	40.25
74	39.50
75	38.75

76	38.00
77	37.25
78	36.50
79	35.75
80	35.00
81	34.25
82	33.50
83	32.75
84	32.00
85	31.25
86	30.50
87	29.75
88	29.00
89	28.25
90	27.50
91	26.75
92	26.00
93	25.25
94	24.50
95	23.75
96	23.00
97	22.25
98	21.50
99	20.75

Step 4: *Compare the Plan's Ratio Percentage With the Safe Harbor Percentage.* Compare the Ratio Percentage from Step 1 with the Safe Harbor Percentage from Step 3. If the plan's Ratio Percentage is equal to or greater than the Safe Harbor Percentage, then the plan's employee classification meets the safe harbor and is deemed nondiscriminatory.

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