

## Health Care Reform: Nondiscrimination Rules

*In March, President Obama signed the Patient Protection and Affordable Care Act (PPACA) and the Health Care and Education Reconciliation Act of 2010 (HCERA), together referred to as the Act. This e-alert is the latest in a series of e-alerts on health care reform and provides additional information about nondiscrimination rules that now apply to insured plans.*

Effective plan years beginning on or after September 23, 2010, PPACA requires non-grandfathered insured health plans to comply with the nondiscrimination rules of Internal Revenue Code (Code) section 105(h)(2). On September 23, 2010, the Internal Revenue Service (IRS) issued a notice requesting public comment on how this rule should apply to non-grandfathered insured health plans.

### Basic Rule

Code section 105(h)(2) generally prohibits discrimination in favor of highly compensated individuals in eligibility to participate and in benefits provided. A "highly compensated individual" is an individual who is one of the five highest paid officers, a shareholder who owns more than 10% in value of the stock of the employer, or among the highest paid 25% of all employees.

Historically, Code section 105(h)(2) has applied only to self-funded health plans. Now, insured health plans, if non-grandfathered, must also comply with Code section 105(h)(2). Code section 105(h)(2) continues to apply to self-funded health plans regardless of whether the plan is grandfathered.

### Application of the Nondiscrimination Rule to Insured Health Plans

PPACA states that nondiscrimination rules "similar to" those applicable to self-funded plans will apply to non-grandfathered insured plans. Based on this limited language, the following plan designs potentially could be discriminatory:

- Requiring non-highly compensated employees to pay a higher premium contribution than highly compensated individuals
- Tying the level of benefits to years of service or compensation
- Providing different, more favorable, benefits to highly compensated individuals

#### POSTED:

Nov 10, 2010

#### RELATED PRACTICES:

##### [Employee Benefits](#)

<https://www.reinhartlaw.com/practices/employee-benefits>

- Offering highly compensated individuals a shorter waiting period for benefits than non-highly compensated employees

Whether these scenarios would actually be discriminatory will depend upon the pending IRS guidance, which is expected by the end of 2010 or early 2011.

## Penalties for Noncompliance

A non-grandfathered insured health plan that fails to comply with Code section 105(h) will be subject to an excise tax penalty of \$100 per individual discriminated against for each day the plan does not comply. The penalty is capped at \$500,000. Plan sponsors are required to self-report the excise tax on Form 8928. A non-grandfathered insured health plan also could be subject to a civil action to compel it to provide nondiscriminatory benefits.

Small employers may be exempt from the excise tax penalty in limited circumstances. For these purposes, a "small employer" is an employer who employed, on average, between two and fifty employees on business days for the preceding calendar year and who employs at least two employees on the first day of the plan year. Where a small employer provides health insurance coverage solely through an insurance contract with a health insurance issuer, no excise tax penalty will be imposed on the small employer for a failure to meet the nondiscrimination rules if the failure is solely the fault of the issuer. Thus, if the health insurance issuer offered discriminatory benefits, the issuer would be subject to a civil money penalty but the small employer would not be subject to the excise tax. However, if the issuer offered nondiscriminatory coverage but the small employer provided the coverage to its employees in a discriminatory manner, then the small employer would be subject to the excise tax penalty. For example, if the issuer offered the same benefits to all employees in the group, but the employer charged its highly compensated employees a lower contribution for the coverage than its non-highly compensated employees, any penalty would be imposed on the employer rather than the issuer.

The penalties for noncompliance imposed on non-grandfathered insured plans are markedly different than those for self-funded plans. Whereas noncompliant, non-grandfathered insured plans are subject to tax or money penalties, noncompliant self-funded plans are subject to no penalty. Instead, the benefits the self-funded plan provides to highly compensated individuals lose their beneficial tax status and are included in the individuals' gross income.

## Action Items

Plan sponsors should prepare to act quickly to revise plans to eliminate any potentially discriminatory benefits. So far, the IRS has not indicated that it will grant interim relief from these rules. Practically, the IRS may be forced to provide a grace period for enforcement. Plan sponsors will have little time to review IRS guidance and incorporate compliance changes to existing plans. In the interim, plan sponsors should begin to review plans and identify potentially problematic provisions, such as those listed above, and consider their options.

Assuming that the rules for non-grandfathered insured health plans will be the same as those for self-funded plans, the plan design items listed above could be problematic and will have to undergo benefits and eligibility testing. Whether a plan design is discriminatory will depend on the demographics of the employer and on the results of such testing.

Plan sponsors should also be aware of the potential collateral implications of having a discriminatory plan design, such as having to renegotiate contracts with executives. Because highly compensated individuals themselves may not be penalized, it may be difficult to modify existing contractual arrangements since they will have little incentive to agree to any modification. Plan sponsors have options available, however, including:

- Keeping the highly compensated individuals in the plan, making the plan design compliant and increasing these individuals' gross income to offset a loss in favored health benefits
- Removing the highly compensated individuals from the plan and giving them a cash payment that they can use to purchase their own coverage
- Replacing the insured benefit with self-funded benefits and requiring the highly compensated individuals receiving the discriminatory benefits to pay the fair market value of such coverage

Any modifications to health coverage provided following termination of employment should be evaluated in light of the nonqualified deferred compensation rules of Code section 409A.

*These materials provide general information which does not constitute legal or tax advice and should not be relied upon as such. Particular facts or future developments in the law may affect the topic(s) addressed within these materials. Always consult with a lawyer about your particular*



*circumstances before acting on any information presented in these materials because it may not be applicable to you or your situation. Providing these materials to you does not create an attorney/client relationship. You should not provide confidential information to us until Reinhart agrees to represent you.*