Employers should review these new requirements when considering possible changes to their group health plans for 2011 because an employer that maintains a discriminatory insured group health plan that violates the new requirements may be subject to significant excise taxes.

New Nondiscrimination Requirements

Under the Act, an insured group health plan that is not “grandfathered” will need to satisfy the nondiscrimination requirements of Section 105(h)(2) of the Internal Revenue Code (the Code). Section 105(h)(2) requires that: (1) the plan not discriminate in favor of highly compensated individuals (HCIs) as to eligibility to participate, and (2) the benefits provided under the plan not discriminate in favor of participants who are HCIs.

Prior to the Act, the nondiscrimination requirements of Section 105(h)(2) applied only to self-insured group health plans. The consequence of maintaining a self-insured group health plan that fails to satisfy the requirements of Section 105(h)(2) is that all or a portion of the benefits provided to HCIs are taxable.

The Act extends the nondiscrimination requirements of Section 105(h)(2) to insured group health plans through new provisions enacted under the Code and the Employee Retirement Income Security Act (ERISA). It also provides that rules similar to the rules under Code Section 105(h) relating to nondiscriminatory eligibility classification, nondiscriminatory benefits and certain controlled groups will apply. The Act further provides that the HCIs will be determined under Code Section 105(h)(5). However, if an insured group health plan is discriminatory, the employer will be subject to excise taxes (discussed below), rather than the benefits being taxable to the HCIs, which is the rule for self-insured plans.

The IRS has requested comments regarding the new requirements, but has not issued proposed regulations or other guidance on how the new requirements should be applied. In
the absence of guidance, it is not clear how the nondiscriminatory eligibility and benefits requirements will be applied to insured group health plans. The IRS may determine that the same nondiscrimination tests will apply or, possibly, that less strict (and more flexible) nondiscrimination tests should apply. Therefore, this is not only an issue for insured group health plans maintained solely for executives, but may also encompass an employer’s group health plan for all employees.

The nondiscrimination tests of Section 105(h) are complex.\(^6\) If an employer offers one or more insured group health plans (or insured benefit options) or requires different employee contributions for different benefit options, then such nondiscrimination testing will be required going forward in order to avoid excise taxes.

**Excise Taxes and Civil Enforcement**

Failure to satisfy the new nondiscrimination requirements may subject an employer to significant excise taxes. Code Section 4980D generally imposes an excise tax of $100 per day per individual subject to discrimination, if an insured group health plan fails to satisfy the requirements of the new provision.

For example, if a group health plan covers 100 participants and provides discriminatory benefits to four HClS, the employer will be subject to an excise tax of $9,600 per day for each day that the plan is discriminatory.

Also, an employee who is subject to discrimination under an insured group health plan that fails to satisfy the new requirements under ERISA may be able to file a civil action under ERISA to compel the plan to provide nondiscriminatory benefits.

**Preparing for 2011 Nondiscrimination Testing**

We recommend that employers prepare for the new nondiscrimination requirements by identifying their insured group health plans and benefit options that will be subject to the new requirements. Because insured executive-only plans will likely not satisfy the nondiscrimination requirements, they will likely need to be terminated unless they are “grandfathered.” With respect to group health plans, employers should also determine the employees who will be included in the testing and conduct preliminary testing to determine whether a plan or benefit option is likely to satisfy the requirements. Also, we recommend that employers review the potential nondiscrimination testing consequences when considering any changes to their plans.

**Endnotes**

1. The health care reform legislation was enacted in two laws: the Patient Protection and Affordable Care Act, signed by President Obama on March 23, 2010, and the Health Care and Education Reconciliation Act, signed on March 30, 2010.

2. Please refer to our Alert No. 1048, “Health Care Reform — Is Your Health Plan Coverage Grandfathered?” for a discussion of the “grandfathering” rules under the Act. Employers should carefully consider these “grandfathering” rules and, in particular, whether changes in coverage will subject a plan (or benefit packages under a plan) to the new nondiscrimination requirements. If an insured plan (or benefit package under a plan) ceases to be “grandfathered,” the employer should determine whether it can demonstrate that the plan (or benefit package) satisfies the new requirements.

3. Treasury Regulation Section 1.105-11 sets forth the nondiscrimination requirements and determines the taxable benefits of a plan that fails to satisfy the requirements. These rules continue to apply to self-insured group health plans.
A plan may need to demonstrate that each plan or benefit option satisfies the nondiscriminatory classification test under Section 410(b). The nondiscriminatory classification test under Section 410(b) generally requires that (1) the classification of employees be reasonable and based on objective business criteria and (2) the ratio percentage (determined by the percentages of HCIs and non-HCIs participating under the plan or benefit option) meet a specified threshold. Treasury Regulation Section 1.410(b)-4. The Internal Revenue Service concluded in a 1994 Field Service Advisory that taxpayers may apply the nondiscriminatory classification standards under the current Treasury Regulations under Code Section 410(b), or the standards under Code Section 410(b) that applied prior to the Tax Reform Act of 1986.

A group health plan generally satisfies the nondiscriminatory benefits requirement if all benefits provided to participants who are HCIs are provided to all other participants. The regulations under Section 105(h)(2) provide that the optional benefits offered under a plan will be treated as a single benefit, but only if (1) all eligible participants may elect any of the options, and (2) either there are no required employee contributions or the required employee contributions are the same amount.
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