

Healthcare Reform Means Problems for Management Carve-out Groups

The new healthcare reform laws create problems for insured management carve-out groups. If there is one single reason for insured groups to try to maintain grandfathered status, this is it.

Insured group health plans must now comply with nondiscrimination rules that previously applied only to self-funded plans. The new rules apply to non-grandfathered management carve-out groups. (The nondiscrimination rules do not apply to “grandfathered” insured management carve-out groups.) Nondiscrimination testing applies to eligibility, benefits, and controlled groups, and testing failure will mean the group will have to pay very high excise tax penalties. The penalty applies to groups 50+.

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One of the goals of healthcare reform is to provide health insurance coverage to as many people as possible. The federal government is purposefully making it difficult to maintain existing health coverage. Likewise, it is requiring significant added tax exposure to groups who wish to provide any coverage, or better coverage, to certain classes of employees.

A plan that treats all employees the same (providing coverage to all who are eligible; with the same waiting periods; treating no one differently based on age, years of service, or compensation; with no differences in maximum reimbursement amounts, types of expenses reimbursed, etc.) generally needn't be concerned with the nondiscrimination issue. But treating employees differently in any way, whether in the plan document or in operation, raises red flags that should be checked with legal counsel or a tax advisor. Tax consequences can be steep.

Certain requirements in IRC Sec. 105(h) were made applicable to insured group plans under the Public Health Service Act. Effective for plan years beginning on or after September 23, 2010, an insured group health plan is prohibited from discriminating in favor of “highly compensated individuals” based on tests “similar to those used for self-insured plans.” For insured plans, there is an excise tax penalty for noncompliance with Sec. 105(h) nondiscrimination requirements. (The penalty does not apply for small employers between 2 and 50 employees.) This treatment differs from self-insured plans, which requires that nondiscriminatory benefits provided to highly compensated individuals be included in the highly compensated individual's taxable income.

DO SEC. 105(H) NONDISCRIMINATION REQUIREMENTS APPLY TO INSURED GRANDFATHERED PLANS?

Insured grandfathered group plans are not subject to Sec. 105(h) testing requirements. Self-insured group plans remain subject to Sec. 105(h) nondiscrimination rules as they existed prior to Health Care Reform, whether or not they are grandfathered. Losing grandfathered plan

status will require an insured plan to pay attention to the nondiscrimination rules and failure impacts.

WHO IS RESPONSIBLE FOR PERFORMING SEC. 105(H) NONDISCRIMINATION TESTING – THE INSURER OR THE GROUP HEALTH PLAN/PLAN SPONSOR?

Health Care Reform applies an excise tax penalty in the amount of \$100 per day for each individual with respect to which the failure relates, if an insured group health plan of 50+ employees discriminates in favor of highly compensated individuals. Employers subject to the penalty are required to self-report and pay the excise tax using IRS Form 8928. The responsibility for performing Sec. 105(h) testing rests with the employer/plan sponsor of the group health plan and not the insurer since the penalty is assessed against the employer/plan sponsor.

Caution Regarding Definition of Highly Compensated Individual (HCI). Code §105(h)(2) uses the term “highly compensated individuals” (HCIs) to refer to the individuals in whose favor discrimination is prohibited under the Code § 105(h)(2) rules. The definition of HCIs for Code § 105(h)(2) testing differs from the definition of HCIs for Code § 125 testing. It also differs from the definition of “highly compensated employee” under Code § 414(q) that is used for testing some employee benefit plans that are subject to nondiscrimination requirements under the Code. Using the wrong definition for testing will often yield incorrect test results. (Source: *EBIA Health Care Reform Manual*)

ARE ALL FULLY INSURED GROUP HEALTH PLANS SUBJECT TO THE SECTION 105(H) NONDISCRIMINATION TESTING REQUIREMENTS, OR IS THERE AN EXCEPTION FOR SMALL EMPLOYERS/SMALL PLANS?

The nondiscrimination testing requirements for insured group health plans were added as an amendment to the Public Health Services Act. There are no exceptions for small plans under this provision of Health Care Reform. Therefore, absent further guidance, even small employers may be subject to Sec. 105(h) nondiscrimination testing on their insured group health plans. However, because small employers with between 2 and 50 employees would not be required to pay the excise tax penalty, there appears to be no specific consequence for failure to perform Sec. 105(h) testing for small employers.

HOW DOES A GROUP SATISFY THE ELIGIBILITY RULES?

A plan satisfies the eligibility requirements if the plan benefits:

- (1) 70% or more of all employees, or
- (2) 80% or more of all the employees who are eligible to benefit under the plan if 70% or more of all employees are eligible to benefit under the plan. (This second percentage test requires a minimum of 56% of employees (80% x 70%).) The nondiscrimination classifications test follows the rules of pension plans, which notes that reasonable classifications generally include specified job categories, compensation categories such as hourly or salaried, and geographic location. Identifying employees by name is not a reasonable classification.

In running the eligibility test, employers can exclude employees who have not completed three years of service; employees under age 25; part-time or seasonal employees; union employees; and employees who are nonresident aliens and who receive no earned income.

HOW DOES A GROUP SATISFY THE BENEFITS RULES?

In addition to the eligibility rules, all benefits provided to highly compensated employees must be provided to all other participants. There are two requirements—nondiscriminatory benefits on the face of the plan and nondiscriminatory benefits in operation. Using the same definition as for self-funded plans (Sec. 105(h)(5)), a highly compensated individual is defined as:

- (1) one of the five highest paid officers, or
- (2) a shareholder who owns more than 10% in value of the stock of the employer, or
- (3) is among the highest 25% of employees ranked by pay.

Accordingly, roughly 25% of employees (including most closely-related domestic affiliates) will be classified as “highly compensated” under this definition, regardless of how much money they earn.

HOW DOES A GROUP SATISFY THE CONTROLLED GROUP RULES?

The controlled group rules for pension plans apply (Sec. 414(b), (c), and (m)). These rules specify that employees of controlled groups of corporations and partnerships and employees of affiliated services groups are to be treated as employees of a single employer.

Having different waiting periods for different classes of employees or contributing different amounts of employer subsidies toward premiums for different classes of employees could cause a plan to fail its annual Sec. 105(h) nondiscrimination test. Also, a plan with two or more benefit options that do not have substantially the same benefits could fail nondiscrimination testing if the highly-compensated individuals tend to elect the benefit option with the better benefit and the non-highly-compensated individuals elect the other option. If any of these circumstances apply to a plan, compliance with the Sec. 105(h) nondiscrimination rules could have a significant impact.

Insured groups that have management carve-outs need to protect their grandfather status. It appears that if an insured group 2-50 wants to move to a non-grandfathered management carve-out plan, it may do so without having to pay an excise tax penalty. However, the same group that is 50+ would be subject to excise taxes for maintaining a non-grandfathered management carve-out plan. With excise tax penalties due of \$100 per day per impacted employee, the taxes are cost prohibitive. The long-term ability to maintain management carve-out plans is unlikely.

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