



JONES DAY  
**COMMENTARY**

## FULLY INSURED GROUP HEALTH PLANS MAY NO LONGER PROVIDE DISCRIMINATORY BENEFITS

The Patient Protection and Affordable Care Act, as amended (“PPACA”), extends the prohibition against discriminating in favor of highly compensated individuals to nongrandfathered fully insured group health plans, effective for plan years beginning on or after September 23, 2010. This prohibition has long applied to self-insured medical reimbursement plans under Section 105(h) of the Internal Revenue Code (the “Code”). Many employers have used fully insured coverage to avoid the Section 105(h) prohibition but must now reconsider these benefits. This prohibition is implicated in situations as varied as: (i) coverage provided only to management; (ii) management paying a lower premium or receiving benefits in addition to those provided to staff; and (iii) special post-termination continuation coverage provided to management.

The Department of the Treasury, with the approval of the Departments of Labor and Health and Human Services, recently issued Notice 2010-63, requesting comments on requirements prohibiting discrimination

in favor of highly compensated individuals in insured group health plans. In addition to requesting comments, this Notice sheds some light on the views of the Departments regarding this rule and penalties for its violation.

### THE SECTION 105(h) NONDISCRIMINATION RULE

To understand the new prohibitions for insured plans, one needs to revisit the nondiscrimination rules that apply to self-insured arrangements. Section 105(h) of the Code, which became effective on January 1, 1980, provides that if a self-insured medical reimbursement plan discriminates in favor of highly compensated individuals as to eligibility or benefits, then any “excess reimbursement” to a highly compensated individual under the plan is includible in such individual’s gross income (herein, the “Section 105(h) Nondiscrimination Rule”). This Rule applies to

all health benefits, including dental and vision coverage, but only applies to the extent the coverage is provided on a pre-tax basis, either through employer contributions that are excluded from the employee's gross income or employee contributions paid on a pre-tax basis. Health coverage is typically provided in this tax-advantaged manner.

**Nondiscrimination Tests.** Section 105(h) sets forth two separate tests for determining whether a plan is discriminatory: one test deals with whether a plan is discriminatory with respect to eligibility, and the other assesses discrimination with respect to benefits. The tests are fairly complex. A general overview of the tests is provided in the following paragraphs. The tests are applied on a controlled group basis, meaning that all employers within a controlled group are treated as a single employer for purposes of these tests. In addition, existing guidance does not provide for a grace period following a merger or acquisition, meaning that without advance planning, such an event may result in a violation.

**Highly Compensated Individual.** A specific definition of "highly compensated individual" applies for purposes of the Section 105(h) Nondiscrimination Rule. This definition is different from (and generally broader than) the definition that applies in other benefits nondiscrimination contexts. For purposes of this Rule, highly compensated individual means an individual who is (i) one of the five highest paid officers; (ii) a shareholder who owns more than 10 percent in value of the stock of the employer (stock owned indirectly or by certain family members is attributed to the shareholder); or (iii) one of the highest paid 25 percent of all employees (other than excluded employees who are not participants). Under this definition, every employer, regardless of size or ownership, will have employees who are considered "highly compensated individuals" for these purposes, even if those employees' compensation would not ordinarily be considered high.

**Excluded Employees.** In testing for discrimination, the following employees may be disregarded: (i) employees with less than three years of service; (ii) employees under age 25; (iii) part-time or seasonal employees; (iv) collectively bargained employees if health coverage was a subject

of bargaining; and (v) nonresident aliens who received no earned income that constitutes income from sources within the United States.

**Benefits Nondiscrimination Test.** In order to pass the benefits nondiscrimination test, all benefits available to participants who are highly compensated individuals or their dependents must be available to all other participants or their dependents (regardless of whether they are excluded employees). There is an exception for employee physicals, thus allowing for executive physical programs. If a discriminatory benefit is available to highly compensated individuals, the amount of the excess reimbursement (*i.e.*, the amount that is taxable to the employee) is the total amount of the discriminatory benefit actually paid by the plan. For example, if a highly compensated individual is eligible for coverage at no cost, while other participants must pay a premium for coverage, the coverage available to highly compensated individuals and their dependents at no cost is discriminatory. If a highly compensated individual or his or her dependent uses the coverage, the total cost of all benefits paid with respect to the highly compensated individual or dependent(s) under the coverage is includible in that individual's gross income.

**Eligibility Nondiscrimination Test.** In order to pass the eligibility nondiscrimination test, the plan must benefit either 70 percent or more of all employees (ignoring excluded employees) or 80 percent or more of the employees who are eligible to benefit under the plan (if 70 percent or more of all employees are eligible to benefit, again ignoring excluded employees). Alternatively, the plan must benefit a classification of employees set up by the employer and found by the Internal Revenue Service to be nondiscriminatory. Generally, a classification is nondiscriminatory if it is reasonable and established under objective business criteria. For example, providing different benefits to employees based on the geographic location of their worksite would typically be found nondiscriminatory. However, providing better benefits only to employees at the executive headquarters (where most employees are highly compensated individuals) would likely be viewed as discriminatory, despite the geographic location distinction.

If the plan is discriminatory with respect to eligibility, the amount of the excess reimbursement (taxable to the employee) equals a percentage of all benefits paid by the plan on behalf of that individual (including for dependents). The percentage equals the total cost of benefits paid on behalf of all highly compensated individuals during the plan year divided by the total cost of benefits paid on behalf of all participants during the plan year. The percentage is not applied with respect to benefits found discriminatory under the benefits nondiscrimination test, as those benefits are already 100 percent taxable as discriminatory benefits.

## THE FULLY INSURED NONDISCRIMINATION RULE

PPACA extends the concept of the Section 105(h) Nondiscrimination Rule to fully insured “group health plans” (the “Fully Insured Nondiscrimination Rule”). However, the extension does not merely apply the same rules in the fully insured context. There are a number of differences between the two Rules. In particular, the categories of plans subject to each of the Rules are different (in more ways than just their method of funding), and the penalties for violating each of the two Rules are different. After regulations are issued, there may be additional differences, given that PPACA requires that “rules similar to” the Section 105(h) rules apply only in the context of fully insured group health plans.<sup>1</sup>

### **Plans Subject to the Fully Insured Nondiscrimination Rule.**

While the Section 105(h) Nondiscrimination Rule applies to all self-insured medical reimbursement plans, the Fully Insured Nondiscrimination Rule applies only to fully insured “group health plans,” a term that is specifically defined and subject to various exceptions. These exceptions include retiree-only plans and certain enumerated excepted benefits. Further,

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<sup>1</sup> PPACA amends the Public Health Services Act to add a new section 2716, which provides, “[a] group health plan (other than a self-insured plan) shall satisfy the requirements of section 105(h)(2) of the Internal Revenue Code of 1986.... For purposes of this [provision] ... [r]ules similar to the rules contained in paragraphs (3), (4), and (8) of section 105(h) of [the] Code shall apply ... [and] [t]he term “highly compensated individual” has the meaning given such term by section 105(h)(5) of [the] Code.” PPACA also incorporates this provision by reference into the Code and the Employee Retirement Income Security Act (ERISA).

the Fully Insured Nondiscrimination Rule does not apply to “grandfathered” group health plans under PPACA. Finally, given that the Fully Insured Nondiscrimination Rule, by its terms, applies only to group health plans, presumably it does not apply to individual policies. However, a nongrandfathered, fully insured group health plan providing coverage to active employees (as well as former employees) is subject to the Fully Insured Nondiscrimination Rule.

**Former-Employee-Only Plan Exception.** Pursuant to agency guidance, certain PPACA changes, including the Fully Insured Nondiscrimination Rule, do not apply to plans that have less than two current employees. Subject to any mandatory aggregation rules that might be included in future guidance to prevent avoidance of the Fully Insured Nondiscrimination Rule, group health plans that cover only retirees and/or former employees may benefit from this exception. The plan would need to be separate from all other group health plans of the company. In addition, current employees (including, potentially, spouses and dependents of former employees) would need to be excluded from coverage. This exception and potential pitfalls in using it are discussed in more detail in a separate *Jones Day Commentary*, titled [“The Retiree-Only Plan Exception: Is It Still Effective after Health Care Reform?”](#)

**Excepted Benefits Exception.** Pursuant to agency guidance, certain PPACA changes, including the Fully Insured Nondiscrimination Rule, do not apply to certain “excepted benefits” set forth in the law. Excepted benefits include dental benefits, vision benefits, accident or disability income coverage, long-term care coverage, coverage for a specific disease or illness, hospital or fixed indemnity coverage, and Medicare supplemental health coverage. Excepted benefits generally must be offered independently from other group health plan coverage. In other words, participants must have a separate right to elect the coverage, and the terms of the two coverages must be distinct from each other. In some instances, the excepted benefits coverage cannot coordinate with or be based on the coverage provided by a group health plan of the same plan sponsor.

**Grandfathered Plans.** Group health plans and health insurance coverage in which at least one individual was enrolled on March 23, 2010 are “grandfathered” and not subject to certain provisions of PPACA, including the Fully Insured Nondiscrimination Rule. A grandfathered plan or coverage is not subject to the Fully Insured Nondiscrimination Rule, even with respect to participants who later enroll in the plan or coverage and even if all individuals who were enrolled on March 23, 2010 are no longer enrolled. Grandfathering can be lost if certain provisions of the plan or coverage are changed or if the plan or coverage terminates or ceases to cover any individuals. In addition, under current guidance, grandfathering is lost if a replacement policy is issued, either by the current insurer or a new insurer. Therefore, grandfathered status is likely not a good long-term strategy for avoiding the Fully Insured Nondiscrimination Rule for most fully insured plans, but it may provide “breathing room” to determine what long-term strategy to pursue. The grandfathered plan rules are discussed in more detail in a *Jones Day Commentary*, titled [“The More Things Change, the More They Stay the Same: Is it Worth Maintaining Grandfathered Status Under the New Health Care Law?”](#)

**Individual Policies.** The Fully Insured Nondiscrimination Rule applies only to group health plans. Therefore, individual policies that do not constitute, or are not treated as part of, a group health plan would not be subject to the Fully Insured Nondiscrimination Rule. In the ERISA context, courts have determined that an individual policy may be treated as a group health plan when it is issued to cover employees who were formerly covered under one group plan. See, e.g., *Tucker v. Employers Life Ins. Co.*, 689 F. Supp. 1073 (N.D. Ala. 1988) (individual policies issued to several employees collectively constituted a group health plan governed by ERISA). Therefore, there is some risk in relying on the use of individual policies to avoid application of the Fully Insured Nondiscrimination Rule.

## PENALTY FOR VIOLATING THE FULLY INSURED NONDISCRIMINATION RULE

As discussed above, the penalty for violating the Section 105(h) Nondiscrimination Rule is that the highly compensated individual is subject to income tax on the amount of any excess reimbursement. There is no penalty imposed on the plan or the employer. This penalty structure does *not* apply for violations of the Fully Insured Nondiscrimination Rule. Rather, penalties imposed on a violation of the Fully Insured Nondiscrimination Rule are an excise tax imposed on the employer and potential civil actions to compel compliance (*i.e.*, to end the discriminatory practice).

**Excise Tax.** Violations of the Fully Insured Nondiscrimination Rule are subject to an excise tax under Code section 4980D, which is imposed on the employer. The tax for each violation of this rule is \$100 for each day in the noncompliance period (*i.e.*, the period during which the plan is discriminatory) with respect to each “individual to whom such failure relates.” The recently issued Notice 2010-63 signals the agencies’ view that this tax applies with respect to each “individual discriminated against.” In other words, if an employer has 75 employees and provides fully insured group coverage to five executives but no coverage to the other employees, the employer is subject to tax of \$7,000 (70 x \$100) for each day the employer provides the discriminatory benefit. Although this may not be the most obvious interpretation of the statute in this context, it is the one that the Department of Treasury adopted in Notice 2010-63.

The Code section 4980D excise tax does not apply in the case of a fully insured group health plan of a small employer (generally defined as having 50 or fewer employees) if the failure is “solely” due to the coverage offered by the health insurer. This may provide relief for some small employers, but the facts will need to fit the exception.

Any failures to comply with the Fully Insured Nondiscrimination Rule during the year must be self-reported annually by filing a Form 8928 with the Internal Revenue Service no later than the due date for filing the employer’s income

tax return. The applicable tax must be paid at such time. Failure to timely file or pay the tax will result in additional penalties. Complex rules allow for reducing (or possibly eliminating) the tax amount in the event of a failure due to reasonable cause. Reduction of the tax amount is not possible if the failure is willful.

**Civil Action.** Under ERISA section 502(a), a participant, plan fiduciary, or the Secretary of Labor may bring a civil action to enjoin a violation of the Fully Insured Nondiscrimination Rule or to obtain appropriate equitable relief to redress such violation or to enforce the Rule. Therefore, a participant could bring a lawsuit seeking to force the plan to provide the discriminatory benefits to all employees. Because this Rule is new, it remains to be seen what courts will decide constitutes equitable relief in such situations. Presumably, the court could decide to bar the provision of the discriminatory benefit rather than mandating its extension to all employees.

## SITUATIONS IN WHICH THE FULLY INSURED NONDISCRIMINATION RULE MAY BE IMPLICATED

The Fully Insured Nondiscrimination Rule may be implicated in a variety of different situations, including:

**Management-Only Coverage.** Some employers provide health coverage only to a select group of management. Because members of management are likely to be highly compensated individuals (under the definition set forth above), this is likely discriminatory.

**Better Benefits for Management.** Some employers make coverage available to all employees but, pursuant to an employment agreement or otherwise, charge a reduced premium or provide increased benefits to a select group of management. For example, management might receive health coverage at no cost, while staff must pay a premium. Alternately, a gold level plan may be provided to management but only lesser coverage to staff. This also is likely discriminatory.

**Special Post-Termination Continuation Coverage.** Some employers, pursuant to an employment agreement or otherwise, provide management with post-termination continuation coverage (including COBRA coverage) under more favorable terms than those provided to staff. The favorable terms could include a longer period of continuation coverage or coverage provided at a lower (or no) premium. These benefits are likely discriminatory.

**Litigation Settlement or Judgment.** An employer may provide (or be required to provide) continued health coverage as part of the resolution of employment-related litigation. If the recipient is a highly compensated individual, this continuation coverage may be discriminatory.

## AVENUES FOR ADDRESSING THE FULLY INSURED NONDISCRIMINATION RULE

There are a variety of strategies, discussed below, that may be considered in determining how to address the Fully Insured Nondiscrimination Rule. Employers should take care in implementing any of these strategies to make sure they are not inadvertently violating the terms of any applicable employment agreements or severance plans or violating the requirements of Code section 409A with respect to the provision of any deferred compensation.

**Coverage Under Self-Insured Plan.** Switching the discriminatory benefit from a fully insured group policy to a self-insured plan and providing the self-insured coverage on an after-tax basis is one avenue for continuing to provide historical benefits, while avoiding excessive taxation or penalties. Switching to self-insured coverage would avoid the Fully Insured Nondiscrimination Rule. After the switch, of course, the Section 105(h) Nondiscrimination Rule would need to be considered. However, as mentioned above, the Section 105(h) Nondiscrimination Rule applies only to the extent the coverage is attributable to employer contributions that are excluded from the employee's gross income or employee contributions paid on a pre-tax basis. If the cost of coverage

is included in the employee's gross income or paid on an after-tax basis, the Section 105(h) Nondiscrimination Rule does not apply. This solution would result in an additional tax cost to the employee, but the ability to provide coverage without the risk of onerous penalties would appear to be of significant value.

**Additional Compensation.** In the case of individuals who are entitled to special post-termination continuation coverage, another option is to provide them with the continuation coverage that is provided to other employees (e.g., retiree coverage, severance coverage, or COBRA coverage) and provide additional compensation to make up for the lost additional benefit.

**Grandfathering as a Bridge to the Exchange.** Post-termination continuation coverage for periods longer than required by COBRA may be desired by executives because of the difficulty of obtaining group coverage (and group rates) outside of an employment situation. It may also be desired because of the difficulty in obtaining coverage if one has a medical condition. Under Healthcare Reform, these problems will be largely eliminated in 2014 when individuals become eligible to buy coverage through the state-based insurance exchanges that are a centerpiece of Healthcare Reform. Therefore, companies with discriminatory benefits that are grandfathered might decide to retain the grandfathered benefit only until 2014, at which point they might provide additional compensation to allow individuals to purchase coverage through an exchange.

**Former-Employee-Only Plan.** As discussed above, the Fully Insured Nondiscrimination Rule, pursuant to Agency guidance, does not apply to separate plans that cover former

employees only. If the discriminatory benefit is provided under such a plan (and such plan is not required to be aggregated with plans that cover current employees for purposes of this rule under forthcoming guidance), the benefit would not result in a violation of the Fully Insured Nondiscrimination Rule. Employers considering this option should review the *Jones Day Commentary* titled "[The Retiree-Only Plan Exception: Is It Still Effective after Health Care Reform?](#)" which discusses the potential risks associated with this exception.

## CONCLUSION

The requirements of the Fully Insured Nondiscrimination Rule affect all nongrandfathered group health plan benefits provided to highly compensated individuals on a discriminatory basis, whether through a plan, severance arrangement, or employment agreement. Plan sponsors of these plans will need to ensure that these benefits are reviewed and properly modified to comply with the new requirement. In modifying these arrangements, plan sponsors will need to take care to avoid inadvertently violating the terms of an existing contract or the requirements of Code section 409A governing deferred compensation.

This is one in a series of *Commentaries* Jones Day intends to provide on the provisions of PPACA. We will provide additional guidance on how the provisions of PPACA, and the developing regulatory framework, affect employer-sponsored health plans and their sponsoring employers as developments occur.

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