

November 29, 2006
Revised October 19,
2007



FOCUS

A CoreSource Operations Communication

Issue #2006-5

TOPIC: Nondiscrimination Rules of Self-Funded Health Plans (Highly Compensated Employees)

ISSUED BY: **Ann Poland**

The Internal Revenue Service (26 USC 105(h)) imposes nondiscrimination standards on self-funded health benefit plans that prohibit discrimination in favor of Highly Compensated Employees (“HCE”). If health benefits are provided under a fully-insured plan, no such standards apply. These standards were updated with the release of the new proposed regulations on cafeteria plans on August 3, 2007. This article is not intended to be a full discussion of the standards of nondiscrimination testing, but an overview. Plans must perform nondiscrimination testing as of the last day of each plan year. Specific questions may be directed to Ann Poland in the Indianapolis Office.

When is a self-funded health plan nondiscriminatory? Only if:

- The plan does not discriminate in favor of HCEs as to eligibility to participate; and
- The benefits and contributions provided do not discriminate in favor of HCEs.

What happens if a plan fails these rules?

- HCEs are taxed on the benefits they receive.

Who is an HCE?

- Officers;
 - Determination as to who is an officer is based upon many facts, including the source of authority, the term of appointment and the nature and extent of the individual’s duties.
- A shareholder who owns more than 5% of the value of the stock of the employer; or
- Compensation from the employer is in excess of \$100,000.

When applying the eligibility test, there are certain classes of employees that may be excluded. These include:

- Employees with less than three years of service before the beginning of the plan year only if those with less than three years of service are not allowed to participate in the plan.
- COBRA participants.
- Part-time and seasonal employees.

- Employees covered by a collective bargaining agreement.
- Nonresident aliens

When does a self-funded group health plan discriminate as to benefits? If the plan does not:

- Provide the same level of benefits to all individuals in the same basis as it does to HCEs. This discrimination test deals with the design of the plan. It is intended to measure the benefits available, not the amount of benefits actually received by the participants. When applying this discriminatory benefit test, all participants within the group must be counted (there are no exclusion as noted above for eligibility).

While CoreSource may agree to administer a self-funded plan that is discriminatory in nature, we would require that the client manager ensure that these issues are brought to our client's attention and the client provides written acknowledgement that they wish us to continue to administer their plan in this fashion. Alternatively, we should recommend that these clients work with Trustmark to establish a fully-insured executive plan for their protection and the protection of their employees. Following is a template letter that can be used to communicate these concerns to our clients. Should a client elect to take this approach and sign the acknowledgement, a copy of the acknowledgement should be sent to the Indianapolis Compliance Unit for inclusion in the client file.

Questions on this issue can be directed by e-mail to Ann Poland in the Indianapolis office.

This information is not intended as legal or tax advice. Clients should be instructed to seek advice from their legal counsel before making final decisions. This is for internal purposes only.

TEMPLATE LETTER FOR CLIENT COMMUNICATION RELATION TO NON-DISCRIMINATION REGS IN FAVOR OF HCE

[DATE]

Contact Name
Name of Client
Address
City State Zip

Re: Executive Perk Plan

Dear _____:

Code Section 105(h) of the Internal Revenue Code outlines the nondiscrimination rules that are applicable to employer provided medical plans. Code Section 105 imposes these rules on self-funded group health plans only. As a result of this provision, only a fully insured plan may discriminate in favor of highly compensated individuals without adversely affecting the favorable tax treatment of benefits actually received from the plan by those employees.

The Code defines “highly compensated” individuals as:

- Officers, based upon the source of authority, the term of appointment and the nature and extent of the individual’s duties.
- A shareholder who owns more than 5% of the value of the stock of the employer; or
- Those who receive compensation from the employer in excess of \$100,000.

The benefit design outlined in the [plan document design/amendment/etc] does raise a concern that benefit “availability” to the [executive] employees may be in violation of the rules under Code Section 105. If the benefit design is determined to be discriminatory, there may be adverse tax consequences to the highly compensated individuals.

An alternative option to consider is to purchase a supplementary plan for your [executives] from a fully insured carrier. Trustmark Insurance offers a product such as this, and many of our clients utilize this method. If Trustmark Insurance product is purchased, CoreSource can continue to administer those claims on your behalf.

We encourage you to contact your legal counsel and have your Plan reviewed. After your legal counsel has provided feedback, or you desire to keep your current self-funded executive program in place, we request you provide a written reply to our letter outlining your final decision.

Sincerely,

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