

## Nondiscrimination Testing of Self-Insured Health Benefits: An Overview

The Internal Revenue Code provides an income tax exclusion for employer-provided payments of healthcare expenses, whether made through insured coverage or self-insured coverage. However, the exclusion for benefits received through self-insured coverage comes with an important condition — for highly paid individuals to take advantage of the exclusion, an employer must be able to demonstrate that the benefit satisfies applicable nondiscrimination tests. This *FYI In-Depth* describes the nondiscrimination tests that apply to self-insured health plans to help employers understand how each test operates and what data they need to collect to conduct the tests.

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### Background

Section 105(b) of the Internal Revenue Code (Code) sets out the income tax exclusion for employer-provided payments of healthcare expenses. Section 105(h) of the Code subjects *self-insured* healthcare plans to the following nondiscrimination tests to ensure that benefits are not provided disproportionately to members of a “prohibited group”:

- An eligibility test. The plan must satisfy a numerical test or benefit a sufficient percentage of employees who qualify under an eligibility classification that does not discriminate in favor of highly compensated individuals.
- A benefits test. The benefits provided under the plan may not discriminate in favor of highly-compensated participants.

#### Health and Welfare Nondiscrimination Testing

This is the fourth in a series on the nondiscrimination rules for health and welfare benefits. Our **November 8, 2017** *FYI In-Depth* provided an overview of the various requirements.

Satisfaction of the requirements must be demonstrated through testing. If either test is failed, a highly compensated participant will have any “excess reimbursements” included in his or her income for the year. The determination of “excess reimbursements” depends on whether the plan fails the eligibility test or the benefits test. This is discussed in more detail below.

## Elements of Nondiscrimination Testing

A general overview of each of the elements is set out below.

### The Prohibited Group

The prohibited group for section 105(h) nondiscrimination testing consists of “highly compensated individuals” (HCIs) and “highly compensated participants” (HCPs). Status as an HCI is determined under a different definition of “highly compensated” than is used in identifying highly compensated employees for cafeteria plan or dependent care assistance program testing and for testing qualified retirement plans. Under the section 105(h) definition, an HCI is an individual who, during the plan year in which the benefit is received, is:

- One of the five highest paid officers
- A 10-percent owner, or
- Among the highest paid 25 percent of all employees during the plan year not including otherwise excludable employees who are not participants in any self-insured medical reimbursement plan of the employer. Fiscal year plans can use compensation in the calendar year in which the plan year ends.

For this purpose, “employer” includes not only the entity employing the individual, but also all other entities that are members of the same controlled group of corporations as the employing entity or trades or businesses that are under the same common control.

### Who is the employer for section 105(h) testing purposes?

All members of a controlled group are treated as a single employer for eligibility testing purposes. Thus, in testing self-insured health benefits offered by one employer, employees from all related employers are counted, which increases the possibility of failing the test. Employers need to be able to collect relevant demographic data on these other employees.

### Which benefits are subject to section 105(h)?

The section 105(h) nondiscrimination rules apply to any self-insured plan that pays for or reimburses healthcare expenses. This includes not only plans providing medical, dental and vision benefits, but also health flexible spending accounts and health reimbursement arrangements. Health savings accounts are not subject to section 105(h), although the self-insured, high-deductible health plans associated with them are. Executive physicals are also exempt.

Section 105(h) does not apply to insured health benefits, although an ACA provision imposes similar nondiscrimination requirements on non-grandfathered insured group health plans. However, in 2011, the IRS postponed application of those requirements until it issues guidance. (See our [January 5, 2011 FYI](#).) To date, no guidance has been issued.

An employee is a 10-percent owner of the employer for a particular year if at any time during such year, he or she owns more than 10 percent of the value of the corporation’s outstanding stock or stock possessing more than 10 percent of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a 10-percent owner is any employee who owns more than 10 percent of the capital or profits interest in the employer.

## Excludable Employees

Section 105(h) provides that the following employees may be disregarded in identifying the highest paid 25 percent of all employees if they are not otherwise participating in the plan:

- Collectively bargained employees who are not eligible to participate in the plan, if health benefits were the subject of good-faith collective bargaining
- Employees who have not completed three years of service at the beginning of the plan year
- Employees who have not attained age 25 by the beginning of the plan year
- Part-time employees who customarily work fewer than 35 hours a week, if other employees doing similar work have substantially more hours. An employee whose customary weekly employment is less than 25 hours may automatically be considered part-time for purposes of the exclusion
- Seasonal employees whose customary annual employment is less than nine months if other employees in similar work with the employer have substantially more months. An employee whose customary annual employment is less than seven months may automatically be considered seasonal for purposes of the exclusion
- Nonresident aliens with no U.S.-source earned income from the employer

Section 105(h) also provides that these employees may be excluded from the eligibility test. Except for collectively bargained employees, it does not appear that the employees must be ineligible to participate in the plan as a prerequisite to being excluded from eligibility testing.

Additional guidance would be welcome.

### Don't be confused!

The definitions of part-time and seasonal employee for section 105(h) purposes are different than those used in applying the “lookback measurement method” for determining full-time employee status under the ACA. (See our [April 17, 2014 FYI In-Depth](#).)

### Eligibility Test

The section 105(h) eligibility test is similar to the test applicable to qualified retirement plans — a self-insured health reimbursement plan must satisfy one of the following three alternative tests:

- The 70% Test — The plan must benefit at least 70% of all non-excludable employees
- The 70%/80% Test — The plan must benefit at least 80% of all non-excludable employees eligible to participate if at least 70% of all non-excludable employees are eligible
- Nondiscriminatory Classification Test — The plan must benefit a classification of employees that does not discriminate in favor of HCIs. Generally, the classification must be reasonable and based on objective business considerations. In addition, the classification must satisfy a mathematical test that compares the percentage of non-HCIs benefiting to the percentage of HCIs who benefit.

### What about retirees?

Self-insured retiree health coverage generally qualifies for the section 105(b) exclusion. However, regulations provide that for purposes of the benefits test, retired participants who were highly compensated while employed will be HCPs, and that the income tax exclusion will not apply to them unless all other retired participants are provided the same type of benefits with the same dollar limits. The regulations do not specifically address the treatment of retirees for purposes of the eligibility test. Note that retirees are not treated as employees in determining the highest paid 25 percent of all employees solely because they receive plan benefits.

**What does “to benefit” mean for the eligibility test purposes?**

It appears that for purposes of the percentage tests, “to benefit” means to actually participate in the plan. For the nondiscriminatory classification test, “to benefit” could mean eligible to participate.

The eligibility test generally is administered on a controlled group basis. This means that non-excludable employees from all related employers are taken into account.

**Benefits Test**

The purpose of the benefits test is to confirm that benefits are not available to HCPs or their dependents on more favorable terms than to other employees. This is generally a facts-and-circumstances test that considers, for example, whether HCPs

receive different or better benefits than others — or pay less for the same benefits. A plan cannot be discriminatory on its face or in operation.

**Restructuring**

An employer that sponsors more than one self-insured plan may run the eligibility and benefits tests separately for each plan or, at its option, designate them as a single plan and run the tests on that basis. A determination that the combined plans fail the tests does not preclude a determination that one or more of the separate plans satisfies the requirements. The regulations provide that if there is only one plan document, the document must specify which plans are to be treated as separate plans for testing purposes.

**When to Run the Tests**

Section 105(h) does not specify when the nondiscrimination tests should be run. Ideally, they would be run before, during and immediately after the close of the plan year. However, most employers do not do this. Those that do not should consider, even before the beginning of the plan year, whether their plan design will likely pass the eligibility and benefits tests based on their demographics and that of other members of their controlled group.

**Tax Consequences of Failing a Nondiscrimination Test**

If a plan fails one of the nondiscrimination tests, only highly compensated participants (HCPs) will be adversely affected — they will lose the benefit of the applicable tax exclusion and have the value of any “excess reimbursements” included in their income. Non-HCPs will still qualify for all the tax advantages applicable to the benefit.

The amount of the excess reimbursement depends on which test is failed. If a plan fails the eligibility test, the HCP’s “excess reimbursement” is determined by multiplying the benefits received by the HCP during the year by a fraction. The numerator of the fraction will be the amount of total benefits paid to or for all HCPs for the plan year while the denominator will be the total amount of benefits paid to all participants for the plan year. If the plan fails the benefits test, the entire amount of the discriminatory benefit received by the HCP will be considered an excess reimbursement and included in income.

**Which health plans are at risk for failing the benefits test?**

Health plans with different waiting periods, contribution rates or that provide different benefits for different groups of employees may fail the benefits test.

## In Closing

Employers need to be aware of the section 105(h) non-discrimination tests and act to ensure that:

- All employers in the controlled group are included in testing,
- Both the eligibility and benefits tests are satisfied, and
- Testing is completed before the end of the plan year

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