



Cafeteria Plans: Section 105(h) Nondiscrimination Rules

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Quick Facts:

- Internal Revenue Code rules impose adverse tax consequences on self-insured health plans that discriminate in favor of highly compensated individuals (HCIs).
- Self-insured health plans must pass two tests to check for nondiscrimination – the eligibility test and the benefits test.
- If a plan fails either test, excess reimbursements to HCIs are taxable.
- Self-insured health plan sponsors should work with qualified service providers to conduct regular nondiscrimination testing.

Overview

This article explains the Internal Revenue Code (Code) Section 105(h) nondiscrimination rules applicable to self-insured health plans. This is the third in a continuing series of articles on cafeteria plans and related topics. The previous articles focused on [health FSA and HSA interaction](#), and [Section 125 nondiscrimination rules](#).

Background

Code Section 105(h) provides nondiscrimination rules that impose adverse tax consequences on reimbursements made under self-insured health plans that discriminate in favor of highly compensated individuals (HCIs) with respect to eligibility or benefits.

Benefits (i.e., the reimbursements or payments for health expenses) provided by a discriminatory self-insured health plan are fully or partially taxable to the HCIs who benefit from the plan's discriminatory features. Also, if the benefits are offered through a Section 125 cafeteria plan, the cafeteria plan nondiscrimination rules will impact whether contributions made by highly compensated employees are treated as taxable compensation.

Problematic Health Plan Designs

In general, a self-insured health plan will not have problems passing the Section 105(h) nondiscrimination tests when the employer treats all of its employees the same for purposes of health plan coverage (e.g., all employees are eligible for the health plan, and the plan's eligibility rules and benefits are the same for all employees). This is the case even if HCIs utilize the plan's benefits more than non-HCIs. However, treating employees differently – either in terms of plan design or operation – may make it more difficult for a health plan to pass the applicable nondiscrimination tests.

Examples of plan designs that may cause problems with nondiscrimination testing include:

- Only certain groups of employees are eligible to participate in the health plan (e.g., only salaried or management employees);
- The employer maintains separate health plans for different groups of employees;

- The health plan has different employment requirements for plan eligibility (e.g., waiting periods and entry dates) for different employee groups; or
- Plan benefits or contribution rates vary based on employment classification, years of service or amount of compensation (for example, highly paid management employees pay a lower premium or receive additional benefits).

Nothing expressly prohibits these types of plan designs, but employers who sponsor self-funded plans with any of these features should be careful to test their plans to ensure they are and remain nondiscriminatory under Section 105(h).

Self-Insured Health Plans

The Section 105(h) nondiscrimination rules apply to self-insured health plans – accident or health plans that directly reimburse medical care expenses (typically from an employer's general assets) rather than through an insurance policy. The nondiscrimination rules contain no exceptions for small employers or plans that have grandfathered status under the Affordable Care Act (ACA).

Self-insured plans that are subject to the Section 105(h) nondiscrimination rules include:

- Medical plans, including preferred provider organization (PPO) plans, health maintenance organization (HMO) plans, “level-funded plans,” and high deductible health plans (HDHPs);
- Dental and vision plans;
- Health flexible spending accounts (FSAs); and
- Health reimbursement arrangements (HRAs).

Some group health plans may include both insured and self-insured components. For example, an employer's health plan may include a fully insured medical benefit and an HRA that reimburses eligible medical expenses up to the fully insured benefit's deductible. Although the fully insured medical benefit is not subject to the Section 105(h) nondiscrimination rules, the self-insured portion of the plan – the HRA benefit – would be subject to these rules. On the other hand, a plan which solely reimburses employees for premiums paid under an insured plan is not subject to Section 105(h).

Section 105(h) Testing

Under Section 105(h), a self-insured health plan must pass two tests – an eligibility test and a benefits test – to be considered nondiscriminatory. If a plan fails either test, HCIs will be taxed on their “excess reimbursements” from the plan. If a self-insured group health plan is discriminatory, it will not impact non-HCIs and the overall plan will retain its tax-favored status.

An HCI is an individual who is:

- one of the five highest-paid officers;
- a shareholder who owns more than 10% in the value of the stock of the employer; or
- among the highest-paid 25% of all employees

HCIs would not include self-employed individuals, and such persons are excluded from this testing, because they are not “employees” for purposes of Section 105. Their health expense reimbursements are handled under separate tax rules. (The “self-employed” here includes partners, sole proprietors, and more-than-2% S Corp shareholders.)

A self-insured health plan with a potentially problematic design should be tested for Section 105(h) nondiscrimination before the start of each plan year. In some cases, further testing may not be necessary. However, additional testing during the plan year may be advisable depending on (i) the results of earlier Section 105(h) testing and (ii) any adjustments to employee pre-tax contributions made as a result of Section 125 cafeteria plan testing (recommended to be done at the beginning, during and close of each plan year – see previous update on [Section 125 nondiscrimination rules](#)). A self-insured health plan cannot correct a failed discrimination test by making adjustments after the end of the plan year. Thus, depending on the plan’s design, an employer may wish to monitor its health plan’s compliance with Section 105(h) rules throughout the plan year so that appropriate adjustments can be made prior to the end of the year that will avoid adverse tax consequences for HCIs.

Because Section 105(h) testing is complex, employers with self-insured plans should work with qualified service providers to perform the required testing. There are some permitted ways to structure health plan benefits in a way that favors highly compensated individuals (for example, a separate fully insured group health plan for HCIs offered outside of a cafeteria plan) but, due to the complicated nature of the rules, employers may want to consult with legal counsel before implementing one of these designs.

Test One: The Eligibility Test

The eligibility test looks at whether a sufficient number of non-HCIs benefit under a self-insured health plan. If not enough non-HCIs are benefitting, the plan will fail this discrimination test.

Testing Group

With a few exceptions, all employees of the employer must be included in the testing group. For nondiscrimination testing purposes, the Code treats two or more employers as a single employer if there is enough common ownership or a combination of common ownership and joint activity. Thus, if companies are part of the same controlled group or affiliated service group under Code sections 414(b), (c) or (m), all employees of those companies must generally be included in the nondiscrimination testing.

The following employees (collectively referred to as “excludable employees”) may be excluded from the eligibility test:

- employees who have not completed three years of service;
- employees who have not reached age 25;
- part-time or seasonal employees;
- employees covered by a collective bargaining agreement, provided they are not eligible to participate in the plan; and
- non-resident aliens with no U.S. source income from the employer.

It is unclear, however, whether excludable employees (other than collectively bargained employees) may be excluded from nondiscrimination testing if they are eligible to participate in the plan.

Testing Requirements

Code Section 105(h) provides three different ways for a self-insured health plan to pass the eligibility test, as follows:

1	70% Test	The plan benefits at least 70% of all non-excludable employees.
2	70%/80% Test	The plan benefits at least 80% of all non-excludable employees who are eligible to benefit under the plan, if at least 70% percent of all non-excludable employees are eligible to benefit under the plan.
3	Nondiscriminatory Classification Test	<p>The plan benefits a classification of employees that does not discriminate in favor of HCIs. A plan satisfies this test if it has:</p> <ul style="list-style-type: none">• A bona fide business classification for any exclusions (e.g., specified job categories, compensation categories or geographic location); and• A sufficient ratio of benefitting non-HCIs to benefitting HCIs.

Federal tax law does not define what it means to “benefit” under a self-insured plan for purposes of Section 105(h) eligibility testing. Based on the wording of the test, it seems logical that “benefitting” means that an employee is actually covered under the plan (and not just merely eligible for coverage). Other interpretations may also be acceptable, but given the lack of IRS guidance, employers may want to work with their legal counsel if they want to use another interpretation.

Also, if an employer offers an insured HMO option in addition to its self-insured health plan, there is a special rule that allows HMO participants to be considered as benefitting under the self-insured plan for purposes of the eligibility test. This special rule may be used if the employer’s contributions to the HMO equal or exceed those to the self-insured health plan.

Test Two: The Benefits Test

The benefits test under Section 105(h) is designed to prevent health plans from providing HCIs with better benefits, either in terms of how the plan is designed or how it operates.

Plan Design

A health plan fails to satisfy Section 105(h) nondiscrimination testing unless all the benefits provided to participants who are HCIs are provided for all other participants. In addition, all the benefits available for the dependents of HCIs must be available on the same basis for the dependents of all other employees who are participating in the plan.

This test analyzes the benefits that may be reimbursed under the plan’s terms – it does not take into account actual benefit payments or claims. Also, employers may be able to aggregate or disaggregate benefit plans under IRS rules if necessary to pass the benefits test so long as the plans pass the eligibility test on the same basis.

The IRS has provided the following guidance on specific plan design features.

Plan Design	IRS Guidance
Employee Contributions	<p>The Section 105(h) rules suggest that employee contributions for HCIs and non-HCIs must be the same. These rules provide that a health plan that provides optional (elective) benefits to participants will satisfy the benefits test if:</p> <ul style="list-style-type: none"> • All participants are eligible to elect the optional benefits; and • There are either no required employee contributions or the required employee contributions are the same amount.
Benefit Limits	<p>A self-insured health plan may establish a maximum reimbursement limit for any single benefit or combination of benefits. However, any maximum limit attributable to employer contributions must be uniform for all participants (and for all dependents of employees who are participants) and may not be modified by reason of a participant's age or years of service.</p> <p>If a plan covers HCIs and the type or the amount of benefits subject to reimbursement under the plan is in proportion to employee compensation, the plan will fail the benefits test.</p>
Waiting Periods	<p>The IRS has suggested that having a longer waiting period for non-HCIs than HCIs will cause a self-insured health plan to fail the benefits test.</p>

The Section 105(h) rules include a special exception for medical diagnostic procedures for employees. This exception allows employers to provide free “executive physicals” to certain key employees (often, all HCIs) without violating the nondiscrimination rules. The medical diagnostic procedures include routine medical examinations, blood tests and X-rays.

Plan Operation

In addition to being nondiscriminatory in its design, a self-insured health plan must not discriminate in favor of HCIs in actual operation. Determining whether a health plan discriminates in operation involves a facts-and-circumstances analysis. A plan is not considered discriminatory merely because HCIs participating in the plan utilize a broad range of plan benefits to a greater extent than other employees participating in the plan. However, a plan may violate the benefits test if the plan’s procedures for approving benefit claims are applied more favorably to HCIs than non-HCIs.

In addition, if a plan (or a particular benefit provided by a plan) is terminated, the termination would cause the plan’s benefits to be discriminatory if the duration of the plan (or benefit) has the effect of discriminating in favor of HCIs. Prohibited discrimination may occur, for example, where the duration of a particular benefit coincides with the period during which an HCI utilizes the benefit.

Impact of Failed Testing

If a plan discriminates in favor of HCIs, they will be taxed on excess reimbursements that would have otherwise been excluded from their income. The excess reimbursements should be included in the HCIs’ gross

income and reported on their Forms W-2. Although excess reimbursements are includible in gross income, these amounts are not subject to income tax or employment tax (FICA or FUTA) withholding.

The method for determining the amount of excess reimbursements depends on whether the health plan failed Section 105(h) testing due to discriminatory coverage (i.e., eligibility) or discriminatory benefits. Also, if an HCI pays for coverage on an after-tax basis (or has his or her cafeteria plan contributions for the self-insured health coverage taxed due to a failed Section 125 nondiscrimination test), the HCI will only be taxed on the portion of the discriminatory coverage or benefit that is attributable to employer contributions. (Note: For 105(h) and other tax purposes, pre-tax contributions paid by an employee under a cafeteria plan are treated as employer contributions.)

Computation of Excess Reimbursements

Discriminatory Coverage	When a health plan fails the eligibility test, the amount of excess reimbursement is determined by multiplying the total amount reimbursed to the HCI by a fraction. The numerator is the total amount reimbursed during that plan year for all HCIs. The denominator is the total amount reimbursed during that plan year for all participants. In computing this amount, any amount that is already included in the HCI's income as a discriminatory benefit is excluded.
Discriminatory Benefit	In the case of a benefit available to HCIs, but not to all other participants (or which otherwise discriminates in favor of HCIs), the amount of excess reimbursement equals the total amount reimbursed to the HCI with respect to the benefit. If a discriminatory benefit is available to non-HCIs, the amount reimbursed to the HCI is offset by the amounts available to non-HCIs.

Under either type of excess reimbursement taxation, it would be necessary to identify for each individual HCI the total self-insured health plan reimbursements received for expenses incurred during the year. This process involves complex administrative issues with respect to the collection of relevant information for calculating taxable compensation.

Insured Health Plans

Section 105(h) nondiscrimination rules do not apply to fully insured group health plans. Thus, employers generally have more flexibility to treat employees differently under their fully insured group health plans. For example, some employers only make health plan coverage available to management employees or make coverage available to all employees, but provide better benefits (or charge lower premiums) to management employees.

Although the Section 105(h) rules do not apply to an employer's fully insured group health plan, the Section 125 nondiscrimination rules will apply if the health plan is offered through a cafeteria plan. If a cafeteria plan is discriminatory, highly compensated employees' health plan contributions will be taxable. For information about the Section 125 nondiscrimination rules, see our compliance update, [Cafeteria Plan Series: Section 125 Nondiscrimination Rules](#) (August 2018).

The ACA includes a provision that would apply rules similar to those under Section 105(h) to fully insured group health plans. However, the agencies that enforce the ACA have issued notice that they are not going to specifically enforce such nondiscrimination rules on fully insured plans unless and until the agencies publish final regulations on the subject. To date they have not issued those final regulations.

Summary

Under Section 105(h), self-insured health plans may not discriminate in favor of HCIs with respect to eligibility or benefits. If a plan fails either or both of the applicable tests, excess reimbursements provided to HCIs are taxable to them.

All self-insured health plans should be evaluated for potential discriminatory provisions, and those with a potentially discriminatory design should be tested for nondiscrimination at least annually to avoid adverse tax consequences for HCIs (as well as significant administrative issues for the employer in terms of calculating and reporting taxable compensation). Any corrections to a discriminatory plan must be made before the end of the plan year in order to avoid these results. Because of the complexity of Code 105(h) nondiscrimination testing, sponsors of self-insured health plans should work with qualified service providers to conduct the tests and obtain recommendations for corrections in the event of testing failure. Contact a member of your account team if you are interested in nondiscrimination testing or have any questions.

Please be aware that this does not represent legal or tax advice and is only Frenkel's interpretation of the laws, regulations and statutes. It is highly recommended that you seek the advice of your legal and tax professional as to the applicability of this information to your particular situation.