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Introduction

On March 23, 2010, federal health care reform was enacted when the Patient Protection and Affordable Care Act (as amended by the Health Care and Education Reconciliation Act) was signed into law. As described in detail in a prior *Alert*, the requirements under health care reform phase in over the next eight years, generally giving employers and insurers time to plan for and adjust to the new requirements. However, one particular requirement with the potential to significantly affect some of the terms of health insurance previously provided to executive employees is effective for plan years beginning on or after September 23, 2010 (*i.e.,* January 1, 2011 for a calendar year plan). The new requirement applies to insured health plans (but not to grandfathered insured health plans[1]) and prohibits discrimination in favor of highly compensated individuals either as to eligibility to participate in the plan or as to benefits provided by the plan. As more fully discussed below, the implications of this prohibition are likely broader than they might first appear. Authoritative guidance on this prohibition is much anticipated, but a recently released IRS notice suggests that it is unlikely that formal guidance will be issued prior to the effective date of the new requirements.

Nondiscrimination rules and penalties

While self-insured plans[2] have long been subject to nondiscrimination rules under Section 105(h)(2) of the Internal Revenue Code (the "Code"), insured plans have not previously been subject to such rules; employers could, and often did, offer various levels of benefits to different groups of employees, including more generous benefits to management. However, as a result of health care reform, non-grandfathered insured health plans must begin to satisfy Section 105(h)(2) of the Code that requires that such plans be nondiscriminatory as to (1) eligibility to participate and (2) benefits.

Under Section 105(h)(3) of the Code, a plan is discriminatory as to eligibility to participate unless the plan benefits (1) 70% or more of all employees,[3] or 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, or (2) such employees as qualify under a classification set up by the employer and found by the Secretary of the Treasury not to be discriminatory in favor of highly compensated individuals. With regard to benefits, Section 105(h)(4) of the Code provides that a plan is discriminatory unless all benefits provided for highly compensated individuals are provided for all other individuals. Note that in testing for discrimination, all employees in the employer's controlled group must be considered.

For purposes of both nondiscrimination requirements, a highly compensated individual generally means an individual who is:

- One of the 5 highest paid officers,
- A shareholder owning more than 10% of the employer, or
- Among the highest paid 25% of all employees.

If an insured health plan is found to be discriminatory, a penalty of $100 per day per nonhighly compensated individual is imposed on the employer.[4] Note that this is a different consequence than for a discriminatory self-insured health plan; in that case, each highly compensated individual is taxed on the medical benefits or reimbursements received from the discriminatory self-insured plan.

Unanswered questions

If an employer adopts uniform eligibility rules and uniform benefit packages with respect to its non-grandfathered insured health plan, the plan apparently will comply with Section 105(h)(2) of the Code. Short of that, nondiscrimination testing will need to be conducted. However, because the health care reform statute states only

that non-grandfathered insured health plans must comply with Section 105(h)(2) of the Code, there are a number of unanswered questions about how actually to perform nondiscrimination testing for such a plan. While regulations on nondiscrimination testing of self-insured health plans exist, those regulations generally are thought to be outdated and confusing and thus do not currently provide useful and complete guidance on how to test a self-insured health plan, much less an insured health plan.

While it was hoped that proposed regulations on nondiscrimination testing for insured plans would be issued in advance of the requirement's effective date, the Department of the Treasury issued Notice 2010-63 on September 20, 2010 requesting public comments on how the Code Section 105(h)(2) nondiscrimination requirement should apply to insured health plans. Because such comments were not due until November 4, 2010, it is unlikely that guidance will be issued prior to the applicable effective date (January 1, 2011 for a calendar year plan). It is, of course, possible that the authoritative agencies could delay enforcement of the nondiscrimination requirement until such time as guidance is issued, but absent that, employers with non-grandfathered insured health plans must make a good faith effort to comply with the nondiscrimination requirement.

Another unanswered question is posed if an employer provides health insurance coverage to a former executive. It is quite common for an executive, in an employment or severance agreement or in a more general severance plan, to be promised health insurance coverage (often in the form of a COBRA subsidy) following employment termination, and such coverage often exceeds that promised to rank and file employees. Although Section §105(h)(2) of the Code does not specifically address this situation, it is conceivable that if such coverage provided to former executives exceeds coverage provided to former non-executives, it is arguably discriminatory in favor of highly-compensated individuals and, therefore, in violation of Section 105(h)(2) of the Code.

Employer action steps

Given the impending effective date of the nondiscrimination requirements for non-grandfathered insured health plans, employers should determine if they maintain any executive-only insured health plans that provide more favorable eligibility criteria or benefits than the plan(s) for rank and file employees. Such executive-only plans almost certainly will not satisfy the new nondiscrimination requirements and should be curtailed to avoid the resulting penalties.

In addition, employers should review employment agreements and severance plans for promises to provide insured health coverage to highly compensated individuals in post-employment situations where the same coverage is not provided to all other employees. If such promised coverage is found, a conservative employer could choose either to provide all terminating employees with the same period of insured health coverage or COBRA reimbursement or to eliminate all post-termination coverage. However, if such conservative employer still wishes to subsidize some sort of health insurance benefit for a terminating executive (but not for other employees), it may be possible to provide additional, taxable cash severance payments to a former executive for the duration of what would have been the period of COBRA subsidy but without an obligation that the executive actually use such payments for COBRA coverage. Other employers could decide to refrain from making any changes to existing employment agreements or severance plans until the release of guidance on these nondiscrimination requirements, with the hope that such guidance would have a prospective effective date. New agreements and plans could contain a contingent provision for taxable severance pay that would replace the COBRA subsidy only if the COBRA subsidy is found to be discriminatory in light of later guidance.

If you have questions about this *Alert,* please contact one of the attorneys in the Compensation & Benefits Group listed above.

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The following disclosure is provided in accordance with the Internal Revenue Service's Circular 230 (31 CFR Part 10). Any tax advice contained in this Alert is intended to be preliminary, for discussion purposes only, and not final. Any such advice is not intended to be used for marketing, promoting or recommending any transaction or for the use of any person in connection with the preparation of any tax return. Accordingly, this advice is not intended or written to be used, and it cannot be used, by any person for the purpose of avoiding tax penalties that may be imposed on such person.

Notes

1 A grandfathered plan is generally one that was in effect on March 23, 2010, provided that the terms of such plan have not been changed subsequently other than as permitted under interim final regulations jointly issued by the Department of Labor, the Department of Health and Human Services and the Department of the Treasury on June 14, 2010.

2 A self-insured health plan is one under which the benefits provided by the plan are paid either from the plan sponsor's general assets or from a trust that is exempt from tax under Internal Revenue Code §501(c)(9) (i.e., a VEBA).

3 Certain employees specified in Section 105(3)(B) of the Code (e.g., part-time or seasonal employees) can be excluded when conducting the nondiscrimination test.

4 Such penalty is capped at the lesser of (i) $500,000 and (ii) 10% of the employer's health plan costs unless the discrimination is due to willful neglect.

Key Contacts

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