Guide to Section 105(h) Nondiscrimination Testing

Under Internal Revenue Code Section 105(h), a self-insured medical reimbursement plan must pass two nondiscrimination tests. Failure to pass either test means that the favorable tax treatment for highly compensated individuals who participate in the plan will be lost. The Section 105(h) rules only affect whether reimbursement (including payments to health care providers) under a self-insured plan is taxable.

When Section 105(h) was enacted, its nondiscrimination testing applied solely to self-insured plans. Under the Patient Protection and Affordable Care Act (ACA), Section 105(h) also applies to fully insured, non-grandfathered plans. However, in late 2010, the government delayed enforcement of Section 105(h) against fully insured, non-grandfathered plans until the first plan year beginning after regulations are issued. To date, no regulations have been issued so there is currently no penalty for noncompliance by fully insured, non-grandfathered health plans.

Practically speaking, if a plan treats all employees the same, then it is unlikely that the plan will fail Section 105(h) nondiscrimination testing.

What Is a Self-Insured Medical Reimbursement Plan?

Section 105(h) applies to a "self-insured medical reimbursement plan," which is an employer plan to reimburse employees for medical care expenses listed under Code Section 213(d) for which reimbursement is not provided under a policy of accident or health insurance.

Common self-insured medical reimbursement plans are self-funded major medical plans, health reimbursement arrangements (HRAs), and medical expense reimbursement plans (MERPs). Many employers who sponsor an insured plan may also have a self-insured plan; that self-insured plan is subject to the Section 105 non-discrimination rules. For example, many employers offer a fully insured major medical plan that is integrated with an HRA to reimburse expenses incurred before a participant meets the plan deductible.

What If the Self-Insured Medical Reimbursement Plan Is Offered under a Cafeteria Plan?

A self-insured medical reimbursement plan (self-insured plan) can be offered outside of a cafeteria plan or under a cafeteria plan. Section 105(h) nondiscrimination testing applies in both cases.

Regardless of grandfathered status, if the self-insured plan is offered under a cafeteria plan and allows employees to pay premiums on a pre-tax basis, then the plan is still subject to Section 125 nondiscrimination rules. The cafeteria plan rules affect whether contributions are taxable; if contributions are taxable, then Section 105(h) rules do not apply.

What Is the Purpose of Nondiscrimination Testing?

Congress permits self-insured medical reimbursement plans to provide tax-free benefits. However, Congress wanted employers to provide these tax-free benefits to their regular employees, not just to their executives. Nondiscrimination testing is designed to encourage employers to provide benefits to their employees in a way that does not discriminate in favor of employees who are highly paid or high ranking.

If a plan fails the nondiscrimination testing, the regular employees will not lose the tax benefits of the self-insured medical reimbursement plan and the plan will not be invalidated. However, highly paid or high-ranking employees may be adversely affected if the plan fails testing.

What Are the Two Nondiscrimination Tests?

The two nondiscrimination tests are the Eligibility Test and Benefits Test.

The Eligibility Test answers the basic question of whether there are enough regular employees who benefit from the plan. Section 105(h) provides three ways of passing the Eligibility Test:

1. The 70% Test: 70 percent or more of all non-excludable employees benefit under the plan.
2. The 70% / 80% Test: At least 70 percent of all non-excludable employees are eligible under the plan and at least 80 percent or more of those eligible employees participate in the plan.
3. The Nondiscriminatory Classification Test: Employees qualify for the plan under a classification set up by the employer that is found by the IRS not to be discriminatory in favor of highly compensated individuals.

The Benefits Test answers the basic question of whether all participants are eligible for the same benefits.

Definition of Terms in the Nondiscrimination Tests

A highly compensated individual (HCI) is an individual who is:

- One of the five highest-paid officers.
- A shareholder who owns more than 10 percent of the value of stock of the employer's stock.

- Among the highest-paid 25 percent of all employees (other than excludable employees who are not participants) during the plan year. Fiscal year plans may determine employee compensation based on the calendar year ending within the plan year.

For shareholder stock ownership, Section 318 constructive ownership rules apply. Per the attribution rules, a spouse is deemed to own the interest held by the other spouse. Also, an employee is deemed to own the ownership interest of the employee's parents, children, and grandchildren. Further, a person with an option to buy stock is considered to own the stock subject to that option and a shareholder who owns 50 percent or more of a corporation is deemed to own a proportionate share of stock owned by the corporation.

Section 105(h) also defines excludable employees. The following employees may be excluded from the highest-paid 25 percent of all employees, unless they are eligible to participate in the plan:

- Employees who have less than three years of service.
- Employees who are not 25 years old.
- Part-time employees (defined as customary weekly employment of less than 35 hours) or seasonal employees (defined as customary annual employment of less than 9 months).
- Collectively bargained employees.
- Nonresident aliens who receive no earned income from U.S. sources.

Exclusions should be applied uniformly. Employees in excludable categories should not be excluded during testing if the employees are eligible under the plan.

How Are the Tests Applied?

The Eligibility Test

All three of the alternative eligibility tests discuss who benefits under the plan. Although the Eligibility Test's name implies that it looks at eligibility, the more cautious interpretation is that an employee benefits under the plan to the same extent as other employees. For purposes of Section 105(h), an employee benefits from the plan when the employee actually participates in the plan.

A self-insured plan must pass one of the following three tests to pass the Eligibility Test:

1. 70% Test: 70 percent or more of all non-excludable employees participate in the plan.
2. 70% / 80% Test: At least 70 percent of non-excludable employees are eligible under the plan and at least 80 percent or more of those eligible employees participate in the plan.
3. Nondiscriminatory Classification Test: The plan benefits employees who qualify under a classification set up by the employer and found by the IRS not to be discriminatory in favor of highly compensated individuals.

   To determine whether a self-insured plan passes the Nondiscriminatory Classification Test, the IRS will look at the facts and circumstances of each case, applying the standards of Section 410(b)(1)(B) that apply to tax-preferred retirement plans. If an employer must rely on the Nondiscriminatory Classification

Test to pass the Eligibility Test, then the employer should consult with its attorney or tax professional about running the Nondiscriminatory Classification Test because it is complicated to apply.

Although Section 105(h) is not clear on the exact process for conducting the Nondiscriminatory Classification Test, the plan may rely on the Section 410(b) regulations' current nondiscriminatory classification test. Under the test, a classification is not discriminatory if it satisfies either the Safe Harbor Percentage Test or the Facts and Circumstances Test.

Safe Harbor Percentage Test. To meet the Safe Harbor Percentage Test, a plan's ratio percentage must be equal to or greater than the applicable safe harbor percentage. If the plan's ratio percentage is 50 percent or more, then the plan passes the Safe Harbor Percentage Test. If the plan's ratio percentage is less than 50 percent, the plan might pass if the ratio percentage exceeds the safe harbor percentage found in the IRS' Nondiscriminatory Classification Table below.

Nondiscriminatory Classification Table

Non-HCI Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage	Non-HCI Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage
0-60	50.00	40.00	80	35.00	25.00
61	49.25	39.25	81	34.25	24.25
62	48.50	38.50	82	33.50	23.50
63	47.75	37.75	83	32.75	22.75
64	47.00	37.00	84	32.00	22.00
65	46.25	36.25	85	31.25	21.25
66	45.50	35.50	86	30.50	20.50
67	44.75	34.75	87	29.75	20.00
68	44.00	34.00	88	29.00	20.00
69	43.25	33.25	89	28.25	20.00
70	42.50	32.50	90	27.50	20.00
71	41.75	31.75	91	26.75	20.00
72	41.00	31.00	92	26.00	20.00
73	40.25	30.25	93	25.25	20.00
74	39.50	29.50	94	24.50	20.00
75	38.75	28.75	95	23.75	20.00
76	38.00	28.00	96	23.00	20.00
77	37.25	27.25	97	22.25	20.00
78	36.50	26.50	98	21.50	20.00
79	35.75	25.75	99	20.75	20.00

The plan's ratio percentage is determined by dividing the percentage of non-highly compensated individuals who benefit under the plan by the percentage of highly compensated individuals who benefit under the plan.

The plan's non-highly compensated individuals' concentration percentage is the percentage of all employees who are non-highly compensated individuals.

If the plan's ratio percentage is equal or greater than the safe harbor percentage, then the plan's employee classification meets the safe harbor and is nondiscriminatory.

Facts and Circumstances Test. If the plan fails the Safe Harbor Percentage Test, then the plan would apply the Facts and Circumstances Test. To pass the Facts and Circumstances Test, the plan's ratio percentage must be greater than or equal to the corresponding unsafe harbor percentage in the chart above.

Also, the IRS must find the classification to be nondiscriminatory based on all the relevant facts and circumstances. No one single factor will be dispositive; here are some of the facts that the IRS will consider:

- The underlying business reason for the classification.
- The percentage of the employer's employees benefiting under the plan.
- Whether the number of employees benefitting under the plan in each salary range is representative of the number of employees in each salary range of the employer's workforce.
- The difference between the plan's ratio percentage and the safe harbor percentage.

The Benefits Test

To pass the Benefits Test, all benefits provided to highly compensated individuals who are participating in the plan must be provided to all other participants. Also, all benefits available for highly compensated individuals' dependents must also be available on the same basis for all non-highly compensated participants' dependents.

Essentially, the Benefits Test requires a plan to have no facial discrimination in the plan's design and no discrimination in its operation.

To have no discriminatory benefits on its face, the plan must have the following features:

- Required employee contributions must be identical for each benefit level.
- The maximum benefit level cannot vary based on a participant's age, years of service, or compensation.
- All benefits provided for participants who are highly compensated individuals are provided for all other participants.
- Disparate waiting periods cannot be imposed for highly compensated individuals and non-highly compensated participants.

To have no discriminatory benefits in operation, the plan must not discriminate in favor of highly compensated individuals in actual operation; this is a facts and circumstances determination that looks to see if "the duration of a particular benefit coincides with the period during which [a highly compensated individual] utilizes the benefit."

When to Test

Section 105(h) and its regulations do not specify when nondiscrimination testing must be done. However, for highly compensated individuals to retain favorable tax treatment, the self-insured plan must satisfy the tests for a plan year.

As a best practice, the employer should test prior to the beginning of the plan year, several months before the end of the plan year, and after the close of the plan year. Testing before and during the plan year will allow the plan sponsor to potentially make election or plan design changes to correct testing problems. The nondiscrimination tests cannot be satisfied by corrections made after the end of the plan year. The employer should keep a record of its test results.

Consequences of Failing the Nondiscrimination Tests

If the plan fails the nondiscrimination tests, then highly compensated individuals' excess reimbursements will be taxable and included in their taxable income. This imputed income is subject to federal income taxes and potentially applicable state taxes; however, it is not subject to Social Security or Medicare taxes. If the plan is discriminatory, then non-highly compensated individuals will not lose their tax benefits and the plan will not lose its status as a valid Section 105 plan.

Amounts that are excess reimbursement are includable in a highly compensated individual's taxable income. The excess reimbursement calculation varies based on whether the benefits were paid to highly compensated individuals due to either discriminatory coverage for failing to meet the Eligibility Test or discriminatory benefits for failing to meet the Benefits Test.

If a self-insured plan fails to meet the Eligibility Test and provides discriminatory coverage, the amount of the excess reimbursement is calculated as:

$$\text{Total amount of reimbursement to the highly compensated individual} \times \frac{\text{Total benefits paid during the plan year for all highly compensated individuals}}{\text{Total benefits paid during the plan year for all participants}} = \text{The dollar amount to be included in the highly compensated individual's income}$$

If a self-insured plan fails to meet the Benefits Test and provides discriminatory benefits, the amount of the excess reimbursement is the amount reimbursed to that highly compensated individual for the discriminatory benefit.

If the benefit was only available to a highly compensated individual and not to other participants, then the total amount reimbursed to that highly compensated individual for that benefit will be included in that individual's gross income.

If the benefit is available to non-highly compensated individuals but it is a lesser benefit, then the amount available to the highly compensated individual is offset by the amounts available to the non-highly compensated individuals.

A pro rata share of the discriminatory coverage or discriminatory benefit will be taxable when coverage is partially paid with employee after-tax contributions and partially paid with employer contributions.

If a self-insured plan fails to meet both the Eligibility Test and the Benefits Test, the excess reimbursement is calculated by first applying the Benefits Test. Then the amount of excess reimbursement under the Benefits Test is subtracted from the numerator and denominator when the Eligibility Test is calculated.

The regulations provide six excess reimbursement examples, found in the Appendix to this Advisor.

Reporting Discriminatory Amounts

If a self-insured plan discriminates in favor of highly compensated individuals, the employer should include the excess reimbursement in the highly compensated individual's gross income and report the income in Box 1 of Form W-2. The amounts should not be reported in Box 3 or Box 5 of Form W-2 because the amounts are not considered wages for FICA or FUTA withholding.

Plan Design Considerations

Plan sponsors should be cautious of plan designs that create separate plans for different employee groups or that do not cover all employees, create different eligibility requirements for different groups of employees, or base employer contributions or benefits on employees' years of service or compensation level.

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Appendix: Excess Reimbursement Examples

Example 1

Corporation M maintains a self-insured medical reimbursement plan which covers all employees. The plan provides the following maximum limits on the amount of benefits subject to reimbursement: $5,000 for officers and $1,000 for all other participants. During a plan year, Employee A, one of the 5 highest paid officers, received reimbursements in the amount of $4,000. Because the amount of benefits provided for highly compensated individuals is not provided for all other participants, the plan benefits are discriminatory. Accordingly, Employee A received an excess reimbursement of $3,000 ($4,000–$1,000) which constitutes a benefit available to highly compensated individuals, but not to all other participants.

Example 2

Corporation N maintains a self-insured medical reimbursement plan which covers all employees. The plan provides a broad range of medical benefits subject to reimbursement for all participants. However, only the 5 highest paid officers are entitled to dental benefits. During the plan year Employee B, one of the 5 highest paid officers, received dental payments under the plan in the amount of $300. Because dental benefits are provided for highly compensated individuals, and not for all other participants, the plan discriminates as to benefits. Accordingly, Employee B received an excess reimbursement in the amount of $300.

Example 3

Corporation O maintains a self-insured medical reimbursement plan which discriminates as to eligibility by covering only the highest paid 40% of all employees. Benefits subject to reimbursement under the plan are the same for all participants. During a plan year Employee C, a highly compensated individual, received benefits in the amount of $1,000. The amount of excess reimbursement paid Employee C during the plan year will be calculated by multiplying the $1,000 by a fraction determined under subparagraph (3) [of 26 CFR 1.105-11].

Example 4

Corporation P maintains a self-insured medical reimbursement plan for its employees. Benefits subject to reimbursement under the plan are the same for all plan participants. However, the plan fails the eligibility tests of section 105(h)(3)(A) and thereby discriminates as to eligibility. During the 1980 plan year Employee D, a highly compensated individual, was hospitalized for surgery and incurred medical expenses of $4,500 which were reimbursed to D under the plan. During that plan year the Corporation P medical plan paid $50,000 in benefits under the plan, $30,000 of which constituted benefits paid to highly compensated individuals. The amount of excess reimbursement not excludable by D under section 105(b) is $2,700:

$4,500 x ($30,000 ÷ $50,000)

Example 5

Corporation Q maintains a self-insured medical reimbursement plan for its employees. The plan provides a broad range of medical benefits subject to reimbursement for participants. However, only the five highest paid officers

are entitled to dental benefits. In addition, the plan fails the eligibility test of section 105(h)(3)(A) and thereby discriminates as to eligibility. During the calendar 1981 plan year, Employee E, a highly compensated individual, received dental benefits under the plan in the amount of $300, and no other employee received dental benefits. In addition, Employee E was hospitalized for surgery and incurred medical expenses, reimbursement for which was available to all participants, of $4,500 which were reimbursed to E under the plan. Because dental benefits are only provided for highly compensated individuals, Employee E received an excess reimbursement under paragraph (e)(2) above in the amount of $300. For the 1981 plan year, the Corporation Q medical plan paid $50,300 in total benefits under the plan, $30,300 of which constituted benefits paid to highly compensated individuals. In computing the fraction under paragraph (e)(3) [of 26 CFR 1.105-11], discriminatory benefits described in paragraph (e)(2) are not taken into account. Therefore, the amount of excess reimbursement not excludable to Employee E with respect to the $4,500 of medical expenses incurred is $2,700:

$4,500 x ($30,000 ÷ $50,000)

and the total amount of excess reimbursements includable in E's income for 1981 is $3,000.

Example 6

Corporation R maintains a calendar year self-insured medical reimbursement plan which covers all employees. The type of benefits subject to reimbursement under the plan include all medical care expenses as defined in section 213(e). The amount of reimbursement available to any employee for any calendar year is limited to 5 percent of the compensation paid to each employee during the calendar year. The amount of compensation and reimbursement paid to Employees A-F for the calendar year is as follows:

Employee	Compensation	Reimbursable amount paid
A	$100,000	$5,000
B	25,000	1,250
C	15,000	750
D	10,000	500
E	10,000	500
F	8,000	400
		Total $8,400

Because the amount of benefits subject to reimbursement under the plan is in proportion to employee compensation the plan discriminates as to benefits. In addition, Employees A and B are highly compensated individuals. The amount of excess reimbursement paid Employees A and B during the plan year will be determined under paragraph (e)(2) [of 26 CFR 1.105-11]. Because benefits in excess of $400 (Employee F's maximum benefit) are provided for highly compensated individuals and not for all other participants, Employees A and B received, respectively, an excess reimbursement of $4,600 and $850.