PPACA Compliance Reminder Series – Beware of IRS Nondiscrimination Rules and Other Tax Changes

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The Patient Protection and Affordable Care Act ("PPACA") made some important changes in the tax rules applicable to group health plans. Most notably,

- The prohibition against discrimination in favor of highly compensated individuals, previously applicable only to self-insured plans, is now applicable to fully insured plans effective January 1, 2011 for calendar year plans.
- PPACA makes changes relative to flexible spending arrangements, health savings accounts, health reimbursement accounts and Archer Medical Savings Accounts relative to over the counter drugs, penalties applicable to non-qualifying distributions, and contribution limits.
- The aggregate value of health benefits must be reported on employee W-2s beginning in 2012.

Nondiscrimination Rules

The Affordable Care Act applies the Internal Revenue Code's nondiscrimination rules to non-grandfathered, fully-insured health plans effective for the first plan year that begins on or after September 23, 2010 (January 1, 2011 for calendar year plans). This rule had previously applied **only** to self-insured group health plans.

Important to note is that unlike the penalty for self-insured plans, which affects highly compensated individuals, if a fully-insured plan is found to be discriminatory, **a penalty will be** imposed on the **employer/plan sponsor**. Future guidance will specify how the employer penalty will be applied, but at the present time it appears that the employer will pay a penalty of at least $100 per day per highly compensated individual who participates.

The Nondiscrimination Rule

The nondiscrimination rule prohibits discrimination in favor of "highly compensated individuals" regarding eligibility to participate or regarding benefits provided under such a plan. "Highly compensated individuals" are those who are:

(1) one of the five highest paid officers of the employer company, or

(2) a shareholder who owns, directly or under the Code's constructive-ownership rules, more than 10% in value of the stock of the employer, or

(3) among the highest paid 25% of all employees other than employees who are not participants.

Nondiscrimination in Eligibility -- Requires that the plan benefit 70% or more of all employees, or 80% or more of all eligible employees if 70% or more of all employees are eligible to benefit under the plan, or employees who qualified under a classification set up by the employer if it was established to IRS' satisfaction that such a classification is not discriminatory in favor of highly compensated individuals based on all of the facts and circumstances.

Nondiscrimination in Benefits -- A plan is discriminatory as to benefits unless all benefits provided for highly compensated individuals are also provided for all other participants. Also, all the benefits available for the dependents of highly compensated individuals must be available on the same basis for the dependents of all other employees who are participants.

Employer Action Items

It is important to evaluate whether your plan is discriminatory. The rules for nondiscrimination testing are complex, and you should consult with legal counsel, your accountants or consultants for details, but for general information, the following "quick checks" may be helpful in determining whether testing is warranted:

- If the plan provides identical health benefits to, for example, all full-time employees with the same contribution rates, benefits and eligibility regardless of age, years of service or compensation, it will generally be nondiscriminatory (subject to some rather complicated rules governing "common control" groups).
- Management carve-outs and executive-only plans with eligibility, benefits or contributions different from those applicable to rank and file employees are likely discriminatory, will require testing and will most likely fail.
- If health benefits are offered that vary with respect to eligibility, coverage or contributions for different employees, the plan should be tested.
- Review offer letters, employment and severance agreements and other similar documents providing favorable or extended health insurance coverage to executive level employees or others fitting the definition of "highly compensated individual"—a contractual right to receive extended or more favorable benefits may be discriminatory and may create an employer penalty liability.

FSA, HSA and HRA Rules

PPACA provides for certain changes relative to flexible spending arrangements ("FSAs"), health savings accounts ("HSAs"), health reimbursement accounts ("HRAs") and Archer Medical Savings Accounts ("MSAs"):

- Effective January 1, 2011, costs for over-the-counter drugs may not be reimbursed through an HRA or health FSA and may not be reimbursable on a tax-free basis through an HSA or MSA unless such drugs are prescribed by a doctor;
- Beginning January 1, 2011, the penalty taxes on distributions from an HSA or MSA that are not for qualified medical expenses are increased to 20% (from 10% for HSAs and 15% for MSAs); and
- Effective January 1, 2013, employee salary reductions to a health FSA will be limited to $2,500 annually, as adjusted for changes in the cost of living. This does not include any amount an employer may contribute.

W-2 Reporting Delayed

PPACA required that employers report the aggregate value of health benefits (employer and employee portions) on an employee's Form W-2 for 2011. However, the IRS has issued a notice providing interim relief such that reporting will not be required until 2012. The reason for the extension is that the IRS recognized that employers needed more time to make the necessary changes to payroll systems and procedures.

Richard B. Spohn chairs Nossaman's Healthcare Practice Group and specializes in healthcare and administrative law. He can be reached at 415.398.3600 or rspohn@nossaman.com.

[1] If a self-insured plan fails to satisfy either the nondiscriminatory eligibility rules or the nondiscriminatory benefit rules, an employee who is considered a highly compensated individual has to include amounts that represent "excess reimbursements" in gross income.