

Managing nondiscrimination testing for health & welfare plans in a changing environment



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Sometimes a simple annual procedure can have a huge potential impact on the financial health of an organization. In this case, we are talking about the annual required nondiscrimination testing of an employer's health and welfare benefit programs.

According to the Internal Revenue Code (IRC), employer health plans (including cafeteria plans) cannot discriminate, in either their design or operation, in favor of highly compensated or key employees. In most cases, these benefit plans—including medical benefits, flexible spending account (FSA) plans, and dependent care plans—also may have a tax-favored status under the IRC, specifically Section 125. The tax-preferred status was designed to encourage employers to provide benefits to their employees, even though the highly compensated employees (HCEs) and other key employees would also benefit from this status.

Nondiscrimination testing is a series of calculations performed on enrollment, benefit, and cost data provided by the employer group. The testing is an annual requirement, and its purpose is to show that HCEs and key employees are not benefiting in a disproportionate way, and that "rank-and-file" employees are eligible for and receiving benefits in proper proportion. The results of the testing, and any action plans resulting from failure of the tests, should be kept with the important plan documentation (i.e., plan documents, summaries of material modification, etc.).

Although the testing is required by the IRC, for the majority of employers the testing process is typically passed without much (if any) needed action. Even those groups who cannot pass certain aspects of the testing have options to make minor changes to their benefit programs and come into compliance.

Those employers who do not perform the testing annually can be subject to a host of fines and penalties, including the disqualification of all highly compensated employees and the taxing of all benefits and funds disbursed to them.

WHAT IS THE TESTING?

To determine if cafeteria plans and reimbursement plans with tax-favored status discriminate in favor of HCEs and key employees, Congress created certain testing requirements to illustrate nondiscrimination in the plan design and execution.

Generally speaking, these tests can be described as having three basic components:

- Eligibility
- Benefits
- Utilization

The tests, which date back to the original IRC Section 125 legislation enacted in 1978, are to be done formally on an annual basis. The IRC also requires employers to have proof of testing and the results (plus a corrective action plan if any of the tests are failed). Reports and action plans should be kept in a safe place, typically with plan documents and other important plan information.

In several areas, the IRC allows for multiple testing methods in an attempt to provide the maximum latitude for employer groups to pass the test requirements. Different employers can and will have different circumstances, and therefore different testing styles are allowed in order to find ways to pass. Unfortunately, there are times when no matter what methodology is used, some portions of the testing will not pass and will require some changes to either the plan or the administration of the plan.

Any adjustments that are required based on the results of the testing must be made prior to, or in conjunction with, the last payroll of the plan year of the test. Per the IRC, no changes can be made to payroll retroactively to a prior tax year.

WHICH PLANS ARE TESTED?

Depending on the types of benefits offered, and how they are financially structured, the following are the plans generally subject to nondiscrimination testing:

- Cafeteria plans (Section 125)
- Medical plans or medical expense reimbursement plans
- Health savings accounts (HSAs)
- Health flexible spending accounts (FSAs)
- Dependent care reimbursement plans (DCAPs)
- Group term life insurance

Specifics under each of the plan types will change, including the testing methodology, definition of a highly compensated

employee, eligible excluded employees, etc. It is important to be familiar with the details of not only the plan but also of the testing process.

IMPACT OF HEALTHCARE REFORM

Last year, the Patient Protection and Affordable Care Act (PPACA) required nondiscrimination testing for the first time on fully insured, non-grandfathered group health plans. Previously required only for self-insured benefit plans, the change raised significant questions and concerns for a variety of organizations. On December 22, 2010, fully insured groups were given a temporary reprieve—the new rules were placed on hold until the IRS could issue guidance on regulatory questions created after various groups, including the consulting and brokerage community, started looking into the real-world applicability of the PPACA.

However, certain other changes related to the PPACA should have already been implemented by employers. One example is the elimination of the reimbursement for over-the-counter drugs through a health FSA. Effective January 1, 2011, all over-the-counter medicines, as well as medications obtained without a prescription, were no longer considered as eligible expenses under a health FSA, as well as Health Reimbursement Arrangements (HRAs), Health Savings Accounts (HSAs), or Archer Medical Savings Accounts (Archer MSAs). Please note that insulin is not subject to these changes.

Still being discussed are other aspects of the PPACA and how they will impact group benefit plans in general, and nondiscrimination testing in specific. An example of the items under consideration includes how the health exchanges, which are scheduled to be in operation in 2014, will impact the testing methodology both from a cost/benefit and an eligibility/demographic waiver perspective.

It is this distinction of what changes are to be implemented now as opposed to which ones are tentative that can have an impact on the result of your testing methodology.

CONCLUSION

Stated simply, nondiscrimination testing is a requirement. It has been part of the health and welfare benefit landscape for quite a while and appears to be something with which all employers will have to continue to comply. Changes that have impacted, or possibly will impact, the testing process (through healthcare reform and PPACA, for instance) are mostly to do with procedure, and are not anticipated to fundamentally eliminate the testing requirements. Employers have a responsibility not only to their organizations, but to their employees, to be sure that nondiscrimination testing requirements have been followed to the best of their ability.

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