# Overview of IRC §105(h) Nondiscrimination Testing

Health Reimbursement Arrangements (HRAs) are a type of tax-advantaged medical account that reimburses employees for eligible health care expenses and are an essential component of many employer-sponsored benefit plans.

Specifically, IRC §105(h) prohibits those plans from discriminating in favor of "highly compensated individuals" (HCIs), and against non-HCIs, in terms of (1) eligibility to participate and as to (2) benefits available under the plan. IRC §105(h) contains two tests—one reflecting the "eligibility" component and another reflecting the "benefits" components—and, in order to comply with the code, a plan must pass both.

The **Eligibility Test**, is stated in IRC §105(h)(2)(A), aims to ensure that "enough" non-HCIs benefit from the plan.

The **Benefits Test**, which is stated in IRC §105(h)(2)(B), aims to ensure that all participants are eligible for the same benefits and that HCIs are not getting better benefits and are not required to make lower contributions than non-HCIs.

## Who qualifies as a "Highly-Compensated Individual" (HCI)

"Highly-Compensated Individuals" are:

- The highest-paid 25% of all "non-excludable" employees;
- The five highest-paid officers; and
- The more-than-10% shareholders.

Thus, by definition, at least 25% of all non-excludable employees are HCIs.

## Who qualifies as an "Excludable" employee?

"Excludable" employees are:

- Employees who have not completed three years of service;
- Employees under age 25;
- Part-time or seasonal employees;
- Employees who are members of a collective bargaining unit, if accident and health benefits have been the subject of good faith bargaining; and/or
- Non-resident aliens with no U.S. source income.

However, if an employer does not exclude all employees in an excludable category, then no employees in that category are excludable. An employer, as an example, could not exclude some employees who have less than three years of service but not others, and it could not exclude some employees who are under age 25 but not others.

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## The Eligibility Test

There are three alternative ways a self-insured plan can pass the Eligibility Test: the 70% test, the 70/80% test, and the nondiscriminatory classification test.

- 70% test: plan benefits 70% or more of all non-excludable employees.
- 70/80% test: 70% or more of all non-excludable employees are eligible to benefit under the plan, and the plan benefits 80% or more of employees who are eligible to benefit (i.e., the plan benefits 56% of non-excludable employees).
- Nondiscriminatory Classification Test: The plan benefits a classification of employees that is both "reasonable" and "nondiscriminatory." A "reasonable" classification is one based on objective business criteria, such as full-time vs. part-time employees; hourly vs. salaried compensation; or geographic location. For more information on this test, see IRC §410(b)(1)(B).

## The Benefits Test

To pass the Benefits test, a self-insured plan must provide all benefits to-HCIs that it provides to HCIs who are participating in the plan. The plan cannot be discriminatory on its face or in operation.

Practically speaking, being "nondiscriminatory on its face" means, for example, that the plan cannot charge non-HCIs more than HCI's for the same benefits or coverage. The same type of benefits available to HCIs must be available to non-HCIs, and the plan cannot impose longer waiting periods on non-HCIs than on HCIs.

Being "nondiscriminatory in operation" is context-dependent. It is a "facts and circumstances" determination. A plan may be discriminatory in operation if it covers a benefit for a period when an HCI (or family member) needs it and then is amended to exclude that coverage once the HCI or family member no longer needs it. However, a plan might not be discriminatory merely because HCIs utilize benefits at a higher rate than do non-HCIs.

## Penalties for Noncompliance with Section 105(h)

If a self-insured plan fails the nondiscrimination tests, HCIs will have to include in taxable income the value of any "excess benefits" they receive. The non-HCIs in the plan will not have to include any amount in taxable income, nor will the plan sponsor have to pay a penalty, nor will the self-insured health plan cease to be a valid plan under IRC §105. The penalty amount for HCIs varies depending on whether the plan failed the Eligibility or Benefits test.

## Penalties for Noncompliance with Section 105(h)

### Failing the Eligibility Test

Failing the Eligibility Test results in discriminatory coverage. The result is that amount of the "excess reimbursement" for a particular HCI is determined by multiplying the total amount reimbursed to the HCI by a fraction, the numerator of which is the total benefits paid during that plan year to or for all HCIs, and the denominator of which is the total benefits paid during that plan year to or for all participants.

### Failing the Benefits Test

Failing the benefits test results in discriminatory benefits. The result is that the amount of the "excess benefit" for an HCI is the amount paid for or reimbursed to that HCI for the discriminatory benefit. If a benefit is available only to an HCI and not to all other participants, then the taxable amount for that HCI is the total amount paid for or reimbursed to the HCI for that benefit. On the other hand, if a benefit available to non-HCIs is a lesser benefit than what is available to HCIs, then the amount available to the HCI will be offset by the amounts available to the non-HCIs.

The tax consequences for HCIs could be more severe if the self-insured plan fails the Benefits Test (which may result in 100% taxation of discriminatory benefits reimbursed to each HCI) than if it fails the Eligibility Test (which results in taxation of a pro rata share of benefits that were reimbursed to an HCI).

**For more information call your HRPro HRA Team**
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