Internal Revenue Service

memorandum

FREV-102945-01
REWeinheimer

date: SEP 10 2001

to: Acting Director, Exempt Organizations Rulings and Agreements T:EO:RA
Attn: Lee Phaup

from: Assistant Chief, Health and Welfare Branch CC:TE/GE:EB:HW
Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities)

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subject: Technical Assistance Request – [redacted]

This is in response to your memorandum of December 29, 2000, requesting technical assistance with respect to the question of whether two self-insured medical reimbursement plans funded through the [redacted] (the Taxpayer) are discriminatory under section 105(h) of the Internal Revenue Code.

The Taxpayer was created on [redacted] to fund benefits provided through various health benefit plans sponsored by the employer [redacted] and its affiliated companies. The Taxpayer is funded by both employer and employee contributions. In the application for recognition of exemption[1], [redacted] such plans are listed. It has been represented that all but two of these plans were the subject of collective bargaining. Your request for assistance is limited to the two plans that are not collectively bargained, identified as Plans [redacted] and [redacted] Plan [redacted] is identified in the application as the [redacted]. The plan document numbered [redacted] submitted with the application, however, refers to the plan as the [redacted] Plan [redacted] is the [redacted].

Under the [redacted] Plan, all full-time employees who routinely work at least 20 hours per week are eligible to participate. The plan itself does not limit eligibility to employees of a certain location, but the Taxpayer's representative represents in the application that eligibility is limited to employees of the [redacted] location. The [redacted] Plan provides that full-time employees who are regularly scheduled to work at least 20 hours each week are eligible to participate. The Taxpayer's representative represents in the application that collectively bargained employees of [redacted] were not eligible to participate in the [redacted] Plan (but they were eligible under a separate [redacted] plan) and that [redacted] sold [redacted] in [redacted]

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[1] In this memorandum, references to the application for recognition of exemption include supplemental letters submitted by the Taxpayer's representative in response to your request for additional information.

For the year [redacted] employees were required to contribute [redacted]% of the cost of coverage under the [redacted] Plan. The [redacted] Plan has three options. Employees in the year [redacted] were required to contribute slightly over [redacted]% of the cost of coverage for each of the three options. For example, the required employee contribution toward the monthly cost of employee-only coverage was $[redacted] under Option A, $[redacted] under Option B, and $[redacted] under Option C. Options A and B are available to all employees eligible to participate; Option C is available only to employees at the [redacted] location. Options A and C provide identical benefits but are administered by different third party administrators. Option B provides lower benefits than those provided under Options A and C.

Section 105(h) of the Code sets forth nondiscrimination rules for self-insured medical reimbursement plans. Under section 105(h)(2)(A), a self-insured medical reimbursement plan satisfies the requirements of section 105(h) only if the plan does not discriminate in favor of highly compensated individuals as to eligibility to participate. Under section 105(h)(2)(B), a self-insured medical reimbursement plan satisfies the requirements of section 105(h) only if the benefits provided under the plan do not discriminate in favor of participants who are highly compensated individuals.

Benefits

Section 105(h)(2)(B) of the Code and §1.105-11(c)(3)(i) of the Income Tax Regulations provide that benefits subject to reimbursement under a self-insured medical reimbursement plan must not discriminate in favor of participants who are highly compensated individuals. Plan benefits do not satisfy this requirement unless all the benefits provided for participants who are highly compensated individuals are provided for all other participants. In addition, all the benefits available for dependents of employees who are highly compensated individuals must be available on the same basis for dependents of all other employees who are participants.

Generally, all benefits under the [redacted] Plan are available to all participants and to their dependents on the same basis. A different benefit schedule applies with respect to retirees. Under §1.105-11(c)(3)(iii) of the regulations, benefits provided to a retiree are generally not considered to be discriminatory benefits if the benefits provided to retired employees who were highly compensated individuals are the same for all other retired participants. Because the benefits under the [redacted] Plan are the same for all retirees and their dependents, the [redacted] Plan passes the benefits test.

The benefits under Options A and C of the [redacted] Plan are identical. They each provide, among other benefits, benefits for [redacted] percent of the cost of major [redacted] Option B provides no benefits for major [redacted]. In addition, benefits under Options A and C for [redacted] are for [redacted] percent of the cost; the same benefits under Option B are for [redacted] percent of the cost. Under §1.105-11(c)(3)(i) of the regulations, a plan providing optional benefits is treated as providing one benefit if all eligible participants may elect any of the benefits covered by the option and either there are no required

employee contributions or the required employee contributions are the same amount. Because the required employee contributions for Option B are lower than for either Option A or C, and because the required employee contributions for Option A are lower than for Option C, this special rule does not apply. Consequently, the [redacted] Plan does not pass the benefits test when tested as a single plan.

However, §1.105-11(c)(4) provides that an employer may use a single plan document for two or more separate plans if the employer designates the plans that are to be considered separately and the applicable provisions of each plan. Thus, if the [redacted] Plan is tested as three plans (one plan for each option), each of the plans will pass the benefits test. The rule for multiple plans under §1.105-11(c)(4) applies to both the eligibility and the benefits tests. Accordingly, if the options are tested separately for the benefits test, they would also have to be tested separately for the eligibility test.

Eligibility to Participate

Under section 105(h)(3)(A) of the Code, a self-insured medical reimbursement plan does not satisfy the eligibility requirements of section 105(h) unless the plan satisfies at least one of the following three tests: (1) the plan benefits at least 70 percent of all employees (the 70% test); (2) the plan benefits at least 80 percent of all the employees eligible to benefit under the plan, and at least 70 percent of all employees are eligible to benefit under the plan (the 80%/70% test); or (3) the plan benefits 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 (the nondiscriminatory classification test). Under §1.105-11(c)(2)(ii) of the regulations, the determination of whether this third test, the nondiscriminatory classification test, is satisfied is made based on the facts and circumstances of each case, applying the same standards as are applied under section 410(b)(1)(B) (relating to qualified pension, profit-sharing, and stock bonus plans) without regard to the special rules in section 401(a)(5) relating to eligibility to participate.

Under section 105(h)(3)(B) of the Code, certain employees may be excluded in determining whether a self-insured medical reimbursement plan satisfies the eligibility requirements. These excludable employees are employees who have not completed three years of service; employees who have not attained age 25; part-time or seasonal employees; employees not included in the plan who are included in a unit of employees covered by an agreement between employee representatives and one or more employers that the Secretary of the Treasury finds to be a collective bargaining agreement, if accident and health benefits were the subject of good faith bargaining between the employee representatives and the employer or employers; and employees who are nonresident aliens and who receive no income from the employer that is income from sources within the United States. All these excludable employees, except the collectively bargained employees, may be excluded from consideration for eligibility testing even if they are participating in the plan.

The application for exemption includes figures relating to employment with [redacted] companies and participation in [redacted] health plans as of [redacted] The Taxpayer's representative mentions that the original numbers, submitted with the application, for participation of non-highly compensated employees[2] in the plans were based on eligibility to participate, not on actual participation, and that revised numbers would be provided based on actual participation. No such revised numbers have been provided. Accordingly, the participation percentage might turn out to be lower than that mentioned in the discussion below.

Only [redacted] of [redacted] employees ([redacted] percent) participated in the [redacted] Plan. This is insufficient to satisfy either the 70% test or the 80%/70% test. It is not clear if any of the classes of employees that can be excluded in performing these tests were excluded. It seems unlikely, though, that the [redacted] Plan would pass either of these two tests after excluding some or all the classes of employees that could be excluded. The Taxpayer's representative implicitly recognizes this in making arguments in the submission why the [redacted] Plan satisfies the nondiscriminatory classification test. The determination of whether that test is satisfied depends on satisfying the standards that apply under section 410(b) of the Code. Ruling jurisdiction for section 410(b) is with the Employee Plans Technical and Actuarial Division.

[redacted] of [redacted] employees ([redacted] percent) participated in the [redacted] Plan as of [redacted] Thus, the [redacted] Plan, if tested as a single plan (and if the actual participation percentage is not significantly lower than the percentage of those eligible to participate), satisfies the 70% test. However, in the discussion of the benefits test, we concluded that the [redacted] Plan would satisfy the benefits test only if each of the options under the [redacted] Plan was tested separately. The Taxpayer's representative did not submit separate participation percentages for each of the three options. Although it is possible for one of the options to satisfy either the 70% or the 80%/70% test, it is impossible for all three of them to satisfy either the 70% test or the 80%/70% test. Thus, for each option tested separately to satisfy the eligibility requirements, at least two – and possibly all – of them would have to satisfy the nondiscriminatory classification test. Again, ruling jurisdiction for making that determination is with the Employee Plans Technical and Actuarial Division.

In summary, the [redacted] Plan satisfies the benefits test. The [redacted] Plan does not satisfy either the 70% test or the 80%/70% test but may pass the nondiscriminatory classification test. The [redacted] Plan fails the benefits test when tested as a single plan, but each option under it passes the benefits test if the option is tested separately. The [redacted] Plan appears to pass the 70% test when tested as a single plan. However, if each option

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[2] The Taxpayer's representative distinguished in the application between highly and non-highly compensated employees; section 105(h) provides less favorable tax results for plans that discriminate in favor of highly compensated individuals. There are significant differences between the definition of highly compensated employee in section 414(q) and §1.414(q)-1T and the definition of highly compensated individual in section 105(h)(5) and §1.105-11(d).

under the [redacted] Plan is tested separately (as is necessary to pass the benefits test), then only one option could pass either the 70% test or 80%/70% test; at least two and possibly all of the three options would have to pass the nondiscriminatory classification test. Accordingly, an analysis under section 410(b) of the Code based on an appropriate calculation of the total nonexcludable employees and the total nonexcludable participants is necessary to determine whether the Taxpayer is entitled to a favorable determination for both the [redacted] Plan and the [redacted] Plan.

If you have any questions or if we may be of additional assistance, please contact Russ Weinheimer at 622-6080.

Felix Zech