

Classing Out Executive Benefits

McGriff Employee Benefits Compliance Team
National Specialty Practices



Questions: Our company would like to reward our executive team for their hard work in turning around the company's recent financial difficulties and making the company profitable again. We would like to pay a greater portion of the premiums for our group health plan for our executives than we pay for our rank-and-file employees. Can we do this? What are the compliance repercussions if we do this?

Summary:

When plan sponsors offer different benefits to, or make different contributions for benefits on behalf of, employees based on different classifications, there are several legal considerations to consider. These include the Internal Revenue Code (Code) Section 125 nondiscrimination rules, the Code Section 105(h) nondiscrimination rules if the health plan is self-insured, the Health Insurance Portability and Accountability Act (HIPAA) nondiscrimination rules, as well as various employment discrimination laws.

Distinctions should be based upon classifications used by the plan sponsor for its usual business practice and should not favor highly compensated individuals. If the health plan is fully insured, it may be possible to implement a plan design under which the executives receive better benefits than rank-and-file employees if they are carved out of the Code Section 125 plan (also called a cafeteria plan).

In a self-insured plan, when benefits are provided to executives that are better than those provided to rank-and-file employees, that is a red flag since executives almost always fall within the definition of HCIs.



Detail:

A. Self-Insured Health Plans

If the company's group health plan is self-insured, the plan must be tested for nondiscrimination under Code Section 105(h).¹ Code Section 105(h) prohibits a group health plan from discriminating in favor of highly compensated individuals (HCIs) with regard to eligibility and benefits under the plan. All self-insured health plans are subject to the nondiscrimination rules of Code Section 105(h), including small plans and grandfathered plans. Health Reimbursement Arrangements and Health Flexible Spending Accounts also fall under the nondiscrimination rules under Code Section 105(h). The definition of HCIs for Code Section 105(h) purposes includes several groups of employees, but the most relevant is the top 25% of employees by compensation during the current plan year.²

Nondiscrimination testing for self-insured plans must be done on a controlled group basis. This means that the employees of all members of a controlled group of entities must be considered when performing the required nondiscrimination testing.³

In the current situation, paying a greater portion of the premiums for executives versus rank-and-file employees will likely cause the plan to fail the Code Section 105(h) nondiscrimination testing.

Whenever benefits are provided to executives that are better than those provided to rank-and-file employees, that is a red flag since executives almost always fall within the definition of HCIs. In this instance offering the executives a

more favorable contribution structure would be a failure of the Code Section 105(h) benefits test. If you established a separate self-insured health plan for the executives it would very likely fail the eligibility test.

B. Fully Insured Health Plans

The Affordable Care Act includes a provision that applies rules similar to the Code Section 105(h) nondiscrimination rules to fully insured plans.⁴ However, in IRS Notice 2011-1, the IRS announced that compliance with the nondiscrimination rules will not be required until regulations are issued in the future, and until that time, the IRS will not enforce sanctions for failure to comply.⁵ Due to this non-enforcement announcement, employers with fully insured plans can currently pay, without penalty, a greater portion of health insurance premiums to highly compensated individuals. However, even though the IRS has announced a non-enforcement policy, the statute continues to contain the nondiscrimination rule. That means it is possible that an employee could file a lawsuit claiming a violation of the nondiscrimination rules in a fully insured plan. Because of the non-enforcement policy, employers generally have greater flexibility to treat employees differently in fully insured group health plans. Thus it may be possible for an employer to provide greater benefits for executives if it uses a fully insured health plan. This strategy is discussed further in Section D below.

If the premiums for the fully insured health plan are paid with pretax dollars under a Section 125 plan, the benefits

will need to be analyzed under the Code Section 125 nondiscrimination rules. See Section C for more discussion.

C. Section 125 Plans

Section 125 plans allow employers to provide their employees with a choice of receiving cash compensation or paying for some of their employee benefits on a pretax basis without any adverse tax consequences. In exchange for this tax advantage, Section 125 plans must pass nondiscrimination tests to ensure the plans do not discriminate in favor of highly compensated employees.⁶ When an employer makes greater contributions to executive employees than for rank-and-file employees for any benefit paid on a pretax basis through a Section 125 plan, it is likely that the nondiscrimination tests will fail.

D. Executive Carve-Out

One plan design that employers have used to provide better benefits to executive employees is to offer a fully insured health plan and carve the executives out of the Section 125 plan. This plan design utilizes the current non-enforcement policy of the nondiscrimination rules

for fully insured plans and renders the Code Section 125 nondiscrimination rules inapplicable. The executives must be specifically excluded from the premium conversion portion of the Section 125 plan, which will require a plan amendment to the Section 125 plan document. Then either the employer can pay 100% of the premiums on behalf of the executives, or the executives can pay their portion of the premiums with after-tax dollars. Either way, they are not participating in the premium conversion portion of the Section 125 plan, so the Section 125 plan nondiscrimination rules should not be an issue.

If an employer is considering this plan design, it should be aware that the proposed Code Section 125 cafeteria plan regulations contain an anti-abuse provision that states that Code Section 125 must be interpreted in a reasonable manner consistent with the purpose of preventing discrimination in favor of highly compensated participants and key employees.⁷ Employers should be mindful of that provision when designing executive carve-out plans. To date, we have not heard of the IRS asserting that executive carve-out plans violate the anti-abuse provision, but that could change in the future.



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E. HIPAA Nondiscrimination Rules

Under HIPAA, group health plans must establish uniform rules for eligibility, premiums and contributions and cannot discriminate based on health factors. An employer may establish group health plan classifications under HIPAA if they are based on bona fide employment-based classifications consistent with the employer's usual business practice.⁸ All the facts and circumstances are considered when determining if the classification is employment-based. Distinctions such as part-time and full-time, geographic location, salaried and hourly, and management and non-management can be treated as distinct groups of similarly situated individuals. Employers may apply different eligibility provisions, benefit restrictions, or costs, as long as the distinctions are consistent with the employer's usual business practice.



Conclusion:

If a company wants to provide better health plan benefits to its executives than its rank-and-file employees, it must consider what type of health plan it is sponsoring (self-insured versus fully insured). If the plan is self-insured, the nondiscrimination rules of Code Section 105(h) will likely prevent this from being done. If the health plan is fully insured, at the present time the nondiscrimination rules that would apply to fully insured plans are not being enforced by the IRS.

However, if the executives pay for the health plan with pretax dollars under the company's Section 125 plan, the Code Section 125 nondiscrimination rules may prevent this as well. If the executives are excluded from the premium conversion portion of the Section 125 plan, the company can pay all of the executives' premiums or some portion, and have the executives pay their share with after-tax dollars. This will avoid the Code Section 125 nondiscrimination issue.

Finally, since "executive" is a term that a company usually uses to distinguish management employees from non-management employees, the HIPAA nondiscrimination rules should not present a problem for this plan design.

References

- 1 - [Code Section 105\(h\)](#).
- 2 - [Code Section 105\(h\)\(5\)](#).
- 3 - [Code Section 105\(h\)\(8\)](#).
- 4 - [42 USC Section 300gg-16](#).
- 5 - [Notice 2011-1](#).
- 6 - [Code Section 125](#).
- 7 - Proposed Treas. Reg. 1.125-7(l)(1), <https://www.treasury.gov/press-center/press-releases/Documents/section125.pdf> at page 122.
- 8 - See Q&A 19 of [FAQs on HIPAA Portability and Nondiscrimination Requirements](#).



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