



Section of Taxation

10th Floor
740 15th Street, N.W.
Washington, DC 20005-1022
202-662-8670
FAX: 202-662-8682

August 3, 2012

OFFICERS

Chair

William M. Paul
Washington, DC

Chair-Elect

Rudolph R. Ramelli
New Orleans, LA

Vice Chairs

Administration

Fred T. Witt Jr.
Phoenix, AZ

Committee Operations

Priscilla E. Ryan
Chicago, IL

Communications

John P. Barrie
Washington, DC

Government Relations

Emily A. Parker
Dallas, TX

Professional Services

William H. Caudill
Houston, TX

Publications

Douglas M. Mancino
Los Angeles, CA

Secretary

Megan Brackney
New York, NY

Assistant Secretary

Thomas D. Greenaway
Boston, MA

COUNCIL

Section Delegates to the

House of Delegates

Richard M. Lipton
Chicago, IL

Susan P. Serota
New York, NY

Last Retiring Chair

Charles H. Egerton
Orlando, FL

Members

Alice G. Abreu
Philadelphia, PA

Kevin D. Anderson
Bethesda, MD

Joan C. Arnold
Philadelphia, PA

Andrew J. Dubroff
Washington, DC

Miriam L. Fisher
Washington, DC

Michael A. Clark
Chicago, IL

Julian Kim
Washington, DC

Mary Ann Mancini
Washington, DC

Eric Solomon
Washington, DC

Steven M. Rosenthal
Washington, DC

Pamela Baker
Chicago, IL

W. Curtis Elliott, Jr.
Charlotte, NC

Scott D. Michel
Washington, DC

Eric B. Sloan
New York, NY

Brian P. Trauman
New York, NY

LIAISONS

Board of Governors

Allen C. Goolsby, III
Richmond, VA

Young Lawyers Division

Adam J. Widlak
Chicago, IL

Law Student Division

Daniel Bruno
Tuscaloosa, AL

DIRECTOR

Christine A. Brunswick
Washington, DC

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments in Response to Notice 2011-1

Dear Commissioner Shulman:

Enclosed are comments in response to Notice 2011-1. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

A handwritten signature in black ink that reads "William M. Paul".

William M. Paul
Chair, Section of Taxation

Enclosure

cc: Emily S. McMahon, Assistant Secretary (Tax Policy), Department of the Treasury
William J. Wilkins, Chief Counsel, Internal Revenue Service

**ABA SECTION OF TAXATION
COMMENTS IN RESPONSE TO NOTICE 2011-1 CONCERNING
AFFORDABLE CARE ACT NONDISCRIMINATION PROVISIONS
APPLICABLE TO INSURED GROUP HEALTH PLANS**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, these Comments should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Evelyn A. Haralampu. Contributions were made by Linda R. Mendel, Juliana Reno, Christine P. Roberts, Priscilla E. Ryan, Laura R. Westfall, and Matthew J. Eickman. These Comments were reviewed by Mark A. Bodron, a Vice Chair of the Employee Benefits Committee, and Joni L. Andrioff, Chair of the Employee Benefits Committee. The Comments were further reviewed by Roberta Casper Watson and James R. Raborn on behalf of the Section’s Committee on Government Submissions and by Pamela Baker, Council Director for the Employee Benefits Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contacts:

Evelyn A. Haralampu
(617) 345-3351
eharalampu@burnslev.com

Joni L. Andrioff
(312) 795-3274
jandrioff@littler.com

Date: August 3, 2012

EXECUTIVE SUMMARY

In Notice 2011-1¹ (the “Notice”), the Department of the Treasury and Internal Revenue Service, the Department of Labor, and the Department of Health and Human Services (collectively, the “Departments”) solicited the views of interested parties respecting the insurance nondiscrimination provisions (the “insurance nondiscrimination rule”) of section 10101(d) of the Patient Protection and Affordable Care Act of 2010² (the “Affordable Care Act” or “Act”), adding section 2716 of the Public Health Service Act³ (the “PHS Act” or “PHSA”), which in turn references section 105(h).⁴ More particularly, the Notice invited responses to 13 issues raised by and related to comments received in response to Notice 2010-63.⁵

In response to the invitation from the Departments, and for the reasons described in detail in these Comments, we provide the following summary of our responses regarding the 13 issues (referred to in these Comments as Items 1 through 13):

- We believe that a design-based test to determine whether benefits are nondiscriminatory for purposes of section 2716 is the proper test.
- We believe that the grant of authority under section 2716(b)(1) is sufficient to permit the Departments to fashion design-based eligibility rules under which plan sponsors would be allowed to test for discrimination in favor of highly compensated individuals based on access (*i.e.*, eligibility, rather than actual plan coverage).
- We recommend, therefore, that the Departments adopt a nondiscrimination rule whereby the “eligibility test” of section 105(h)(3)(A), as carried over to section 2716, would be design-based rather than utilization-based.
- If, nonetheless, the Departments choose to adopt a utilization-based approach, we recommend the following: (1) generous safe harbor plan designs that permit design-based testing where coverage is broad-based; (2) excluding from the testing fraction's numerator and denominator those non-highly compensated individuals satisfying certain requirements; and (3) a generous transition rule before the rules go into effect.
- In the event the Departments adopt a utilization-based nondiscrimination test, we recommend that individuals who obtain coverage through an exchange be excluded from both the numerator and denominator of the testing fraction.
- Unfortunately, we see no statutory basis for permitting an insured group health plan to use a section 414(q) highly compensated employee definition in performing the nondiscrimination tests.

¹ 2011-2 I.R.B. 259.

² Pub. L. 111-148, 124 Stat. 119.

³ Pub. L. No. 78-410, 58 Stat. 682 (1944).

⁴ Unless otherwise indicated, except for section 2716, references to a section are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), and references to section 2716 are to section 2716 of the PHS Act.

⁵ 2010-41 I.R.B. 420.

- We recommend that the Departments adopt a rule under which insured group health plans may be disaggregated for nondiscrimination testing purposes based on their geographic locus, subject to an anti-abuse rule to prevent employers from providing better benefits only to employees at the executive headquarters (where highly compensated individuals are more likely to work).
- Regarding the need for “safe harbor” plan designs, if the Departments ultimately decide to test nondiscrimination as to eligibility on a design-basis, we believe that no safe harbor rules would be needed. If, on the other hand, the Departments decide to adopt a utilization-based test, then we recommend the adoption of a safe harbor satisfying five specific requirements described in more detail in Item 6 of these Comments.
- For eligibility testing purposes, we recommend the adoption of the permissive aggregation of “substantially similar” plans, based on the principles articulated in Regulation section 1.105-11(c)(4). For benefits testing purposes, we recommend the adoption of a rule under which various options are deemed to be “substantially similar” if the actuarial value of the aggregate benefits provided by the plan are within 10 percentage points (*i.e.*, a “Silver-Level” plan⁶ and a “Gold-Level” plan would be deemed to be “similar” for this purpose).
- Regarding the application of nondiscrimination rules to “expatriate” and “in-patriate” coverage, we recommend that the Departments adopt a safe harbor for international medical expatriate plans.
- We recommend that multiple employer health plans be permitted to elect to be tested for nondiscrimination in any of the following three ways: (1) as a single plan, provided that all employers offered the same health coverage options under the plan; (2) on an employer-by-employer basis; or (3) for each employer participating in a multiple employer health plan that elected to be tested on an employer-by-employer basis, by aggregating its portion of the multiple employer plan with any other single employer health plan maintained by the employer or with all single employer health plans maintained by members of the same controlled group as the employer.
- Regarding the issue of whether coverage provided on an after-tax basis should be disregarded in applying section 2716, we recommend that, consistent with the application of the nondiscriminatory classification test to a self-insured group health plan, the testing methodology under section 2716 should treat an individual who has been taxed on the full premium for insured coverage as not benefiting under the plan.
- We recommend that the Departments establish a liberal transitional rule for application of the nondiscrimination rules following a merger, acquisition, or other corporation transaction, under which plans and benefit package options may continue to be tested without regard to changes in the controlled group for a

⁶ Act § 1302(d).

specified period following such a transaction, similar to the rule in section 410(b)(6) applicable to qualified plans. We further recommend that the Departments adopt such a period that extends, at a minimum, to the end of the second plan year following such a transaction.

- To the extent consistent with the statute, we believe the section 2716 penalty should apply in proportion to the seriousness of the violation. We recommend that any failure of section 2716 due to reasonable cause (and not willful neglect) that an employer does not correct within 30 days of discovery would still be subject to substantial annual penalties, but such penalties would relate directly to the highly compensated individuals who are being provided the discriminatory benefits.

BACKGROUND

These Comments are submitted in response to the request for comments by the Departments in the Notice, which solicited the views of interested parties respecting the insurance nondiscrimination rule of section 10101(d) of the Affordable Care Act, adding section 2716 of the PHS Act, which in turn references section 105(h). More particularly, the Notice invites responses to 13 issues raised by and related to comments received in response to Notice 2010-63.⁷

COMMENTS

Set forth below are each of the 13 Items listed in Section IV of the Notice, and our comments in response to each Item:

1. *The basis on which the determination of what constitutes nondiscriminatory benefits under § 105(h)(4) should be made and what is included in the term “benefits.” For example, is the rate of employer contributions toward the cost of coverage (or the required percentage or amount of employee contributions) or the duration of an eligibility waiting period treated as a “benefit” that must be provided on a nondiscriminatory basis?*

Because section 2716 requires that insured group health plans be subject to the nondiscriminatory benefits rules under section 105(h)(2) and rules “similar” to the rules contained in section 105(h)(4) (nondiscriminatory benefits), we believe the existing statute and regulatory guidance under section 105 provide the proper place to begin an analysis of testing nondiscriminatory benefits for section 2716 purposes.

The Regulations under section 105 provide a “design-based” approach to testing whether benefits are nondiscriminatory. The Regulations state, in relevant part:

Plan benefits will not satisfy the requirements of this subparagraph 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 the dependents of employees who are highly compensated individuals must also be *available on the same basis* for the dependents of all other employees who are participants. A plan that provides optional benefits to participants will be treated as providing a single benefit with respect to the benefits covered by the option provided that (A) all eligible participants may elect any of the benefits covered by the option and (B) there are either no required employee contributions or the required employee contributions are the same amount. This [nondiscriminatory benefits] test is applied to the benefits subject to reimbursement under the plan *rather than to the actual benefit payments or claims* under the plan. The presence or absence of such discrimination will be determined by considering the *type* of benefit subject to reimbursement provided highly compensated individuals, as

⁷ See ABA Section of Taxation, “Comments in Response to Notice 2010-63 Concerning Requirements Prohibiting Discrimination in Favor of Highly Compensated Individuals in Insured Group Health Plans” (May 4, 2011) (“Notice 2010-63 Comment”), *available at* <http://www.americanbar.org/content/dam/aba/administrative/taxation/050411comments.authcheckdam.pdf>, regarding the ABA Section of Taxation’s comments in response to Notice 2010-63.

well as the amount of the benefit subject to reimbursement. A plan may establish a maximum limit for the amount of reimbursement which may be paid [under a self-insured plan to] a participant for a single benefit, or combination of benefits. However, any maximum limit attributable to employer contributions must be uniform for all participants and for all dependents of employees who are participants and may not be modified by reason of a participant's age or years of service. In addition, if a plan covers employees who are highly compensated individuals, and the type or the amount of benefits subject to reimbursement under the plan are in proportion to employee compensation, the plan discriminates as to benefits.⁸

The Regulations goes on to state: "A plan is not considered discriminatory merely because highly compensated individuals participating in the plan *utilize* a broad range of plan benefits to a greater extent than do other employees participating in the plan."⁹

These principles of nondiscriminatory benefits, as articulated in the Regulations promulgated under section 105: (a) test the availability of each type of benefit to all participants similarly situated, rather than the actual utilization of those benefits; (b) prohibit basing the type or amount of benefits subject to reimbursement on the size of a participant's compensation; (c) allow the employer to set a maximum limit on benefits, as long as such maximum attributable to employer contributions is uniform for all participants and dependents without regard to age or years of service; and (d) require that any employee contributions for optional benefits must be the same amount for all employees similarly situated.

From these principles, we conclude that the basis of what constitutes nondiscriminatory benefits under section 105(h)(4) is a design-based test rather than a "utilization-based" test. As long as benefits are similarly available to a nondiscriminatory group of participants who are similarly situated, the benefits should be deemed nondiscriminatory. For example, if an employer offers a nondiscriminatory group of employees a choice of the same four health plans (*e.g.* indemnity, health maintenance organization, preferred provider organization, and point-of-service) available to similarly situated employees on similar terms, including those relating to employer and employee contributions, the arrangement offers nondiscriminatory benefits under section 105, even if highly compensated individuals utilize the more expensive option offered in greater numbers.

Furthermore, "benefits" for purposes of section 105 refer to reimbursements for medical care as defined in section 213(d) for the employee, spouse, and statutory dependents.¹⁰ Under section 105, the definition of "benefits," therefore, excludes the rate of the employer contributions toward the cost of coverage, the required percentage or amount of employee contributions, and the duration of an eligibility waiting period. While these concepts may be addressed elsewhere in section 105, they are not "benefits," as therein defined.

Thus, for the reasons above, we believe that a design-based test to determine whether benefits are nondiscriminatory for purposes of section 2716 is the proper test.

⁸ Reg. § 1.105-11(c)(3)(i) (emphasis added).

⁹ Reg. § 1.105-11(c)(3)(ii) (emphasis added).

¹⁰ I.R.C. § 105(b).

2. *The suggestion made in previous comments that the Departments have the authority to provide for an alternative method of compliance with § 2716 that would involve only an availability of coverage test.*

Section 105(h)(2)(A) uses the term “eligibility” as one of the two criteria for testing whether a self-insured plan discriminates in favor of highly compensated individuals. However, section 105(h)(3) defines “eligibility” to mean that a participant is *benefiting* under the plan. The wording of section 105(h)(3) is very similar to the wording in section 410(b)(1)(A), which provides minimum coverage requirements for tax-qualified retirement plans. The Regulations promulgated under section 410(b) provide that a participant in a pension plan is considered to be benefiting under that plan only if the participant receives an allocation under the plan or has an increase in accrued benefits under the plan.¹¹ In the case of a “cash or deferred arrangement” under section 401(k) (“401(k) plan”), however, a participant is treated as benefiting under the plan only if the participant is eligible to receive benefits under the plan.¹²

Whether an individual receives a benefit under a health plan depends upon whether he or she receives medical services. Whether an individual receives an allocation under a 401(k) plan depends upon whether he or she contributes to the plan. In contrast, participants in a defined benefit plan or a defined contribution plan that is not a 401(k) plan do not need to take any action in order to receive an allocation or have an increase in accrued benefits. Thus, it appears that the meaning of “benefiting” under a health plan is closer to the meaning of “benefiting” under a 401(k) plan (rather than under a defined benefit or non-401(k) profit sharing plan) because the concepts of allocations and increases in accrued benefits do not apply to a health plan. Given that participation is voluntary for both a 401(k) plan and a group health plan, we believe that it makes sense to apply similar eligibility tests to the nondiscrimination testing of both types of plans.¹³

Further, although we recognize that a design-based test may not be the test that applies to self-insured plans, the consequences of not satisfying the nondiscrimination rules that apply to self-insured plans are very different than the consequences for not satisfying the nondiscrimination rules of section 2716 with respect to an insured plan. The ramifications for not complying with the nondiscrimination rules for self-insured plans fall on highly compensated individuals, who lose a tax benefit. But the more comprehensive consequences of not complying with the nondiscrimination rules of section 2716 subject an insured plan to a civil action and the plan or the plan sponsor to an excise tax under section 4980D. Section 2716 provides that rules “similar to” the rules contained in section 105(h)(3) are to apply to insured health plans, thereby permitting a different approach to be adopted for insured health plans.

We concur with comments previously submitted in response to Notice 2010-63 that the grant of authority under section 2716(b)(1) is sufficient to permit the Departments to fashion design-based eligibility rules under which plan sponsors would be allowed to test for discrimination in favor of highly compensated individuals based on access (*i.e.*, eligibility, rather

¹¹ Reg. § 1.410(b)-3(a)(1).

¹² Reg. § 1.410(b)-3(a)(2).

¹³ PHS Act § 2716(b)(1) (“Rules similar to the rules contained in paragraphs (3), (4), and (8) of section 105(h) of such Code shall apply.”).

than actual plan coverage).¹⁴ We recommend, therefore, that the Departments adopt a nondiscrimination rule whereby the “eligibility test” of section 105(h)(3)(A), as carried over to section 2716, would be design-based rather than utilization-based. Under this approach, if an employee had satisfied the plan’s eligibility criteria (*e.g.*, he or she were included in a covered class and had satisfied any applicable waiting period), he or she would be deemed to be eligible irrespective of whether he or she actually enrolls in the plan. In support of this recommendation, we note that design-based and utilization-based tests are intended to accomplish the same goal: to ensure that highly compensated individuals are not offered a better group health plan design than other employees. We believe that there are strong policy-based reasons that support our recommendation. In our Notice 2010-63 Comment, we explained those reasons at length, which include the following:

To impose a qualitative testing regime on employers would vastly complicate the maintenance and operation of group health plans. It would also burden employers with an additional layer of costs that many may deem unacceptable. This could lead to the wholesale abandonment of group health plans, particularly by smaller employers who are not subject to the Act’s “employer responsibility” requirements, which take effect in 2014. We believe that such a result would be counter to the intent of the insurance nondiscrimination rule.

Moreover, we believe that there is little to be gained by such a rule. The benefit packages offered by employer sponsored group health plans tend to be similar from employer to employer and from industry to industry, and the Act will further accelerate this trend by imposing on carriers rules governing essential health benefit packages. A design-based test will ensure that highly compensated participants are not provided with greater contributions or more favorable benefit package options and contribution amounts.¹⁵

Further, as we stated in our Notice 2010-63 Comment, adoption of a design-based eligibility test would be consistent with the existing rules regarding nondiscrimination testing of contributory retirement plans, (*e.g.*, section 401(k) plans and plans that allow after-tax employee contributions) in which an employee is treated as benefiting under the plan if he or she is *eligible to participate* in the plan.¹⁶

Design-based testing appears to be consistent with Congressional intent. According to the Senate Democratic Policy Committee’s Section-by-Section Analysis of PPACA, section 2716 will ensure that “[e]mployers that provide health coverage will be prohibited from limiting *eligibility for coverage* to highly compensated individuals.”¹⁷

¹⁴ See, *e.g.*, Public Comment Letter dated Nov. 4, 2010 from Kathryn Wilbur, Senior Council, Health Policy, American Benefits Council, p. 9 (“We read the reference to ‘rules similar’ in PHSA section 2716(b)(1) to provide the Departments with sufficient authority to issues substantive rules that diverge from . . . those set forth in Code section 105(h)(2) . . .”).

¹⁵ Notice 2010-63 Comment, Section II.C., p. 7.

¹⁶ Notice 2010-63 Comment, Section II.C., p. 8.

¹⁷ See <http://dpc.senate.gov/healthreformbill/healthbill96.pdf>, available at http://dpc.senate.gov/dpcissue-sen_health_care_bill.cfm (emphasis added).

Separately, we are concerned that a utilization-based test could be particularly burdensome if applied to plans of small employers, where the decision by one or a handful of eligible non-highly compensated individuals could result in the plan failing to pass the test.

We underscore that, in our view, the question of eligibility testing on the basis of availability – as opposed to actual plan participation – goes to the heart of the PHS Act insurance nondiscrimination rule and is consistent with the principles articulated in our comments in response to Item 1, above. We believe that a utilization-based test would require expensive and time-consuming data collection and analysis, the burdens of which would fall most heavily on smaller employers. It is not inconceivable that such a test would lead to the same ultimate fate realized by section 89 – repeal.

For the reasons set out above, we submit that a design-based test accomplishes the aims of the Act and is consistent with principles articulated in existing Regulations under section 105.

If, nonetheless, the Departments choose to adopt a utilization-based approach, we recommend the following:

(a) Generous safe harbor plan designs that permit design-based testing where coverage is broad-based (*see* our response to Item 6, below);

(b) Exclusion from the testing fraction's numerator and denominator of those non-highly compensated individuals who (i) are covered under a plan of a spouse or parent, (ii) are covered under a plan of a former employer, (iii) are covered under a governmental plan or program (*e.g.*, Medicare, Medicaid, TRICARE), (iv) are covered under a plan sponsored by a state-based exchange (irrespective of whether they are eligible for a premium- or cost-sharing subsidy), or (v) receive a free choice voucher from their employer; and

(c) A generous transition rule before the rules go into effect (*e.g.*, to 2014).

3. *The application of § 2716 to insured group health plans beginning in 2014 when the health insurance exchanges become operational and the employer responsibility provisions (§ 4980H of the Code), the premium tax credit (§ 36B of the Code), and the individual responsibility provisions (§ 5000A of the Code) and related Affordable Care Act provisions are effective.*

The inclusion of health insurance exchanges adds a new and potentially disruptive variable into the nondiscrimination testing equation. Employees may, if they choose, purchase insurance on an exchange rather than purchasing the employer-sponsored coverage. This choice may be motivated by cost – the lower an employee's income and the higher the applicable government subsidy (under section 36B(c)) for exchange coverage, the more likely it is that the employee will choose exchange coverage. However, it may also be motivated by other factors, such as concerns about privacy issues at the employer, a desire to have all family members covered by the same policy, or obtaining coverage that does not change with every job. Few, if any, of these factors are within the employer's control.

An employer offering coverage to all of its full-time employees should not be subject to penalties under section 2716 simply because employees choose other available options.

Moreover, because an employee's purchase of exchange coverage already puts the employer at risk of penalties under section 4980H(b), section 2716 would act as a second penalty for the same employee and would be unnecessarily punitive.

Accordingly, we again recommend that the Departments adopt a design-based nondiscrimination test. If the Departments decide instead to adopt a utilization-based nondiscrimination test, we similarly recommend that individuals who obtain coverage through an exchange be excluded from both the numerator and denominator of the testing fraction.

4. *The suggestion in previous comments that the nondiscriminatory classification provision in § 105(h)(3)(A)(ii) could be used as a basis to permit an insured health care plan to use a highly compensated employee definition in § 414(q) of the Code for purposes of determining the plan's nondiscriminatory classification.*

Section 2716(b)(2) provides that “the term ‘highly compensated individual’ has the meaning given such term by section 105(h)(5) of [the] Code.” Therefore, we see no basis for permitting an insured group health plan to use a section 414(q) highly compensated employee definition in performing the nondiscrimination tests. This is unfortunate because, for many organizations, this definition may cause employees who are considered “rank-and-file” for other purposes to be highly compensated individuals for insurance nondiscrimination testing purposes.

5. *The suggestion in previous comments that the nondiscrimination standards should be applied separately to employers sponsoring insured group health plans in distinct geographic locations and on whether application of the standards on a geographic basis should be permissive or mandatory.*

Section 2716(b)(1) applies rules “similar” to the rules contained in section 105(h)(3) (nondiscriminatory eligibility classification), section 105(h)(4) (nondiscriminatory benefits), and section 105(h)(8) (certain controlled group rules). While the rules under these provisions of section 105 are silent on disaggregation in testing, analogous testing rules under sections 401(a)(4) and 410(b) operate to determine whether a retirement plan benefits a nondiscriminatory group of employees within a controlled group. The Regulations under section 410(b) require disaggregation in some circumstances and permit it in other circumstances.¹⁸ Because section 2716 requires the application of rules that are only “similar” to sections 105(h)(3), 105(h)(4), and 105(h)(8), we believe that the Departments have the authority under the statute to adopt a rule that allows for permissive disaggregation in nondiscrimination testing, based on geography, using the analogous rules of sections 410(b) and 401(a)(4) and the Regulations thereunder. Permissive disaggregation could be allowed not only for each member of a controlled group, but also for a single employer if its employees work in distinct geographical locations.

The nondiscrimination testing required by section 105(h) does not lend itself to seamless application to insured plans. For example, plans of employers with multiple locations routinely purchase insurance coverage in local markets, which are separately underwritten. The same coverage may be priced differently based on local and regional differences in costs (which typically reflect differences in the underlying cost-of-living and medical cost inflation). An

¹⁸ Reg. § 1.410(b)-7.

employer that endeavors in good faith to cover a broad cross-section of its employees across multiple states and localities may not be able to satisfy section 2716 if the law were applied as if insurance were globally underwritten. In contrast to self-insured group health plans, which are universally underwritten, insured plans reflect local markets. Thus, the nondiscrimination rules in section 105(h), which are appropriate and workable in the context of self-insured arrangements, do not work equally well when applied to insured group health plans. Something more is needed.

Based on the foregoing, we recommend that the Departments adopt a rule under which insured group health plans may be disaggregated for nondiscrimination testing purposes based on their geographic locus, subject to an anti-abuse rule to prevent employers from providing better benefits only to employees at the executive headquarters (where highly compensated individuals are more likely to work). The anti-abuse rule could, for example, take the form of a test based on the actuarial equivalence of benefits.

6. *The suggestion in previous comments that the guidance should provide for “safe harbor” plan designs. Specifically, comments are requested on potential safe and unsafe harbor designs that are consistent with the substantive requirements of § 105(h).*

We believe that if the Departments ultimately decide to test nondiscrimination as to eligibility on a design-basis (as we have previously recommended), then no safe harbor rules would be needed because an employer could accomplish the equivalent of a “safe harbor” plan by offering coverage to all non-excludable employees.

If, on the other hand, the Departments decide to adopt a utilization-based test, then we recommend that the following safe harbor plan design be adopted:

- (a) The plan be offered to (i) all non-excludable employees or (ii) a non-discriminatory classification of non-excludable employees;
- (b) The plan be “affordable” within the meaning of section 36B(c)(2)(C)(ii)¹⁹ (*i.e.*, the plan covers 60% of plan costs);
- (c) The plan provides an essential health benefit package within the meaning of section 1302 of the Act;
- (d) The employer-paid premium is not less than some fixed percentage of the cost of individual coverage (for example, the Commonwealth of Massachusetts requires 33% in order for an employer to satisfy the premium contribution test under its “fair share testing” rules),²⁰ which are analogous to the Act’s “Employer Responsibility” provisions);²¹ and
- (e) Where the plan has more than one benefit package option (*e.g.*, indemnity, point-of-service, health maintenance organization, or preferred provider organization), all

¹⁹ Added by Act § 1401.

²⁰ 114.5 CMR 16.03(3)(d).

²¹ Act §§ 1513, 10106(e); Health and Education Reconciliation Act of 2010 § 1003(b).

participants in the plan have access to all such options on the same terms and subject to the same eligibility criteria and other conditions.

Separately, and irrespective of whether the insurance nondiscrimination rule is based on design or utilization, we concur with the recommendation included in previous comments that the Departments adopt a broad eligibility safe harbor.²² Such a safe harbor might, for example, treat any waiting period of 90 days or less as equivalent for testing purposes. Such a rule would accommodate employers with multiple groups of employees with different turnover rates, thereby providing design flexibility that responds to bona fide business circumstances.

Finally, we recommend that the Departments consider an additional safe harbor for a benefit plan or benefit package option that is made available only to employees who are not highly compensated individuals (or the equivalent thereof under applicable Regulations), either alone or teamed with a separate benefit plan or benefit package option limited to highly compensated individuals (or the equivalent thereof under applicable Regulations), provided that the employer-paid portion of the individual premium is either (a) the same flat dollar amount under both arrangements or (b) expressed as a percentage of compensation and the applicable percentage is equal under both arrangements.

7. *Whether employers should be permitted to aggregate different, but substantially similar, coverage options for purposes of § 2716 and, if so, the basis upon which a “substantially similar” determination could be made.*

For eligibility testing purposes, we recommend the adoption of the permissive aggregation of “substantially similar” plans, based on the principles articulated in Regulation section 1.105-11(c)(4). That Regulation permits designating two or more plans as a single plan for purposes of nondiscriminatory eligibility and benefits testing. For benefits testing purposes, we recommend the adoption of a rule under which various options are deemed to be “substantially similar” if the actuarial value of the aggregate benefits provided by the plan are within 10 percentage points (*i.e.*, a “Silver-Level” plan²³ and a “Gold-Level” plan would be deemed to be “similar” for this purpose).

8. *The application of the nondiscrimination rules to “expatriate” and “inpatriate” coverage.*

U.S.-based employers with significant operations outside the United States often provide group or supplemental coverage to outbound employees under separate medical plans, which are typically insured plans. These plans typically are designed to offer expatriates health benefits that are identical, or as close as possible, to the health benefits offered to employees working in the United States. These plans are particularly important when expatriates are located in countries that do not have adequate public health systems by U.S. standards. Previous comments have recommended that the Departments adopt a safe harbor for international medical expatriate plans.²⁴ We concur. The safe harbor design needs to be broad enough to take into account that employees covered by such plans tend to be highly compensated because expatriates tend to hold

²² See Public Comment letter dated March 11, 2010 of Justine Handleman, Vice President, Legislative and Regulatory Affairs, Blue Cross Blue Shield Association, p. 2.

²³ Act § 1302(d).

²⁴ Public Comment Letter of Edward P. Potanka, CIGNA Corporation, dated Nov. 2, 2010.

management and executive level position.²⁵ A broader safe harbor for these plans would not be counter to the goal of the nondiscrimination rule for two reasons. First, eligibility for coverage for expatriates under such plans is predicated on where the expatriates are assigned to work, not on their level of compensation. Second, if they were based in the United States, they would be offered the same health coverage as the employer's U.S. based employees and that coverage must satisfy either section 105 or section 2716.

9. *The application of the nondiscrimination rules to multiple employer plans.*

We recommend that multiple employer health plans be permitted to be tested for nondiscrimination in any of the following three ways. First, a multiple employer health plan could elect to be tested as a single plan, provided that all employers are offered the same health coverage options under the plan. This testing method would be particularly useful for multiple employer plans that are organized as voluntary employees' beneficiary associations ("VEBAs"). The Regulations provide that "employees of one or more employers engaged in the same line of business in the same geographic locale will be considered to share an employment-related bond for purposes of an organization through which their employers provide benefits."²⁶ This type of permissive aggregation naturally fits the VEBA design. Second, the multiple employer health plan could elect to be tested on an employer-by-employer basis. Third, each employer participating in a multiple employer health plan that elected to be tested on an employer-by-employer basis could be permitted to aggregate its portion of the multiple employer plan with any other single employer health plan maintained by the employer or with all single employer health plans maintained by members of the same controlled group as the employer.

10. *The suggestion in previous comments that coverage provided to a "highly compensated individual" (as defined in § 105(h)(5)) on an after-tax basis should be disregarded in applying § 2716.*

Section 105 does not apply when the value of self-insured group health coverage is included in employees' income.²⁷ When the value of self-insured group health coverage is included in employees' income, section 104(a)(3) governs the taxation of benefits. Section 104(a)(3) provides that gross income does not include:

[A]mounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer).

When the value of self-insured group health coverage is excluded from employees' income under section 106(a), section 105 governs the taxation of benefits. Section 105(b) excludes benefits provided under employer-provided group health coverage from employees'

²⁵ *Id.* ("In some industries, because expatriate employees may hold management or even executive-level positions, there could be a higher representation of highly compensated employees versus non-highly compensated employees").

²⁶ Reg. § 1.501(c)(9)-2.

²⁷ I.R.C. § 105(a).

income except that, in the case of a discriminatory self-insured group health plan, employees who are highly compensated individuals are taxed on some or all of the benefits.

One of the options for testing for discrimination as to eligibility under section 105(h) is the nondiscriminatory classification test.²⁸ The employer must take the following steps to perform the nondiscriminatory classification test (applying section 105 and using analogous principles from sections 401(a)(4) and 410(b) and the Regulations thereunder):

Step 1. Determine which employees are excluded from its testing group. Generally, the employer may exclude:

- (a) employees with less than three years of service;
- (b) employees who have not attained age 25;
- (c) part-time and seasonal employees;
- (d) collectively bargained employees who are excluded from the plan; and
- (e) nonresident aliens with no U.S. income.²⁹

Step 2. Identify each employee (other than those excluded in Step 1) as either a highly compensated individual or a non-highly compensated individual.³⁰

Step 3. Compute the percentage of non-highly compensated individuals who benefit under the plan.

- (a) The numerator of the fraction is the number of non-highly compensated individuals who benefit under the plan.³¹ In counting the number of non-highly compensated individuals who benefit from the plan, any non-highly compensated individuals who were taxed on the value of their coverage are not counted.³²
- (b) The denominator of the fraction is the total number of non-highly compensated individuals (other than those excluded in Step 1 above).

Step 4. Compute the percentage of highly compensated individuals who benefit under the plan.

- (a) The numerator of the fraction is the number of highly compensated individuals who benefit under the plan. In determining the numerator, any

²⁸ I.R.C. § 105(h)(3)(A)(ii).

²⁹ I.R.C. § 105(h)(3)(B).

³⁰ I.R.C. § 105(h)(5). See Item 4, above, for a discussion of the definition of “highly compensated individual.”

³¹ See Item 2, above, for a discussion of what it means for an employee to “benefit” under a plan.

³² I.R.C. § 105(a).

highly compensated individuals who were taxed on the value of their coverage should be excluded.³³

- (b) The denominator of the fraction is the total number of highly compensated individuals (other than those excluded in Step 1).

Step 5. Divide the percentage from Step 3 by the percentage from Step 4 to calculate the ratio percentage.

Step 6. Compare the ratio percentage to the safe harbor and unsafe harbor percentages in Regulation section 1.410(b)-4(c)(4)(iv). If highly compensated individuals are defined as the top 25% of employees ranked by pay, the safe harbor and unsafe harbor percentages are 38.75% and 28.75%, respectively. If the ratio percentage exceeds the safe harbor percentage, the plan passes the nondiscriminatory classification test. If the ratio percentage is between the safe and unsafe harbor percentages, passage of the nondiscriminatory classification test depends on the facts and circumstances. If the ratio percentage is less than the unsafe harbor percentage, the plan fails the nondiscriminatory classification test.

Section 2716 does not preclude use of a similar testing methodology for insured group health plans. If the same testing methodology is used for insured plans, we believe employees who are taxed on the full premium for the coverage should be excluded from the numerators of the fractions in Steps 3(a) and 4(a).

As noted in our comments in response to Item 2 above, the penalty structure for failure of the nondiscrimination tests is radically different for self-insured group health plans under section 105(h) and insured group health plans under section 2716. If a self-insured group health plan is discriminatory, employees who are highly compensated individuals must include some or all benefits in income. If an insured group health plan is discriminatory, the plan is subject to an excise tax under section 4980D. However, the difference in penalty structure does not dictate that a different testing methodology is required. Consistent with the application of the nondiscriminatory classification test to a self-insured group health plan, the testing methodology under section 2716 should treat an individual who has been taxed on the full premium for insured coverage as not benefiting under the plan. Such a rule would more closely follow the principles of section 105(h) and would permit the employer to avoid potentially significant penalties under section 4980D simply by taxing one or more highly compensated individuals on their health insurance premiums.

11. *The treatment of employees who voluntarily waive employer coverage in favor of other coverage.*

See our Comments in response to Items 2 and 3, above.

12. *Potential transition rules following a merger, acquisition, or other corporate transaction.*

³³ I.R.C. § 105(a).

We recommend that the Departments establish a liberal transitional rule for application of the nondiscrimination rules following a merger, acquisition, or other corporation transaction, under which plans and benefit package options may continue to be tested without regard to changes in the controlled group for a specified period following such a transaction, similar to the rule in section 410(b)(6) applicable to qualified plans. We further recommend (as discussed in more detail in our Notice 2010-63 Comment) that the Departments adopt such a period that extends, at a minimum, to the end of the second plan year following such a transaction.³⁴ Provision of such transition relief would ease administrative burdens associated with mergers, acquisitions, and other corporation transactions involving one or more entities that maintain insured health plans, by providing employers and plan sponsors some time to evaluate their options.

13. *The application of the sanctions for noncompliance with § 2716.*

The policy underlying the insurance nondiscrimination rule is to encourage broad-based employer health coverage, which makes the penalty provisions critically important. If penalties are too high, employers will be inclined to abandon coverage or to seek to self-fund, even in instances where self-funding might be inappropriate, expensive to the employees, or inefficient. To the extent consistent with the statute, we believe the section 2716 penalty should apply in proportion to the seriousness of the violation.

An insured group health plan that fails to comply with the nondiscrimination rules under section 2716 is subject to an excise tax under section 4980D for each day in the noncompliance period. Notice 2010-63 assumes that this penalty is calculated with respect to each individual who is discriminated against.³⁵ Under the interpretation of section 4980D(b) offered by Notice 2010-63, an employer with 1,000 employees that provides discriminatory benefits in favor of 250 highly compensated individuals would incur a \$75,000 penalty per day as long as the discriminatory policies exist (*i.e.*, \$100 per day multiplied by 750 non-highly compensated employees).

We do not believe that section 4980D(b) compels this result. The statute reads, in pertinent part:

The amount of the tax imposed by subsection (a) [of section 4890D] on any failure shall be \$100 for each day in the noncompliance period *with respect to each individual to whom such failure relates.*³⁶

We submit that the phrase “individual to whom such failure relates” might well be interpreted to mean any highly compensated individual who is discriminated in favor of as a result of the failure.

³⁴ See Notice 2010-63 Comment, Section VIII, p. 12, for additional comments regarding treatment in the context of mergers and acquisitions.

³⁵ See Notice 2010-63 (“An insured group health plan failing to comply with the nondiscrimination requirements of Code section 105(h) is subject to the taxes, remedies, and penalties that generally apply for a plan failing to comply with the requirements of chapter 100 of the Code (*generally, an excise tax of \$100 per day per individual discriminated against* for each day the plan does not comply with the requirement)” (emphasis added).

³⁶ I.R.C. § 4980D(b)(1) (emphasis added).

As demonstrated by the example above, a penalty of the magnitude resulting under the approach suggested in Notice 2010-63 is excessive and counter-productive to the goal of the Act to maintain and increase the number of individuals who have health insurance. Under the interpretation of section 4980D that we recommend, any failure of section 2716 due to reasonable cause (and not willful neglect) that an employer does not correct within 30 days of discovery would still be subject to substantial annual penalties, but such penalties would relate directly to the highly compensated individuals who are being provided the discriminatory benefits. Such an approach is consistent with the approach under section 105(h).³⁷

³⁷ See Item 10, above, under which we propose for employers to self-correct discriminatory insurance plans without incurring the section 4980D penalty.