Internal Revenue Service

memorandum

FREV-104062-98
Br.6:FJZech

date: APR 28 1998

to: Director, Exempt Organizations Technical Division CP:E:EO
Attn: Chief, Technical Branch 4

from: Chief, Branch 6 CC:EBEO:6
Office of the Associate Chief Counsel
(Employee Benefits and Exempt Organizations)

subject: Technical Assistance Request - [redacted]
Welfare Benefit Trust

This is in response to your memorandum of February 17, 1998, requesting technical assistance with respect to whether the captioned taxpayer's self-insured medical reimbursement plan is discriminatory under section 105(h) of the Internal Revenue Code.

The taxpayer was created on [redacted] to provide self-funded medical benefits to employees. Benefits are funded by employer contributions and employee contributions. Some benefits are partially funded by salary reduction contributions through a cafeteria plan.[1]

Employees are classified as either full-time (32 or more hours per week) or part-time (more than 10 but less than 32 hours per week). All full-time and part-time employees are eligible for participation in the plan after two months of service. However, if they elect to participate, they must pay 100% of the cost until they have six months of service, at which time, the employer pays approximately 50% of the cost. Employer contribution is set at total costs less employee contributions.

As of September 28, 1996, there were [redacted] total employees of which [redacted] were highly compensated individuals (HCIs). Of the HCIs, [redacted] were excludable

[1]Section 8.07 of Rev. Proc. 98-4, 1998-1 I.R.B. 113, provides that the Service does not issue letter rulings or determination letters on whether a cafeteria plan satisfies the requirements of section 125. In addition, section 3.01(7) of Rev. Proc. 98-3, 1998-1 I.R.B. 100, provides that the Service will not issue rulings or determination letters concerning whether amounts used to provide accident and health benefits under sections 105 and 106 are includible in the gross income of participants and considered "wages" for purposes of sections 3401, 3121, and 3306 when the benefits are offered through a cafeteria plan. Accordingly, we express no opinion as to whether the taxpayer's cafeteria plan complies with the requirements of section 125 of the Code.

employees ([redacted] of the excludable HCIs were not plan participants). As defined in the plan for eligibility purposes, there were [redacted] part-time employees ([redacted] of which were not excludable employees). Of the nonexcludable part-time employees, [redacted] were non-participants and [redacted] were participants. There were a total of [redacted] excludable employees[2].

The taxpayer offers a total of 9 plans to its employees. For employees living in [redacted] there are generally four plans available: (1) the [redacted] plan for full-time employees; (2) the [redacted] plan; (3) the [redacted] plan for part-time employees; and (4) the [redacted] plan. Employees in [redacted] and [redacted] are eligible for the same plans as are the employees in [redacted] For employees living in all other states, there are five plans available: (5) the [redacted] plan for full-time employees; (6) the [redacted] plan for part-time employees; (7) the [redacted] plan; (8) the [redacted] plan; and (9) the [redacted] plan[3]. In addition. there are a number of HMO's in which employees may elect enrollment as an alternative to participation in other available plans[4].

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[2]The taxpayer's September 11, 1997 letter states that there are [redacted] excludable employees. However, that number includes employees who worked more than 25 hours per week. Under section 1.105-11(c)(2)(C) of the regulations, employees who have a customary work week of less than 25 hours may be considered part-time. Employees who have a work week between 25 and 35 hours may be considered part-time only if other employees in similar work with the same employer have substantially more hours. The taxpayer considers any employee who works less than 32 hours to be part-time. It is not clear from the facts whether those employees working more than 32 hours are doing similar work and how many of those who are doing similar work are working substantially more than 32 hours. Accordingly, the [redacted] excludable employees stated in the taxpayer's September 11 1997 letter has been reduced by the [redacted] "part-time" employees who have a work week of more than 25 hours, leaving [redacted] excludable employees.

[3]Employee contribution to the [redacted] and [redacted] plans may be made through pre-tax cafeteria plan salary reduction. The cafeteria plan is not available to part-time associates. See page 10 of SPD 3.

[4]Section 1.105-11(c)(4)(iii) provides that for purposes of the eligibility test. a self-insured plan will be deemed to benefit an employee who has enrolled in an HMO that is offered on an optional basis by the employer in lieu of coverage under the self-insured plan if, with respect to that employee, the employer's contributions to the HMO plan equal or exceed those that would be made to the self-insured plan as a single plan. Accordingly, if the taxpayer's optional HMO contributions meet the

Section 105(h) of the Code sets forth the nondiscrimination rules for self-insured medical reimbursement plans. Section 105(h)(2)(A) provides that a self-insured medical reimbursement plan satisfies the requirements of section 105(h) only if the plan does not discriminate in favor of HCIs as to eligibility to participate. In addition, section 105(h)(2)(B) provides that 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 HCIs.

Discriminatory Benefits

Section 105(h)(2)(B) of the Code and section 1.105-11(c)(3)(i) of the Income Tax Regulations provide that benefits subject to reimbursement under a plan must not discriminate in favor of participants who are HCIs. Plan benefits will not satisfy the requirements of this subparagraph unless all the benefits provided for participants who are HCIs are provided for all other participants. In addition, all the benefits available for the dependents of employees who are HCIs must also be available on the same basis for the dependents of all other employees who are participants.

In the instant case, plans 7, 8, and 9 provide for a $350, $550 and $600 individual deductible, respectively. Part-time employees are not eligible to participate in plans 7 and 8. If plans 7, 8, and 9 are treated as one plan and there are any HCIs in plans 7 or 8, the first $250 of benefits received by HCIs in plan 7 and the first $200 received by HCIs in plan 8 are benefits not available to participants who are in plan 9. Accordingly, if tested as one plan, the taxpayer's self-insured medical reimbursement plan fails the nondiscriminatory benefits provisions of section 105(h)(2)(B) of the Code and section 1.105-11(c)(3)(i) of the regulations.

However, section 1.105-11(c)(4) of the regulations provides that, "A single plan document may be utilized by an employer for two or more separate plans provided that the employer designates the plans that are to be considered separately and the applicable provisions of each plan." Thus, if the plans are tested as 9 separate plans or grouped into a number of plans having identical benefits, each plan will pass the nondiscriminatory benefits test of section 105(h)(2)(B).

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requirements of section 1.105-11(c)(4)(iii), the HMO participants must be considered as participants in the self-insured plan.

FREV-104062-98

Eligibility to Participate

Section 105(h)(3)(A) of the Code provides that a self-insured medical reimbursement plan does not satisfy the eligibility requirements unless such plan (i) benefits 70 percent or more of all employees (the 70% benefit test), or 80 percent or more of all the employees who are eligible to benefit under the plan if 70 percent or more of all employees are eligible to benefit under the plan (the 70/80% test); or (ii) such employees as qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of HCIs.

Section 1.105-11(c)(2)(ii) of the regulations provides that whether a plan satisfies the requirements of section 105(h)(3)(A)(ii) will be determined based upon 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) (concerning eligibility to participate).

Section 105(h)(3)(B) of the Code provides that, for purposes of determining whether a plan meets the eligibility requirements, there "may be excluded from consideration" employees who have not completed 3 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 a collective bargaining agreement if accident and health benefits were the subject of good faith bargaining; and employees who are nonresident aliens and who receive no earned income from the employer which constitutes income from sources within the United States. With the exception of collectively bargained employees, neither section 105(h)(3)(B) nor the regulations require that these employees be excluded from benefits under the plan as a prerequisite to being excluded from consideration for eligibility testing. That is, the employer may elect to exclude such employees from consideration when testing for eligibility even if they nevertheless participate in the plan. However, if the employer elects to do so, they must be excluded not only in determining the total number of employees, but also in determining the number of employees participating in the plan. In the alternative, the employer may choose to exclude all excludable employees who are not participating in the plan.

In order to determine whether the taxpayer's self-insured medical reimbursement plan passes the eligibility test, we must compare the nonexcludable participating employees to the total nonexcludable employees. Subtracting [redacted] excludable employees from [redacted] total employees leaves [redacted] total nonexcludable employees. Seventy percent of [redacted] is [redacted] Excludable HCIs who were participating equals [redacted] ([redacted] excludable HCIs minus [redacted] nonparticipating excludable HCIs). Subtracting the [redacted] excludable participating HCIs from the [redacted] participating

employees results in [redacted][5]. This number falls short of [redacted] or 70% of nonexcludable employees needed to pass the 70% test. . Moreover, it is unlikely that the plan benefits 70% of the eligible employees and would pass the 70/80% test.

If the plan is divided into the smallest number of plans that can be formed, each of which has identical benefits for all participants, each plan must then meet the eligibility requirements of section 105(h)(3)(A). Even if we assume that the benefits provided by the [redacted] plans for full-time employees in plans 1 and 5 and for part-time employees in plans 3 and 6 are sufficiently similar to pass the benefits test. there are 7 plans remaining to be tested independently for compliance with the eligibility requirements. It is the taxpayer's responsibility to designate the plans that will be tested separately and provide information concerning the total number of employees participating in each plan and the total number of excludable employees participating in each plan.

Because the part-time employees (as defined for plan participation purposes) total 44% of the total employees ([redacted] part-time divided by [redacted] total), plans 1. 2, 5, 7 and 8 do not have 70% participation if all employees are counted. If the excludable employees are not considered, the nonexcludable part-time employees comprise 77% of the total nonexcludable employees ([redacted] nonexcludable part-time employees divided by [redacted] total nonexcludable employees). Accordingly, because part-time employees are not eligible to participate in plans 1, 2, 5, 7 and 8 these plans cannot possibly pass either the 70% or 70/80% eligibility tests. These plans, and perhaps some of the plans available to both part and full-time employees, will have to satisfy the alternative nondiscriminatory classification test of section 105(h)(3)(A)(ii) in order to satisfy the section 105(h) eligibility test.

With respect to the section 105(h)(3)(A)(ii) classification test, each of the taxpayer's plans might be able to satisfy the section 105(h) eligibility requirements by meeting the same standards as are applied under section 410(b). Ruling jurisdiction for section 410(b) is with the Employee Plans Technical and Actuarial Division. If each of the taxpayer's plans can pass both the section 105(h) eligibility and benefits tests they would be entitled to a favorable determination.

To summarize, if tested as one plan, the taxpayer's plan does not pass the 70% eligibility test and does not pass the discriminatory benefits test. Unless a substantial

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[5]Although most of the numbers used in this memorandum are from the taxpayer's letter of September 28, 1996, that letter does not indicate the total number of employees participating in the plan. The number, [redacted] for plan participants comes from Schedule F of the taxpayers [redacted] Form 1024.

number of the employees have less than 2 months service, the plan also does not pass the 70/80% test. If tested as separate plans, the taxpayer's plan will pass the benefits test but all of the separate plans cannot pass the 70% or 70/80% eligibility tests. However, the separate plans may be able to pass the classification test. Accordingly, an analysis under 410(b) is required to ascertain whether the taxpayer is entitled to a favorable letter.

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

Harry Beker