

VEBA

Nondiscrimination Testing:

An Obstacle Restricting Health Plan Design Choices

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Limiting benefits provided to HCEs, officers, and shareholders might help.



ARE VEBAS THAT OFFER HEALTH BENEFITS forced to operate at a disadvantage? As employers look at ways to contain health costs by differentiating benefits and simply at ways to offer benefits with features comparable to those

in the marketplace, nondiscrimination testing for VEBAs is an obstacle that may make VEBA plans less attractive than non-VEBA plans.

A VEBA (“Voluntary Employee Beneficiary Association”) allows benefits to be funded

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through a nontaxable trust as provided in Internal Revenue Code of 1986 ("Code") section 501(c)(9). (All section references are to the Code unless otherwise indicated.) Those benefits generally can include life, sickness, accident, and certain other welfare benefits. As is usually the case, the tax benefit comes with restrictions, including special VEBA nondiscrimination testing under section 505 to protect nonhighly compensated employees. Non-VEBA health plans are not subject to the same restrictions.

Many employers are interested in design features intended to keep health costs down. An example of a possible cost-containment feature for a health plan is premium shifting. This design allocates a greater percentage of the premium to the employee (versus the plan sponsor) if the employee chooses to cover his or her spouse even though the spouse has other coverage available. Another variation of this design allocates a greater percentage of the premium to the employee if the employee chooses the employer plan coverage despite having other coverage available.

Employers interested in implementing premium shifting may be able to find non-VEBA plans, such as an insured health plan, using this feature. However, as will be discussed, nondiscrimination testing makes this design difficult to implement for VEBAs.

VEBA nondiscrimination testing also may cause problems when an employer using a VEBA plan tries to mimic health plan features used by its competitors in non-VEBA arrangements. For example, many plans limit participation to employees who work 30 hours or more per week. Employers using VEBA plans may find their plans subject to testing of such provisions, with little or no guidance on how to apply the tests to such limits.

There may be no perfect solution, but there may be ways to limit the testing problems and still offer cost containment or other special fea-

tures in a VEBA. Limiting benefits to officers, shareholders, and highly compensated employees may provide an alternative to switching to a non-VEBA plan.

This article discusses medical benefits in the context of the special VEBA nondiscrimination rules. This discussion does not address the special VEBA rules for collectively bargained plans. It also does not address other Code restrictions such as section 105 testing for self-funded benefits. Other benefits offered under a VEBA, such as life insurance, are subject to different standards.

VEBA NONDISCRIMINATION TESTING, OBJECTIVE CONDITIONS, AND PROHIBITED INUREMENT

• A number of nondiscrimination limitations apply to VEBAs. This article focuses on section 505 nondiscrimination tests and the restrictions on objective conditions and prohibited inurement.

Section 505 Nondiscrimination Tests

The nondiscrimination tests in section 505 apply to medical benefits in a VEBA, though certain employees, such as a half-time employee, are excludable (see "Excludable Employees" below). These tests generally limit a plan from favoring highly compensated employees with respect to eligibility and benefits:

- *Eligibility Test:* Each class of benefits under the plan must be provided under a classification of employees set forth in the plan and found by the IRS not to discriminate in favor of employees who are highly compensated individuals.
- *Benefits Test:* The plan may not discriminate in favor of employees who are highly compensated individuals in offering benefits in each class of benefits.

A "highly compensated individual" is determined under rules similar to those for determining highly compensated employees under section 414(q).

Objective Conditions And Prohibited Inurement Restrictions

The regulations under section 501(c)(9) contain general restrictions on VEBA benefits, including the prohibited inurement limitation preventing the provision of benefits that favor officers, shareholders, or highly compensated employees. The regulations generally allow some limitations based on objective conditions, but not if the conditions favor officers, shareholders, or highly compensated employees.

CONVOLUTED HISTORY OF VEBA NONDISCRIMINATION TESTING • VEBA nondiscrimination testing has evolved in fits and starts, with Congress acting to limit perceived abuses and the ill-fated section 89 playing a role. To understand how to apply the nondiscrimination tests, it helps to look at the convoluted history of the Code and of the guidance relating to its applications.

1980 Final Regulations

Early guidance in the form of the 1980 final regulations under section 501(c)(9) provides that an employer-funded VEBA may not restrict membership or eligibility for benefits to officers, shareholders, or highly compensated employees of the employer. The regulations also provide information on the “prohibited inurement” requirement of section 501(c)(9). *Treas. Reg.* §§1.501(c)(9)-1, -2, and -4.

TEFRA ‘82

In the Tax Equity and Fiscal Responsibility Act of 1982, Congress lowered the limits on amounts that could be contributed to qualified pension plans and limited the benefits that could be paid from those plans. As a result of these restrictions, the IRS noted that some tax practitioners began recommending that employers use VEBAs to obtain tax sheltering advantages. The IRS had a flood of VEBA applica-

tions, but was hampered by lack of specific guidance on many issues.

DEFRA ‘84

The Deficit Reduction Act of 1984 created section 505, which established new nondiscrimination rules. Section 4976 also was created, which provides for an excise tax on disqualified benefits of VEBAs and other welfare benefit plans. The IRS began working on guidance for the new section 505 nondiscrimination rules and suspended most VEBA applications pending issuance of that guidance.

Section 89

Before the IRS completed the promised guidance for section 505, the Tax Reform Act of 1986 created section 89, which provided new eligibility and benefit requirements applicable to medical (and certain other) benefits. After a flurry of preparation for the new law, section 89 was retroactively repealed by Public Law Number 101140 (Nov. 8, 1989).

Internal Revenue Manual Safe Harbor

Although years have passed since the repeal of section 89, there still are no regulations under section 501(c)(9) concerning the nondiscrimination requirements of section 505(b). To allow cases to be processed until regulations are published, the IRS created safe harbor guidelines in its Internal Revenue Manual (“IR Manual”) section on VEBAs (IR Manual §7.25.9.1 et seq.) as a way of meeting the nondiscrimination requirements of section 505(b).

Current State Of VEBA Nondiscrimination Guidance

Despite the passage of time and new regulations, it appears prudent to continue considering compliance with the 1980 regulations. However, compliance with the 1980 regulations will not guarantee compliance with newer sec-

tion 505 requirements. Practitioners also should consider section 505 and the IR Manual's safe harbor rules.

STANDARDS FOR APPLYING TESTING AND LIMITATIONS • The 1980 regulations and the IR Manual provide background and some guidance on the standards for applying testing and limitations.

Some Restrictions Based On Objective Conditions Allowed

Treasury Regulation §1.501(c)(9)-2(a)(2)(i) provides that eligibility for benefits may be restricted by objective conditions relating to the type or amount of benefits offered. Eligibility for membership may be restricted by objective conditions or limitations reasonably related to employment, such as a limitation to a reasonable classification of workers, a limitation based on a reasonable minimum period of service, a limitation based on maximum compensation, or a requirement that a member be employed on a full-time basis. However, any objective criteria used to restrict eligibility for membership or benefits may not be selected or administered in a manner that limits membership or benefits to officers, shareholders, or highly compensated employees of an employer funding the employees' association. Similarly, eligibility for benefits may not be subject to conditions or limitations that have the effect of entitling officers, shareholders, or highly compensated employees of such an employer to benefits that are disproportionate in relation to benefits of other members. The regulations list some restrictions that are allowable. For example, in the case of an employer-funded organization, a provision that excludes or effectively excludes certain employees who are members of another organization or are covered by a different plan funded by the employer, to the extent that such other organization or plan offers similar benefits on compa-

table terms, will be considered a reasonable restriction. See Treas. Reg. §1.501(c)(9)-2(a)(2)(ii) for other examples of reasonable restrictions.

Prohibited Inurement

Under Treas. Reg. §1.501(c)(9)-4, prohibited inurement generally means that no part of the net earnings of the VEBA may inure to the benefit of a private shareholder or individual other than through payment of VEBA benefits. However, VEBA benefits are restricted. A VEBA benefit cannot include the payment to any member of disproportionate benefits, when such payment is not pursuant to objective and nondiscriminatory standards. For example, the payment to highly compensated personnel of benefits that are disproportionate in relation to benefits received by other members of the association will constitute prohibited inurement. The payment to similarly situated employees of benefits that differ in kind or amount will constitute prohibited inurement unless the difference can be justified on the basis of objective and reasonable standards adopted by the association or on the basis of standards adopted pursuant to the terms of a collective bargaining agreement. In general, benefits paid pursuant to standards or subject to conditions that do not provide for disproportionate benefits to officers, shareholders, or highly compensated employees will not be considered disproportionate.

IR Manual On Prohibited Inurement

The IR Manual includes a discussion of the prohibited inurement restriction. Under IR Manual §7.25.9.7, "private shareholder or individual" refers to persons having a personal or private interest in the activities of the organization and includes the members, officers, trustees, employees, and fiduciaries of the organization and contributing employers. According to the IR Manual, the payment of disproportionate benefits to members who are officers,

shareholders, or highly compensated employees of a contributing employer constitutes inurement. The IR Manual specifically provides that Treas. Reg. §1.501(c)(9)-4(b) dealing with inurement and Treas. Reg. §1.501(c)(9)-2(a)(2) dealing with membership restrictions should be considered together for problems involving disproportionate benefits. The IR Manual also notes that acts of inurement may constitute violations of the fiduciary responsibility rules of the Employee Retirement Income Security Act of 1974 (“ERISA”).

IRS Safe Harbor For Section 505 Nondiscrimination Standards

Section 505 generally provides that standards for eligibility and benefits may not discriminate in favor of highly compensated employees. Note that the section 505 limitations do not apply to officers or shareholders as a class; instead, they apply to highly compensated employees. Thus, the test does not limit an officer or shareholder who is a nonhighly compensated employee.

The IR Manual provides a safe harbor that may be met either by design or by testing. The safe harbor addresses both plans in which everyone is treated equally and plans with unequal provisions:

- *Plans With Equal Terms.* The safe harbor applies for a medical benefit only if the benefit is offered to participants in equal amounts under equal terms, eligibility requirements, and conditions, without regard to salary level, position, or ownership interest in the employer.
- *Plans With Unequal Terms (Safe Harbor Ratio Test).* A medical benefit does not meet the nondiscrimination safe harbor if the terms or operation of the plan provide a greater benefit for highly compensated individuals than for lower paid employees. A plan need not make a particular benefit available to all employees—or, more particularly, to all employees who

would not otherwise be excluded from consideration. However, if the benefit is not made available to all such employees, the ratio of highly compensated individuals eligible to receive the benefit to the total number of highly compensated individuals (who are not otherwise excluded from consideration) may not exceed the ratio of lower paid employees eligible to receive the benefit to the total number of lower paid employees (who are not otherwise excluded from consideration).

“Excludable Employees”

Certain employees may be excluded from consideration under section 505(b) and for purposes of the safe harbor ratio test:

- Employees who have not completed three years of service;
- Employees who have not attained the age of 21;
- Seasonal employees or employees who work less than half time;
- Employees not included in the plan who are included in a unit of employees covered by a collective bargaining agreement if the benefits were the subject of good faith bargaining; and
- Employees who are non-resident aliens and who receive no earned income (within the meaning of section 911(d)(2)) from the employer which constitutes income from sources within the United States (within the meaning of section 861(a)(3)).

Bottom Line On Compliance With Objective Conditions, Prohibited Inurement, And Section 505

To comply with all of these provisions, the safest course would be to provide the same benefits to all employees. The little guidance that is available gives few clear answers for the real-world situations that employers face. An employer wishing to be cost-effective and compet-

itive may be able to do so, for example, by providing different benefits, as long as those benefits do not favor the officers, shareholders, or highly compensated employees. If these benefits also are designed to meet the objective conditions and prohibited inurement rules, the IR Manual safe harbor ratio test also would appear to be satisfied.

APPLICATIONS • Examples help show how nondiscrimination testing works in practice:

- *Example Of A VEBA Plan With No Premium Shifting:* In Plan X, all employees working more than half-time participate in the plan. Benefits are the same for all participants. There is no premium shifting. This is a design that should pass scrutiny.
- *Example Of A VEBA Plan With Premium Shifting:* It seems that a premium-shifting plan could be designed to satisfy the safe harbor without collecting testing data. Plan Y provides for eligibility and benefits with premium shifting as follows: a) the eligibility is open to everyone; and b) the officers, shareholders, and highly compensated employees are subject to paying the higher premium regardless of availability of other coverage. Other employees pay the higher premium only if other coverage is available. Other than the premium-shifting provision, the benefits are the same for all participants.
- *Example Of A VEBA Plan With Premium Shifting And With 30-Hours-Per-Week Limitation:* Plan Z provides for benefits and premium shifting in the same manner as Plan Y, but participation is limited to those working at least 30 hours per week. Under Plan Z, some testing probably would be necessary to ensure that the eligibility test is met.

Do Plans X, Y, And Z Comply With The Objective Conditions Limitation?

The 1980 regulations generally provide that eligibility for benefits may be restricted by ob-

jective conditions relating to the type or amount of benefits offered, but that they may not limit benefits to officers, shareholders, or highly compensated employees.

All three plans limit participation based on hours worked, which arguably is an objective condition. There is little information on what it means for the benefits not to be limited to the officers, shareholders, or highly compensated employees.

Do Plans X, Y, And Z Comply With Prohibited Inurement Restrictions?

The payment of disproportionate benefits to officers, shareholders, or highly compensated employees is considered inurement.

- Plan X does not appear to have any prohibited inurement issues.
- Limiting premium shifting under Plans Y and Z to the disadvantage of the officers, shareholders, or highly compensated employees may address this concern. The regulations are unclear as to the effect of the premium shifting on individuals other than officers, shareholders, and highly compensated employees, so there may be some risk, but the classification of officers, shareholders, and highly compensated employees seems to address a major area of concern.

Do Plans X, Y, And Z Comply With Section 505?

Section 505 and the IR Manual safe harbor address discrimination in favor of highly compensated employees.

- Plan X appears clearly to meet this test because the benefits are under the same terms for all employees. Because the half-time employees are “excludable,” the section 505 safe harbor seems to be satisfied.
- Plan Y also appears to meet this test. In looking at the safe harbor under the IR Manual de-

scription, the premium shift of this plan arguably may not be provided on equal conditions/terms to all employees, because the highly compensated employees are given the higher premium. However, the number of highly compensated employees who receive the “better” benefit should always be zero. Thus, the safe harbor ratio test would seem to be met.

- Plan Z uses a 30-hours-per-week limit for participation, so it appears that the plan would have to be tested to meet the safe harbor. Excludable employees, such as those working less than half-time, are not considered for purposes of the ratio test. However, it seems likely that many employees working fewer than 30 hours per week would be working more than half-time. A strict reading of the safe harbor ratio test suggests that if the eligibility ratio for the nonhighly compensated employees is lower than for the highly compensated employees, then the safe harbor ratio test is not met. Thus, a nonhighly compensated employee working fewer than 30 hours per week, but more than half-time, would lower the ratio of nonhighly compensated employees who are eligible in comparison to the highly compensated employees. On the other hand, the IRS (Preamble to Final Regulations, T.D. 7750) also seems to provide that VEBAs “need not comply with anti-discrimination rules as stringent as those that apply to qualified pension trusts described in [Code Section] 401.” The pension rules in section 410(b) generally apply a 70 percent eligibility threshold for passing the section 410(b) ratio test. Thus, as long as the nonhighly compensated employee ratio is at least 70 percent of the highly compensated employee ratio, that pension eligibility test is met. However, I found no guidance suggesting that a VEBA could rely on any standard less than 100 percent. This means that a plan with a 30-hours-per-week limit might fail the nondiscrimination safe harbor ratio test. At best, the plan then would rely on

an argument that it otherwise met the murky section 505 requirements. This puts VEBAs at a disadvantage, especially with the common design of insured plans allowing exclusion of those working fewer than 30 hours per week.

REALITY CHECK? • For the employer trying to use a VEBA and provide real-world benefits, many aspects of VEBA testing do not offer easy answers to testing questions. An IRS representative informally commented on some of the nondiscrimination testing questions. The responses are summarized below. (None of the IRS comments were officially made, and they should not be relied upon.)

- *Did the IRS feel that premium shifting might be discriminatory?* Yes. The IRS would be likely to review premium shifting for nondiscriminatory effect, if the premium shifting was not structured so that the officers, shareholders, and highly compensated employees always paid the higher premium.
- *What did the IRS feel about the idea of limiting benefits for officers, shareholders, and highly compensated employees?* The design of premium shifting where the officers, shareholders, and highly compensated employees paid the higher premium regardless of other coverage does not appear to be discriminatory.
- *What did the IRS think about a VEBA with an eligibility requirement of 30 or more hours?* There is no safe harbor for these plans. With respect to a 30-hours-per-week eligibility exclusion (where the employee does not fall into any of the Excludable Employees categories), it would come down to a “gut feel” on the part of the auditor or reviewer. It would be a “facts and circumstances” determination.
- *How does the IRS apply the safe harbor to a plan that performs the ratio test with a result of less than 100 percent coverage of nonhighly compensated employees?* There is no safe harbor reliance for this plan. It is not clear whether the safe harbor

in the IR Manual requires 100 percent participation for nonhighly compensated employees if there is 100 percent participation by highly compensated employees, but the facts and circumstances test would apply if the safe harbor is not met. There is no specific standard such as the 70 percent retirement standard for eligibility under section 410(b). The IRS probably would go back to the section 501(c)(9) regulations for some direction.

- *Does the IRS feel that updated direction will be out soon?* No. Regulations are unlikely soon, since this is a “back burner” issue. It is possible for an employer to apply for a private letter ruling, but this is expensive. The IRS might refuse to answer the nondiscrimination question if the facts presented a close call that might be affected by any pending regulations (even though no guidance is expected soon).

The IRS comments seem to support certain designs that limit officers, shareholders, and

highly compensated employees, but the 30-hours-per-week eligibility requirement appears to place VEBAs in a facts and circumstances testing context rather than meeting an eligibility safe harbor. Based on IRS informal comments, it seems likely that a plan could exclude some employees working between half-time and 30 hours per week. Unfortunately, there is no black-line test to give VEBAs comfort as to the testing of such a plan. Each plan would need to be evaluated based on facts and circumstances.

CONCLUSION • Nondiscrimination testing is a reality for VEBAs, as is the paucity of guidance. However, the demands of rising health care costs may lead VEBAs to modify health plan designs to meet the twin demands of health care cost containment and nondiscrimination testing.

PRACTICE CHECKLIST FOR

VEBA Nondiscrimination Testing: An Obstacle Restricting Health Plan Design Choices

A VEBA allows benefits to be funded through a nontaxable trust as provided in section 501(c)(9). Those benefits generally can include life, sickness, accident, and certain other welfare benefits. The tax benefit comes with restrictions, including special VEBA nondiscrimination testing under section 505 to protect nonhighly compensated employees.

- The nondiscrimination tests in section 505 apply to medical benefits in a VEBA, though certain employees, such as a half-time employee, are excludable. These tests generally limit a plan from favoring highly compensated employees with respect to eligibility and benefits:

— *Eligibility Test:* Each class of benefits under the plan must be provided under a classification of employees set forth in the plan and found by the IRS not to discriminate in favor of employees who are highly compensated individuals.

— *Benefits Test:* The plan may not discriminate in favor of employees who are highly compensated individuals in offering benefits in each class of benefits.