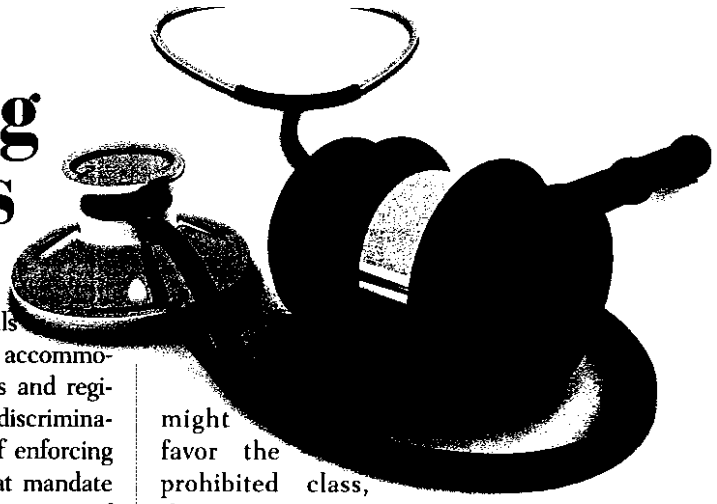
Discrimination Testing Of Medical Care Plans



By Carlton Harker, FSA, MAAA

Introduction

Leading up to the enactment of the new Health Care Reform Law, there was a considerable amount of anti-insurance rhetoric that resulted in three significant legislative provisions that will prove to be hurtful to the group insurers: (a) minimum permissible loss ratio, (b) loss of federal anti-trust exemption (provided by the McCarran-Ferguson Act) and (c) loss of IRC Section 105(h) discrimination exemption.

By all appearances, it would seem that, as a consequence, the new law *tilts* the health care financing *playing-field* noticeably in favor of self-funding. Many practitioners would argue that the legislators consciously, or otherwise, took note of the virtues of self-funding – particularly its lack of conflicted interests. Their loss of the IRC Section 105(h) exemption is one of the primary motivations for this Article; the other motivation is the Supreme Court decision in *MetLife v. Glenn* in which the Court opined that with ERISA plans, the presence of any conflicted interest(s) (even if only structural) of the fiduciaries will *count against* the plan in a litigation (i.e., a higher standard of review)

It is the argument of this Article that the virtues of self-funding (a) continue to be noteworthy and (b) should properly play an increasing role in the health care reform *adventures* that are far from completed. It is also the argument of this Article that if there is a *chink in the armor* of self-funding, it is that the discrimination disciplines required by law have not been fully brought to bear. Thus, the assertion is made that the best interests of self-funding will be served if increased attention is given to the broad topic of discrimination.

In the interest of time and space, this Article does not discuss the numerous details involved in the actual testing protocols; nor does it discuss the numerous strategic details available to plan sponsors in accommodating to the testing options and regimens. Suffice it to say that discrimination testing is the process of enforcing the laws and regulations that mandate that in accepting the tax advantages of IRC Section 105(a), such plans must not help the prohibited class (highly compensated, e.g.) nor hurt the protected class (age, sex, race, ethnicity, health condition, tenure, disability, e.g.).

In this Article, a range of topics will be briefly discussed: (a) essence of discrimination testing, (b) legal background (statutory and judicial), (c) past practices with discrimination testing, (d) new scope or definition of discrimination, (e) Sarbanes-Oxley and risk management, (f) practical urgency for testing, (g) complexity of the testing rules, (h) advances in cybernetics/IT, (i) role of globalism, (j) shifting roles of professionals, (k) increasing aggressiveness of regulators, (l) new Health Care Reform Law and (m) recommended actions.

Essence of Discrimination Testing

IRC Section 105(h) requires that no medical reimbursement plan (regardless of how funded) shall discriminate in favor of the highly compensated individual. The Code then proceeds (a) to define HCI, (b) to show the two prongs of the discrimination test (eligibility and benefits) and (c) to set forth the penalties for failing to meet such tests. One of the prongs is the so-called eligibility (or percentage test); it must be done by grouping all of the employers that are (a) controlled, (b) affiliated or (c) operating as an affiliated service group. The clarifying regulations deal with a host of issues and are, for the most part helpful.

Legal Background

With respect to discrimination that might favor the prohibited class, the primary statutes are Internal Revenue Code Sections 105(h), 125, 152 and 414. With respect to discrimination that might disfavor the protected class, the primary laws are the Civil Rights and Equal Pay Acts. With respect to discrimination that might disfavor the older worker, the primary statute is the Age Discrimination in Employment Act. A summary of useful court decisions (mostly ERISA-related) is available to the reader on Pages 38-40 of the Text *Self-Funding of Health Care Benefits* (published by the IFEBP). Such decisions deal with the critical questions of who may or may not be an employee or a participant for plan participation and for federal tax purposes.

In the final hours leading to the Health Care Reform passage, the Senate Reconciliation changes added to HR3590 a Section 10101 that added a new Section 2716 to the PHSA. This new Section required that all health care plans (other than self-funded) had to meet the discrimination requirements of IRC Section 105(h).

Past Practices with Discrimination Testing

For the most part, self-funded medical reimbursement plans have gone untested. Plan sponsors did not have the incentive to do it; the practitioners as a consequence did not push for it; the carriers found it economically advantageous to ignore it; the regulators created rules that were too complex and expensive for them to enforce; it has not been a required item on the Form 5500; the accountants did not have it on their audit checklist; and too few understood it.

New Scope or Definition of Discrimination

In recent years, the scope of and the definitions with discrimination have expanded: (a) subject benefit plans have grown in number (cafeteria and premium option plans, flexible spending accounts and dependent child assistance plans), (b) members qualifying for the protected class have increased and (c) ERISA-protected plan design freedoms are now under attack for permitting discrimination (HIPAA, mental parity, e.g.). Moreover, in recent years, new signs of interest in discrimination testing are appearing: (a) Sarbanes-Oxley and risk management, (b) growing audit interest, (c) globalism, (d) new regulatory *rumblings*, (e) rising concerns of benefit attorneys and (f) new opportunities for cybernetics/IT to do the *heavy lifting involved* with the testing.

Sarbanes-Oxley and Risk Management

The intent of this statute is clear and even a rudimentary understanding of risk management would dictate the following: i.e., any management decision short of knowing for certain that a subject health care is or is not discriminatory is indefensible and too risky. Treating risk management as though it were not important has no place in our new health care plan millennium. At the present time, an increasing sense of urgency to get serious with such testing is coming from (a) the regulators, (b) the benefit attorneys and (c) risk managers. The writer asserts that ignoring discrimination would at times be a Sarbanes-Oxley infraction.

Practical Urgency for Testing

Unexpected consequences from the discovery of a plan that was found to be discriminatory might include the following: (a) as the result of the failure of the Benefits test, a HCI receives a W-2 with a sharp increase in he Block 1 earnings amount for a large claim putting such individual in jeopardy with the IRS or perhaps in bankruptcy, (b) as the result of the failure of the eligibility test, the plan sponsor shows a large number of unexpected increases in to amounts reported in Block 1 of the W-2 Forms of some 25% of its employees, (c) the plan sponsor will face harsh penalties if found guilty of discriminating against the protected class (e.g., race, creed, national origin, age) and (d) the plan sponsor will also face unpleasant consequences if found guilty of discriminating by health-related factors or by tenure, e.g., as described in HIPAA or the new Health Care Reform Act. A new instance of discrimination results when a plan fiduciary has conflicted interest(s) that are not disclosed; the justification for this logic is the Supreme Court decision in *MetLife v. Glenn*. The act of discrimination is due to the fact that such conflicted

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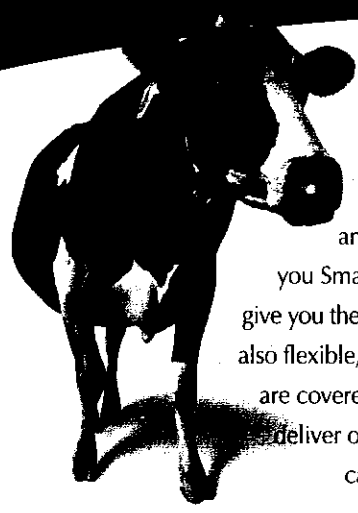

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interests weakens the standing of the fiduciary should a legal contest occur; non-disclosure thereof discriminates against those who have a reason to know but are not told.

Complexity of the Testing Rules

The rules set forth in the laws, regulations and ruling are complex for a variety of reasons; (a) the role that the individual may play in the *testing drama* will vary depending on the (i) test (eligibility, benefits, fair cross-section, classification, e.g.) and (ii) benefit (self-funded medical reimbursement, cafeteria, premium-only, flexible spending account, dependent assistance, e.g.), (b) the characteristics of the individual will also determine such role: i.e., (i) being a shareowner and the extent of such ownership, (ii) being an officer, (iii) being a special-status employee (part-time, seasonal, newly-employed, under age 25, protected by a labor-negotiated agreement, or certain alien workers, e.g.), (iv) having special employment status (leased, self-employed, partners, retired, COBRA, independent contractors, sole proprietors, Sub-S owner and (v) being or not being a plan participant, and (c) the organizational structure of the entity: (i) Chapter C, limited liability, non-profit or Sub-S Corporation, (ii) controlled organizations under special IRC Section 414 rules, (iii) partnership, (iv) church and (v) government entity, e.g. For each of these terms, there are lengthy definitions some of which are near-circular or facts/circumstances in nature. Some of the tests consist only of (a) a set of principals with a safe-harbor example while others are very lengthy and involved.

Advances in Cybernetics/IT

What is needed and providentially will soon be available is (a) a Web-based work-product, (b) that is available directly to all plan sponsors, vendors, professionals and practitioners, (c) that is user-friendly and accessible, (d) that will bring order out of the confusion, (e) that would serve as a decision model, (f) is private and secure and (g) that can be relied upon in it assertion that the plan is or is not free of discrimination to the satisfaction of the relevant professionals (regulators, accountants, and attorneys).

Role of Globalism

Audit practices in the United States and abroad are not uniform. Our *casual* approach with respect to the discrimination may not be agreeable to, say, the British auditors.

Shifting Roles of Professionals

The past practices of discrimination testing have been for the primary players to be either or both the accountant and the attorney. The testing procedure has as a consequence been a rather expensive and unpleasant experience; hardly one eagerly sought by the plan sponsor. The testing practices are changing somewhat in that the HR staff, an actuary, a risk manager, a broker/consultant or a computer/IT specialist are often directly involved.

Increasing Aggressiveness of the Regulators

Regulators include the Internal Revenue Service, the Department of Labor, the Department of Health and Human Services and the Department of Veterans Affairs. It is the assertion of the writer that (a) the focus on, (b) the money and resources devoted to, (c) the political and social implications of health care financing systems will ratchet up the activities of the Regulators. Their ulterior motive may be to find failure with what we have in what ever way possible so as to usher in single-payer.

New Health Care Reform Law

The new Health Care Reform Act dealt with discrimination in two ways: (a) expanded to and made more explicit the treatment of the protected class and (b) extended the requirements of IRC Section 105(h) to fully insured plans. These are two changes of enormous significance and must not be taken lightly.

Recommended Actions

Two actions are needed as soon as possible in response to the above-cited challenges: (a) a new text titled *Health Care Plan Discrimination* that we can all use and that will be readily available at no charge on a Web-Site and that will standardize our practices and understandings and (b) an actuarially-designed and managed Web-based computer program that will be *open to the public* (employers, practitioners, professionals, etc.) for a low fee and which will permit data input by the user (with controls, of course) and that will function as a traditional mathematical model. The accessibility, consistency, low-cost, user-friendly, privacy-protected and simplistic features of this recommendation should be most helpful in allowing all of us to live with the discrimination testing disciplines that will doubtless be with us for a long time.

Carlton Harker, FSA, MAAA is a well known and respected member of the self-funding community and has been an active participant in the Self-Insurance Institute of America's educational programs for many years. In addition to authoring numerous books on a diversity of subjects related to self-funded health care, Carlton has appeared as a speaker and panel member at various industry educational functions. Harker has appeared as an expert witness in many hearings and trials. Mr. Harker is the Principal of Self-Funding Actuarial Services, 8025 North Point Blvd., Suite 207 W., Winston-Salem, NC 27106. (tel) 336-759-2035, (fax) (336)892-0392, or via e-mail at harker2@earthlink.net He maintains a web site at www.self-fundhealth.com