

# Actuarial Work-Products, Inc.

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**TO: Addressee No. 1**

**Addressee No. 2**

**Addressee No. 3**

Actuarial Svcs.

414 Main Street  
Portland, OR 97114  
Tel. (601) 414-8888  
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Health Underwriter

XYZ Manufacturing

8025 North Point, Ste 207W  
Winston Salem, NC 27116  
Tel. (336) 759-2035  
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Self-Funding

123 South Main Street  
Baltimore, MD 21211  
Tel. (410) 777-7777  
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**RE: Discrimination Testing  
Medical Reimbursement Plan  
Single Employer and Single Plan**

**Employer** \_\_\_\_\_

**Type of Organization** \_\_\_\_\_ **Designation** \_\_\_\_\_

**Plan Name** \_\_\_\_\_

**Funding: Fully Insured** \_\_\_\_\_ **Self-Funded** \_\_\_\_\_ **Administration: TPA** \_\_\_\_\_ **ASO** \_\_\_\_\_

**Is TPA Insurer-Owned?** \_\_\_\_\_ **Is Stop-Loss Carrier Insurer-Owned?** \_\_\_\_\_

**Plan Designation: DOL** \_\_\_\_\_ **Other** \_\_\_\_\_ **Test Year** \_\_\_\_\_

**Is the Database To Be Utilized?** \_\_\_\_\_ **Is the HCI data To Be Suppressed?** \_\_\_\_\_

**Engager is Addressee No 1**

**Eligible User is Addressee No 2**

This Work-Product provides an Actuarial Opinion with respect to the discrimination testing of the subject Medical Reimbursement Plan as required by (a) Section 105(h) of the Internal Revenue Code and relevant Treasury Regulations, (b) civil rights and age discrimination laws, (c) the 2010 Health Reform Act or (d) basic principles and practices of the Federal Trade and commerce Laws and of risk management. This Certification is in five parts:

1. Narrative or Explanation
2. Statement of Actuarial Opinion
3. Submitted Data
4. Testing Results
5. Comments of the Actuary.

Sincerely,

\_\_\_\_\_  
Principal  
Actuarial Work-Products, Inc.

## **PART 1**

# **NARRATIVE OR EXPLANATION**

### **Purpose of Certification (Work-Product)**

Some medical reimbursement plans may discriminate in favor of the so-called highly-compensated individuals with respect to eligibility, benefits, provisions, compensation or contributions in violation of IRC Section 105(h).

The financial penalties of such violations may be large. There could be additional taxable income to the participant (or beneficiary) because of such discriminatory benefits. Also, such discrimination could be a Sarbanes-Oxley infraction bringing with it additional problems not the least of which might be criminal charges.

The discrimination issue is asserted to be a proper subject of an actuarial opinion for these reasons: (a) actuarial expertise in recent years has been extended to risk analyses, particularly when such analyses are complicated (such as discrimination testing) and (b) such opinion might be helpful in defending an alleged infraction as contemplated by Sarbanes-Oxley.

Moreover, it is the assertion of the certifying actuary that three potentially-important corollary issues should be considered: (a) Does the subject medical reimbursement Plan discriminate unfairly against the so-called protected class? (b) Does the Plan violate any federal health plan-related mandates including the mandates of the 2010 Patient Protection and Affordability Act? and (d) Does the Plan and/or its administration violate the Federal Trade and Commerce Laws including the new requirements of risk management including the dangers of undisclosed structural conflicted interests of the Plan fiduciaries? These four questions are needful more for risk management reasons than for IRS tax penalty reasons.

The Reader will note that prior to the 2010 Health Reform Act, only self-funded medical reimbursement plans were subject to the discrimination rules of IRC Section 105(h). This Act removed this restriction making both self-funded and fully insured plans subject to IRC Section 105(h).

### **Work-Product Commentary**

These comments may be helpful: The Plan that is to be tested in this Work-Product is a single health care plan that is sponsored by a single employer. A companion Work-Product deals with multiple employers and/or multiple plans. So long as the percentage tests are met and there is no favoritism to a HCI, the discrimination tests will be met. Also, significant civil (not tax) penalties may result if the plan discriminates against the protected class of employees and damage results.

A basic and important principle that is followed in this Work-Product is this: when the plan permits any person who might otherwise be deemed to be excludible (part-time, seasonal, collectively-bargained, newly-employed, underage, certain aliens, leased, retired, partners, sole proprietors, self-employed, shareowners-only, e.g.) to be a plan participant, such person will be treated as an employee when performing the eligibility tests. COBRAs will be treated as any other employee.

This Work-Product will always show the results of both the (a) eligibility and (b) benefits tests. Discretionary with the Plan Sponsor are the following: (a) take remedial action to modify any test failure to a test success, (b) provide the needed census for the eligibility tests either (i) directly or (ii) through the Database, (c) accept the failure of the benefits test and provide the requisite W-2 Forms to the appropriate individual(s), and (d) accept the failure of the eligibility test and provide the requisite W-2 Forms using the HCI-related fraction provided in this Work-Product. This Work-Product deals with discrimination only and presumes that the subject Plan qualifies for the tax benefits set forth in IRC Section 105(a).

This Work-Product anticipates that any excludible individual may be a plan participant at the discretion of the plan sponsor. The Work-Product also anticipates that such inclusion may result in (a) tax consequences to such participants or possibly to (b) the loss of the plan's IRC Section 105(a) deductibility exclusion.

Extensive background reading may be found at (a) IRC Section 105(h), (b) the clarifying Treasury Regulations and (c) the relative professional commentaries.

## **Self-Employed Individuals**

In testing for discrimination, any participant who is not a common law employee (such as an independent contractor, sole proprietor, partner, Sub-S owner, or one leased under a PEO contract) should be treated as an employee. However, such self-employed individual is a participant as a contract right and not an employee right. If the Plan is found to be non-discriminatory, no monetary consequences for such individual occur for reasons of discrimination.

However, while such self-employed individual gains participant status as a contract right, the tax advantages to the employee, provided by IRC Section 105(a), are denied; as a result, such individual must be provided an IRS Form 1099 for the economic (i.e., actuarial value) of the provided benefits.

To understand these complexities, consider an independent contractor, John, who is a participant in a self-funded medical plan that fails the eligibility tests. John is a HCI because of his over-10% ownership; John also has a special benefit package. When John does his year-end taxes, he should receive three items from the employer: (a) a Form 1099 for the actuarially-determined economic value of the basic plan benefit (say, \$8,000), (b) an amended Form W-2 (Box 1 only) for the amount of benefits paid directly and exclusively attributable to John's special benefit package (say, \$12,000) and (c) an amended Form W-2 (Box 1 only) for the increase of John's paid benefits by the fraction defined in IRC Section 105(h) for plans that fail the eligibility test (say,  $\$12,000 \times 10\%$  or \$1,200) Where needed, such fraction is made part of this Work-Product. Standard accounting procedure is for the employer to provide a single W-2 to the employee.

Permitting such self-employed individuals to be Plan participants is discouraged but may be acceptable if certain safeguards are taken: e.g., done sparingly, supported by a plan amendment that is approved by the stop-loss carrier, defensible as having a business necessity or a common business bond, evidenced by a written contract between the employer and the self-employed individual making it clear that being a participant does not necessarily confer ERISA rights

## Highly Compensated Individuals (HCI)

For purposes of self-funded medical reimbursement plan discrimination testing, a HCI is (a) one of the five highest paid officers; (b) one with more than 10% ownership; or (c) one of the highest paid 25% of all non-excludable employees. Excludable employees include: (a) one with less than three years of service, (b) one who is under age 25; (c) one classed as seasonal or part-time; (d) one working under a collectively-bargained agreement or (e) a non-resident alien with no U.S. earned income. Such enumeration is made with respect to all of the employers in the Test Plan. For discrimination purposes, the spouse or dependent child of an employee, or former employee, may gain status as a HCI.

## When Tests Are Not Met

If the Benefits Test is not met, the affected HCI must be given a W-2 (Block 1 only) for the amount of benefit received as a consequence of such discrimination. Example: Employer induces John, a HCI, to accept employment by waiving his 90-day probationary period; during such period, John has an auto accident and is reimbursed \$100,000 by the plan for his medical expenses; Employer gives John a W-2 for the \$100,000.

If the Eligibility Test is not met; a fraction must be computed, defined as follows:

$$\frac{\text{All Benefits Paid to HCI Only}}{\text{All Benefits Paid to All Participants.}} = \frac{100,000}{300,000} = .33$$

This fraction is multiplied by the benefit paid to each HCI with the product becoming taxable income to such HCI as set forth in a W-2. Given Mary's benefits to have been \$2,000 for the Test year, the W-2 taxable amount would be 2000 x .33 or \$666.

To the greatest extent possible the attesting actuary urges that the Certification show that both the Eligibility Test and the Benefits Test are met; to do otherwise creates a plethora of problems all of which are best avoided. That is, while the remediation of a failed Eligibility Test or Benefits Test may be possible by using the Classification Test or Cross-Section Test, such reliance thereof should be under advice by legal counsel and not be deemed a risk/actuarial

matter; furthermore, if the Eligibility Test is not met and no remediation is sought, the preparation of the requisite W-2 should be under advice of accounting counsel. The Work-

Product is useful in (a) identifying the HCIs and their plan benefits as well as (b) computing the requisite ratio, above cited.

Unfair discrimination against the so-called protected class is a potential violation of the civil rights laws (either state or federal). The very presence of a conflicted interest on the part of a plan fiduciary (whether or not used) could result in such fiduciary being held to a higher standard of review should there ever be plan-related litigation. Since both of these potential discrimination violations have the potential of expanding the Plan Sponsor's financial liability, they are both appropriate issues for this Work-Product.

**PART 2**

**STATEMENT OF ACTUARIAL OPINION**

**DISCRIMINATION TESTING**

**MEDICALREIMBURSEMENT PLAN**

**SINGLE EMPLOYER AND SINGLE PLAN**

I am a principal of both Self-funding Actuarial Services, Inc. and Actuarial Work-Products, Inc. (affiliated Corporations); am a member of the Society of Actuaries and am a member of the American Academy of Actuaries. My firm has been retained by the Engager to provide calculations of certain actuarial items for the above-cited Health Care Plan. I relied upon the Engager shown herein as to the accuracy and completeness of the underlying information that was used in this Certification. In other aspects, my examination included (a) reviews of the actuarial assumptions, methods, submitted data and (b) such tests of actuarial calculations as I considered necessary under the circumstances.

**Testing Results**

<b><u>IRC 105(h) Discrimination Test</u></b>	<b><u>Is Test Met?</u></b>
Eligibility	_____
Benefit	_____
Classification	_____ NA
Fair Cross-Section	_____ NA

<b><u>Risk-Related Tests</u></b>	<b><u>Response?</u></b>
Any Protected Class Discrimination?	_____
Any Age Discrimination that is not Supportable by an Actuarial Opinion?	_____

Has the feasibility of either of the following been actuarially determined:

Medicare Part D Subsidy? \_\_\_\_\_

Mental Parity % Opt-Out? \_\_\_\_\_

Are Any Mandates of the 2010 Health Reform Act Not Met? \_\_\_\_\_

Any Conflicted Interests? \_\_\_\_\_

## **Comments of the Actuary**

The User should rely on the Paragraph that summarizes the findings:

### **Discrimination Testing**

Paragraph 1. Since both the Eligibility Test and the Benefits Test are met, the Test Plan is non-discriminatory as contemplated by the Internal Revenue Code and relevant Treasury Regulations.

Paragraph 2. Since the Benefits Test is not met, the Participant(s) receiving the discriminatory benefits must (a) be given a W-2 for the total amount of benefits received due to such discrimination and (b) (it is recommended that) such discriminatory benefit be amended.

Paragraph 3. Since the Eligibility Test is not met, (a) each HCI must be given an W-2 for an amount determined by the formula set forth in Part 1 of this certification and (b) (it is recommended that) the reason for such test failure be corrected. The Sponsoring Employer has the option of appealing to, and relying, on the success of either of the Classification Test or the Fair Cross-Section Test. The success of either of these two alternate Tests will be a substitute for the failure of the Eligibility Test. Because such alternate tests are rarely used and then generally under the advice and direction of legal counsel, this Work-Product briefly refers the User to such alternate tests but does not offer an opinion with respect to them.

### **Risk Management Testing**

Protected Class Discrimination. The only acceptable response is no. To be otherwise is a potential civil rights violation.

Mandates of the 2010 Health Reform Act. The only acceptable response is no. To be otherwise is a potential violation of this Act which must be avoided.

Potential Conflicted Interest. A no response is a safe harbor signifying no potential risk-related violation. A yes response signifies a potential risk-related violation because one (or more) of the Plan fiduciaries has a conflicted interest that might be hurtful to the Plan or its sponsor in the event of a litigation; this issue was litigated in the *MetLife v. Glenn* Supreme Court decision.

## Conditions and Terms of Opinion

1. That this Work-Product is an Actuarial Opinion as contemplated by the American Academy of Actuaries.
2. That I am qualified to offer such opinion by reason of my meeting the requisite examination, experience and continuing education requirements of the American Academy of Actuaries
3. That this Actuarial Work-Product is the result of a mathematical computer program processing inputted data and documentation by Actuarial Work-Products, Inc. as summarized herein.
4. That I am independent of and have no conflicted interest with any party with respects to this Work-Product.
5. That the Work-Product was prepared at the request of the Eligible User, who is identified herein, and who may or may not be the ultimate user of such Work-Product.
6. That I have been engaged, as contemplated by the relevant American Academy of Actuaries, by the Engager identified herein.
7. That I intend to be a fiduciary with respect to this Work-Product and will act accordingly, striving to meet any and all standards of conduct necessary to meet this end.
8. That the professional liability for this Work-Product is assumed by Self-Funding Actuarial Services, Inc. which has in place an appropriate professional liability insurance policy. A PDF of the summary page of this policy is available at: [www.awpse.com/eando.pdf](http://www.awpse.com/eando.pdf).

09/25/2008

Date

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Principal  
Actuarial Work-Products, Inc.



## PART 3

# SUBMITTED DATA

### Addressee No. 1

Health Underwriter  
414 Main Street  
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Tel. (601) 414-8888  
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### Addressee No. 2

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Fax. (336) 896-0392  
ID E0001  
Contact Carlton Harker  
[harker2@earthlink.net](mailto:harker2@earthlink.net)

### Addressee No. 3

XYZ Manufacturing  
123 South Main Street  
Baltimore, MD 21211  
Tel. (410) 777-7777  
Fax. (410) 777-7777  
ID P0001  
Contact Jack Jones  
[jjones@xyz.rr.com](mailto:jjones@xyz.rr.com)

## Requested Work-Products

Discrimination Testing  
Medical Reimbursement Plan  
Single Employer and Single Plan

## General Information

Employer: XYZ Manufacturing Company

Plan Name: Health Care Plan of XYZ Manufacturing

Plan Designation: DOL: 901 Other: XYZ Test Year: 2010

Funding Method: Self-Funded Administration: TPA

Is Database completed? Yes

HCI Data Suppressed? No

Engager: Health Underwriter

Eligible User: Self-Funding Actuarial Svcs.

## Percentage Test Data

Number of Employees \_\_\_\_\_

Number of Excluded Employees \_\_\_\_\_

Number of Participants

    Excludible and Non-Excludible \_\_\_\_\_

    Non-Excludible Only \_\_\_\_\_

## HCI-Related Data

<u>Grouping</u>	<u>Employee</u>			<u>Benefits Paid</u>
	<u>Designation</u>	<u>Compensation</u>	<u>Participant</u>	
Top	_____	_____	_____	_____
Five	_____	_____	_____	_____
Highest	_____	_____	_____	_____
Paid	_____	_____	_____	_____
Officers	_____	_____	_____	_____
Total	_____	_____	_____	_____
More	_____	_____	_____	_____
Than	_____	_____	_____	_____
Than	_____	_____	_____	_____
10%	_____	_____	_____	_____
Owners	_____	_____	_____	_____
	_____	_____	_____	_____
	_____	_____	_____	_____

Total	_____	_____	_____	_____
Highest	_____	_____	_____	_____
Paid	_____	_____	_____	_____
25%	_____	_____	_____	_____
	_____	_____	_____	_____
	_____	_____	_____	_____
	_____	_____	_____	_____
	_____	_____	_____	_____
	_____	_____	_____	_____
Total	_____	_____	_____	_____
Total-All	_____	_____	_____	_____

Other Groupings

Total – Excludible Employees \_\_\_\_\_

Total – Lowest Paid 75% \_\_\_\_\_

Total – All Employees and Top 10% Shareholders \_\_\_\_\_

**Benefits Test**

Does the Plan discriminate in favor of the HCI with respect to the following:

- Eligibility (including probationary periods)? \_\_\_\_\_
- Benefits (including optional benefits)? \_\_\_\_\_
- Contributions (Employer or Participant)? \_\_\_\_\_
- Years of Service or compensation? \_\_\_\_\_

## Risk Management Tests

Does the Plan unfairly discriminate against any protected class of employees (i.e., civil rights or age-related)? \_\_\_\_\_

Does the Plan commit any age discrimination without the benefit of an actuarial certification as provided by the ADEA? \_\_\_\_\_

Has the feasibility of either of the following been actuarially Determined:

Medicare Part D Subsidy? \_\_\_\_\_

Mental Parity % Opt-Out? \_\_\_\_\_

Are any of the 2010 Health Reform Act mandates not met? \_\_\_\_\_

Does the Plan (a) violate any of the Federal Trade and Commerce Laws (anti-trust, restraint of trade, price-fixing, anti-competition, unfair trade practices, e.g.); or (b) violate any of the common principles of risk management (as defined in Sarbanes-Oxley); or (c) permit any undisclosed structural conflicted interests? \_\_\_\_\_

## Actuarial Value of Plan Benefits

Such value is needed whenever an individual who is not a common-law employee is permitted to be a Plan participant as a contractual matter and may be determined in either of two ways:

<u>Tier</u>	<u>Annualized Actuarial Value</u>	
	<u>COBRA Premiums</u>	<u>Monte Carlo Simulation</u>
Individual	_____	_____
Part/Child	_____	_____
Part/Spouse	_____	_____
Part/Child(ren)	_____	_____
Part/One	_____	_____

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Part/Children	_____	_____
Part/Two	_____	_____
Family	_____	_____

**Required Fraction**

This fraction is needed in the event that the Eligibility Test is not met and not corrected. To obtain such fraction, the HCI-Related Data must be provided. Examples of how the fraction is applied are shown in Part 1 for Participant John (Self-Employed Individual) and for Participant Mary.(When Tests Are Not Met).

- 1. Numerator (Paid Benefits for All HCI) \_\_\_\_\_
- 2. Denominator (Paid Benefits for All Participants) \_\_\_\_\_
- 3. Fraction: (1) divided by (2) \_\_\_\_\_

**PART 4**

**TESTING RESULTS**

**Eligibility Test**

**70% Test**

- 1. Total Count of Individuals \_\_\_\_\_
- 2. Non-Employees Who Are Also Non-Participants
  - (a) Shareowners \_\_\_\_\_
  - (b) Leased \_\_\_\_\_
  - (c) Retired \_\_\_\_\_
  - (d) Self-Employed (Sub-S Owners, Sole Proprietors, e.g.) \_\_\_\_\_
  - (e) Independent Contractors \_\_\_\_\_
  - (f) Partners \_\_\_\_\_
  - (g) Total \_\_\_\_\_
- 3. Total Count of Employees (1) – (2g) \_\_\_\_\_
- 4. Participation
  - a. Number Participating

- i. Excludible Only \_\_\_\_\_
- ii. Non-Excludible Only \_\_\_\_\_
- iii. Total \_\_\_\_\_

b. Number Non-Participating.

- i. Excludible Only \_\_\_\_\_
- ii. Non-Excludible Only \_\_\_\_\_
- iii. Total \_\_\_\_\_

c. Total Individuals (4)(a)(iii) + (4)(b)(iii) \_\_\_\_\_

5. Is 70 % Test Met? \_\_\_\_\_

Item .7x(3) Must Not Exceed (4)(a)(iii)

I.e., \_\_\_\_\_ Must Not Exceed \_\_\_\_\_

**70/80 Test**

6.. Is the 70/80% Test Available?

- a. Employees from (3), above \_\_\_\_\_
- b. Excludible Non-Participants from (4)(b)(i), above \_\_\_\_\_
- c. Eligible Employees (6)(a) –(6)(b) \_\_\_\_\_
- d. .7x(6)(a) \_\_\_\_\_
- e. Is Test Available? (6)(d) must not exceed (6)(c) \_\_\_\_\_  
I.e., \_\_\_\_\_ Must Not Exceed \_\_\_\_\_

7. Is 70/80% Test Both Available and Met? See (6)

- a. Eligible Employees (6)(c) \_\_\_\_\_
- b. Total Participants (4)(a)(iii) \_\_\_\_\_
- c. .8x(7)(a) \_\_\_\_\_
- d. Is 70/80% Test Met? (7)(c) Must Not Exceed (7)(b) \_\_\_\_\_  
I.e., \_\_\_\_\_ Must Not Exceed \_\_\_\_\_

**Benefits Test**

1. Are all of the Benefits Tests questions answered no? \_\_\_\_\_

## **Risk Management Tests**

1. Does the Plan or its administration permit any discrimination against the Protected Class? \_\_\_\_\_
2. Does the Plan or its administration permit any age discrimination that is not supported by an actuarial certification? \_\_\_\_\_
3. Have feasibility studies been made to determine whether it is actuarially prudent to elect the (a) Medicare Part D Subsidy or (b) Mental Health Parity % Opt-Out? \_\_\_\_\_
4. Have any of the Health Care Reform Act requirement not been met? \_\_\_\_\_
5. Do any of the Plan Fiduciaries have any structural or undisclosed conflicted interests? \_\_\_\_\_



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## **PART 5**

# **COMMENTS OF THE ACTUARY**

1. Elaborative explanatory comments may be found in the appropriate Sub-Site under these headings:
  - Description of Work-Products
  - Fees
  - Background Reading.
  
2. This Work-Product is the property of the Engager who has the fee responsibility and is the party engaging the Actuary. The Eligible User must be approved by Actuarial Work-Products, Inc.