

Health & Welfare Benefit Nondiscrimination Rules

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Employers are generally permitted to structure plans with different eligibility, benefits, and contributions between classes of employees so long as the employer does not discriminate against a protected class (e.g., age, disability, race, religion, or sex) or based on health status. However, to offer benefits on a tax-favored basis, plans must be structured in accordance with benefit nondiscrimination rules. Benefit nondiscrimination rules restrict the ability to favor highly compensated individuals or key employees on tax-favored basis. Benefit nondiscrimination rules are enforced by the IRS. Failure to comply with benefit nondiscrimination rules risks the highly compensated and key employees being taxed on benefits received under the discriminatory plan.

Applicable Codes

Benefit nondiscrimination rules are imposed in a few different code sections. Each code section indicates that to provide the benefits on a tax-favored basis (saving on both employee income tax and employer payroll tax), the plan must be structured in accordance with certain nondiscrimination rules.

Code Section	Applicable Benefits
§125	Any benefits run through an employer's cafeteria plan
§129	Dependent care account plans (DCAPs)
§105(h)	Self-funded group health plans
§79	Group term life and supplemental life insurance

Some plans will be subject to multiple sets of rules. For example, a self-funded group health plan that is run through an employer's cafeteria plan to allow employees to make contributions on a pre-tax basis is subject to §125 and §105(h) nondiscrimination rules.

Definitions – Highly Compensated & Key Employees

Each of the benefit nondiscrimination rules limits the ability to favor highly compensated individuals and key employees on a tax-favored basis. The definitions for these terms differ slightly depending upon which rules apply.

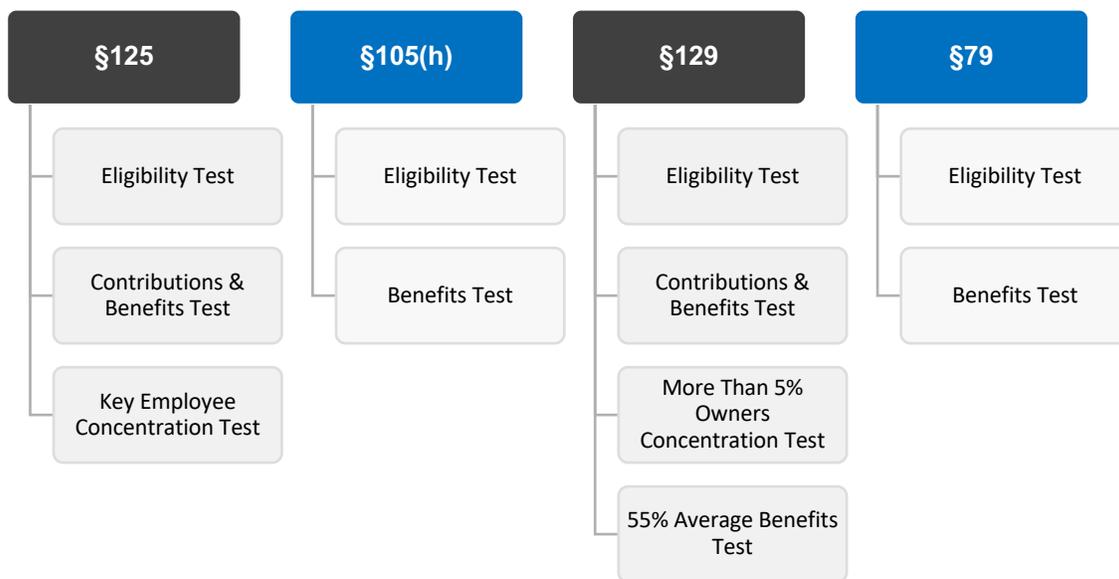


NOTE:

- *Spouses and dependents of highly compensated individuals or key employees who are also employees may be considered highly compensated or key employees as well.*
- *Sole-proprietors, partners in a partnership, and >2% S-Corp shareholders may not participate in employer-sponsored benefits on the same tax-favored basis as employees. Therefore, they can be disregarded for purposes of compliance with benefit nondiscrimination rules.*

Discrimination Testing

Each of the nondiscrimination rules require different testing, but typically look at an employee census (all employees on payroll), salaries, benefit eligibility, and actual participation (including employee and employer contributions). A plan must pass all applicable tests to be compliant. The tests generally consider whether there are enough non-highly compensated and non-key employees who are eligible to participate and actually participating (i.e., receiving tax-favored benefits).



§125 and §129 discrimination tests must be passed as of the last day of the plan year. §105(h) and §79 discrimination tests must be passed on all days during the plan year (i.e., the plan must always be operating in a nondiscriminatory fashion). The conservative approach is to run applicable discrimination tests annually. Especially for purposes of §125 and §129 testing, it makes sense to run discrimination testing early enough in the year to leave time to make corrections and ensure the plan is compliant as of the last day of the plan year. While annual testing is generally recommended, if testing is done and the plans are clearly in good shape, it may not be necessary to test again until there are significant changes in structure or participation. There are no specific penalties for failure to test, but if audited, plans must show that applicable discrimination tests are able to be passed. For this reason, employers should ensure they maintain the data necessary to run the testing in response to an audit (i.e., keep relevant records for approx. 6 – 8 years after the plan year ends).

Discrimination Testing Failures & Corrections

To make corrections and bring plans into compliance with the applicable nondiscrimination rules, the employer must adjust the amount or percentage of tax-favored benefits available to highly compensated or key employees. The most extreme fix would be to require that any employee contributions made by such individuals are made after-tax and all employer contributions are imputed as additional taxable compensation (i.e. requiring that benefits are treated as taxable to highly compensated and key

employees). However, in most cases the employer can bring a plan into compliance by simply reducing the benefits provided to highly compensated or key employees on a tax-favored basis. Following are several examples of common arrangements, along with suggestions for potential corrections if there is a failure of the applicable discrimination tests:

- **Example 1 – Differing Waiting Periods.** Employer offers a self-funded group medical plan with employee contributions handled pre-tax through the employer's cafeteria plan. All full-time employees are eligible with the same employer contribution; however, salaried employees are eligible on the date of hire while hourly employees are eligible on the 1st of the month following 60 days from hire.
 - In this scenario, it is necessary to consider §125 and §105(h) nondiscrimination rules because it involves a self-funded group health plan and the benefit is run through the employer's cafeteria plan.
 - This structure may be discriminatory under §125 depending upon the make-up of the salaried class of employees. If there is a decent mix of highly and non-highly compensated employees in the salaried class, this may be okay.
 - This structure will generally be discriminatory under the §105(h) benefits test because the rules specifically prohibit shorter waiting periods for highly compensated individuals.
 - To make a correction, there are really two options: (1) make the waiting period the same for salaried and hourly employees; or (2) make the coverage taxable for salaried employees, or at least the highly compensated individuals, for the first couple of months (i.e. the difference in the waiting periods). If choosing the second option, it would be necessary to handle employee contributions after-tax and impute taxable income for the employer contribution.
- **Example 2 – Differing Eligibility.** Employer offers a self-funded group medical plan that is paid 100% by employer contributions (for employee and dependent coverage) and is not run through the employer's cafeteria plan. The coverage is available only to managers. All other full-time employees are offered a limited medical plan option.
 - In this scenario, it is necessary to consider §105(h) nondiscrimination rules because it involves a self-funded group health plan. This structure will often be discriminatory under the §105(h) eligibility test because the management group is unlikely to include enough non-highly compensated employees.
 - NOTE: If this was a fully-insured plan, this structure would not be a problem because neither §125 nor §105(h) nondiscrimination rules would apply.
 - To make a correction, the employer may need to increase the population of employees eligible to participate to include more non-highly compensated employees; or the employer could provide the coverage after-tax to management, or at least the highly compensated individuals (i.e., impute taxable income for the employer contribution).
- **Example 3 – Differing Benefit Packages.** Employer offers self-funded group medical plans with employee contributions handled pre-tax through the employer's cafeteria plan. All full-time employees are eligible to participate, but employees in Minnesota are offered a different plan option than the employees in Texas.
 - In this scenario, it's necessary to consider §125 and §105(h) nondiscrimination rules because it involves self-funded group health plans and the benefits are run through the employer's cafeteria plan. Even assuming the different benefit packages result in differing monthly premiums, in many cases this structure will be okay under §125 and §105(h) nondiscrimination rules, assuming there is a decent mix of highly and non-highly compensated employees at each location. However, it could be problem if most of the highly compensated and key employees are at the location receiving the richer benefit package.
 - If a correction is needed, it may be necessary to consider offering the same benefits to both locations.

- **Example 4 – Differing Contributions.** Employer offers a fully-insured group medical plan with employee contributions handled pre-tax through the employer's cafeteria plan. All full-time eligible employees are eligible to participate, but employees receive differing contributions depending upon years of service (larger contributions for those with more years of service).
 - In this scenario, fully-insured group health plans on their own are not subject to any nondiscrimination rules, but it is necessary to consider §125 nondiscrimination rules because employee contributions are handled pre-tax through the cafeteria plan. Including this medical benefit within the cafeteria plan may cause a failure of the §125 nondiscrimination tests if the employees receiving the most generous employer contribution are generally highly compensated or key employees. Keep in mind, this benefit will be aggregated with all other benefits run through the cafeteria plan for discrimination testing purposes.
 - To make a correction, the employer may need to adjust the criteria for which employees receive the more generous employer contribution, or the employer could treat the difference between the employer contributions as taxable (i.e., impute the difference as additional taxable income) for the highly compensated or key employees.

- **Example 5 – Differing Contributions for Owners.** Employer, a partnership, offers a self-funded group medical plan with employee contributions handled pre-tax through the employer's cafeteria plan. All full-time eligible employees and the partners of the partnership are eligible to participate in the group medical plan, but partners are not required to contribute anything toward the cost of coverage.
 - In this scenario, the partners are disregarded because they are not permitted to participate on the same tax-favored basis as employees (i.e., the employer contribution toward their coverage should be taxed under partnership tax rules). Contributing 100% toward partner coverage while requiring other full-time employees to make a monthly employee contribution will not cause an issue under §125 and §105(h) nondiscrimination rules.

Penalties for Discriminatory Plans

If a plan fails discrimination testing and appropriate corrections are not made before the end of the plan year, the IRS could discover this via audit and require that benefits received under the plan be retroactively recharacterized as taxable income for the highly compensated and/or key employees. This may result in additional income taxes for the highly compensated and key employees as well as additional payroll taxes for the employer. A failure to comply with the applicable nondiscrimination rules will not disqualify the entire plan or affect non-highly compensated employees; the penalty would affect only highly compensated and key employees.

Summary

Nondiscrimination rules are widely misunderstood, which makes it hard for employers to navigate them. To make things simple and avoid having to understand the rules, many employers choose to offer identical eligibility, benefits, and contributions to all employees (or at least all full-time employees). However, a basic understanding of the nondiscrimination rules, including when they apply and what they prohibit, may provide employers with a bit more flexibility to offer benefits as desired. That being said, for any employers choosing to differentiate, we generally recommend the design be reviewed for discrimination, and if appropriate, performing discrimination testing to ensure their structure meets applicable benefit nondiscrimination rule requirements.

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