Employee Benefit Nondiscrimination Rules Review

July 2021

Legislation and regulations are subject to change. This guidance is current as of the date of this publication.

Benefit Nondiscrimination Rules

General Requirement

To offer benefits on a tax-favored basis, plans must be structured in accordance with applicable benefit nondiscrimination rules, which are monitored and enforced by the IRS. Benefit nondiscrimination rules restrict the ability to favor highly compensated individuals (HCIs) or key employees **on a tax-favored basis**.

Owners (e.g., sole proprietors, partners and >2% S-Corp shareholders) and non-employees are not considered because they cannot participate in benefits on the same tax-favored basis as employees. In other words, employers can treat owners and non-employees differently without worrying about compliance with benefit nondiscrimination rules.

Discrimination Testing Requirements

There is not a clear requirement to perform discrimination testing annually. However, if a plan is audited, it would be necessary to show that the plan met applicable nondiscrimination requirements (e.g., by producing discrimination testing results or running the testing at such time). Therefore, it is important to keep records of testing results and/or the data required to run testing. The conservative approach is to test annually, preferably early in the year to leave time to make corrections if needed. Some employers are comfortable testing initially, but then if the plan(s) pass applicable discrimination testing, testing again only following significant changes in the structure of the plan offering or participation levels.

Potential Discriminatory Plan Corrections

If a plan fails discrimination testing, the employer can make adjustments prior to the end of the plan year to avoid any negative tax implications for highly compensated individuals or key employees. The following corrections may be used to bring a discriminatory plan into compliance:

- Exclude HCIs or key employees from participating, or from participating on a tax-favored basis (i.e., employee contributions after-tax, impute income for employer's contribution).
- Limit the amounts elected by HCIs or key employees on a tax-favored basis.
- Adjust eligibility rules to include additional non-HCIs.

Penalty for Non-Compliance (for Discriminatory Plans)

If a plan is discovered to be discriminatory by the IRS, the IRS could require retroactive taxation of the benefits (or excess benefits) received by HCIs and key employees, which may also require payment of retroactive payroll taxes.

§125 Rules – Cafeteria Plans

Application

§125 nondiscrimination rules consider any benefits run through the employer's cafeteria plan. For testing purposes, the benefits are aggregated, not considered separately.

Definition of Highly Compensated Individuals (HCIs) and Key Employees

- HCIs = (i) Officers; (ii) >5% shareholders (if also employees); and (iii) highly compensated individuals (compensation in the previous year of $130,000 or more for 2021). There is an option to treat the top-paid 20% of employees as HCIs rather than using the compensation threshold.
- Key Employees = (i) Officers with annual compensation in excess of $185,000 for 2021; (ii) >5% owners; and (iii) >1% owners with annual compensation in excess of $150,000.

Discrimination Tests

§125 nondiscrimination rules include three tests. A cafeteria plan must pass all three tests to meet the nondiscrimination requirements.

1. Eligibility Test – Cannot discriminate in favor of HCIs as to eligibility to participate.
2. Contributions & Benefits Test – Cannot discriminate in favor of HCIs as to contributions and benefits.
3. Key Employee Concentration Test – Key employees cannot utilize more than 25% of the non-taxable benefits.

****For a premium only plan (POP), it is only necessary to pass the eligibility test*

§105(h) Rules – Self-Funded Group Health Plans

Application

§105(h) nondiscrimination rules apply to self-funded group health plans.

Definition of Highly Compensated Individuals (HCIs)

- HCIs = (i) 5 highest paid officers; (ii) >10% shareholders (if also employees); and (iii) top 25% highest-paid employees.

Discrimination Tests

§105(h) nondiscrimination rules include two tests. A self-funded group health plan must pass both tests to meet the nondiscrimination requirements.

1. Eligibility Test – Cannot discriminate in favor of HCIs as to eligibility to participate or benefit.
2. Benefits Test – Cannot discriminate the benefits or contributions in favor of HCIs:
    - Are all participants eligible for the same benefits under the plan?
    - Are all benefits offered under the same conditions to all participants?
    - If optional benefits are offered, are all participants able to elect each benefit option for the same additional contribution?
    - Are disparate waiting periods being used?
    - Do benefits vary based on age, years of service, or compensation?

§129 Rules – Dependent Care Account Plans (DCAPs)

Application

§129 nondiscrimination rules apply to dependent care account plans (DCAPs), also known as dependent care FSAs.

Definition of Highly Compensated Individuals (HCIs)

- HCIs = (i) >5% shareholders (if also employees); and (iii) highly compensated individuals (compensation in the previous year of $130,000 or more for 2021). There is an option to treat the top-paid 20% of employees as HCIs rather than using the compensation threshold.

Discrimination Tests

§129 nondiscrimination rules include four tests. A DCAP must pass all four tests to meet the nondiscrimination requirements.

1. Eligibility Test – Cannot discriminate in favor of HCIs as to eligibility to participate.
2. Contributions & Benefits Test – Cannot discriminate in favor of HCIs as to contributions and benefits.
3. More-Than-5% Owners Test – Owners cannot receive >25% of the benefits run through the plan.
4. 55% Average Benefits Test – Average benefits provided to non-HCIs must be at least 55% of the average benefits provided to HCIs.

§79 Rules – Group Life Insurance

Application

§79 nondiscrimination rules apply to group life insurance plans.

Definition of Key Employees

- Key Employees = (i) Officers with annual compensation in excess of $185,000 for 2021; (ii) >5% owners; and (iii) >1% owners with annual compensation in excess of $150,000.

Discrimination Tests

§79 nondiscrimination rules include two tests. A group life insurance plan must pass both tests to meet the nondiscrimination requirements.

1. Eligibility Test – Cannot discriminate in favor of key employees as to eligibility to participate or benefit.
2. Benefits Test – All benefits available to key employees must be available to all other participants.