A Compliance Brief

Health & Welfare Benefit Nondiscrimination Rules

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Benefit Nondiscrimination Rules

Many employers differentiate benefit eligibility, waiting periods, coverage, and employer contributions between classes of employees or between different entities within the same controlled group or affiliated service group. The reasons for doing so vary greatly and can be impacted by the employer's location and industry.

Employers are generally permitted to differentiate benefit offerings 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, which restrict the ability to favor highly compensated individuals or key employees on a tax-favored basis.

Nondiscrimination rules are complex and hard for employers to navigate. To make things simple, many employers choose to offer identical benefits to all employees (or at least to all full-time employees); however, it's generally okay to differentiate benefit offerings in favor of lower-paid employees (sometimes referred to as "reverse discrimination") or to offer more generous benefits to a class of employees with a decent mix of highly and non-highly compensated employees. On the other hand, offering richer benefits to a class consisting primarily of higher paid employees (e.g., management or executives) will violate benefit nondiscrimination rules, potentially resulting in the benefits being taxable to highly compensated and key employees who participate in the discriminatory plan.

Applicable Codes

Benefit nondiscrimination rules are imposed by a few different Code sections, all with similar restrictions on favoring highly compensated or key employees.

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
§127	Educational assistance programs
§137	Adoption assistance programs

Some plans are 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 both §125 and §105(h) nondiscrimination rules.

Benefit nondiscrimination rules for health savings accounts (HSAs) depend upon whether the HSA is run through the employer's cafeteria plan. If the HSA is not run through the employer's cafeteria plan, then comparability rules apply requiring uniform contributions for all those enrolled in the employer's HDHP based on tier of coverage. If the HSA is run through the employer's cafeteria plan (i.e.,

employees are permitted to make pre-tax HSA contributions), then comparability rules do not apply, but the HSA would be aggregated with all other benefits run through the employer's cafeteria plan for purposes of determining compliance with §125 nondiscrimination rules.

Definitions – Highly Compensated & Key Employees

The benefit nondiscrimination rules limit 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, and compensation thresholds are adjusted annually.

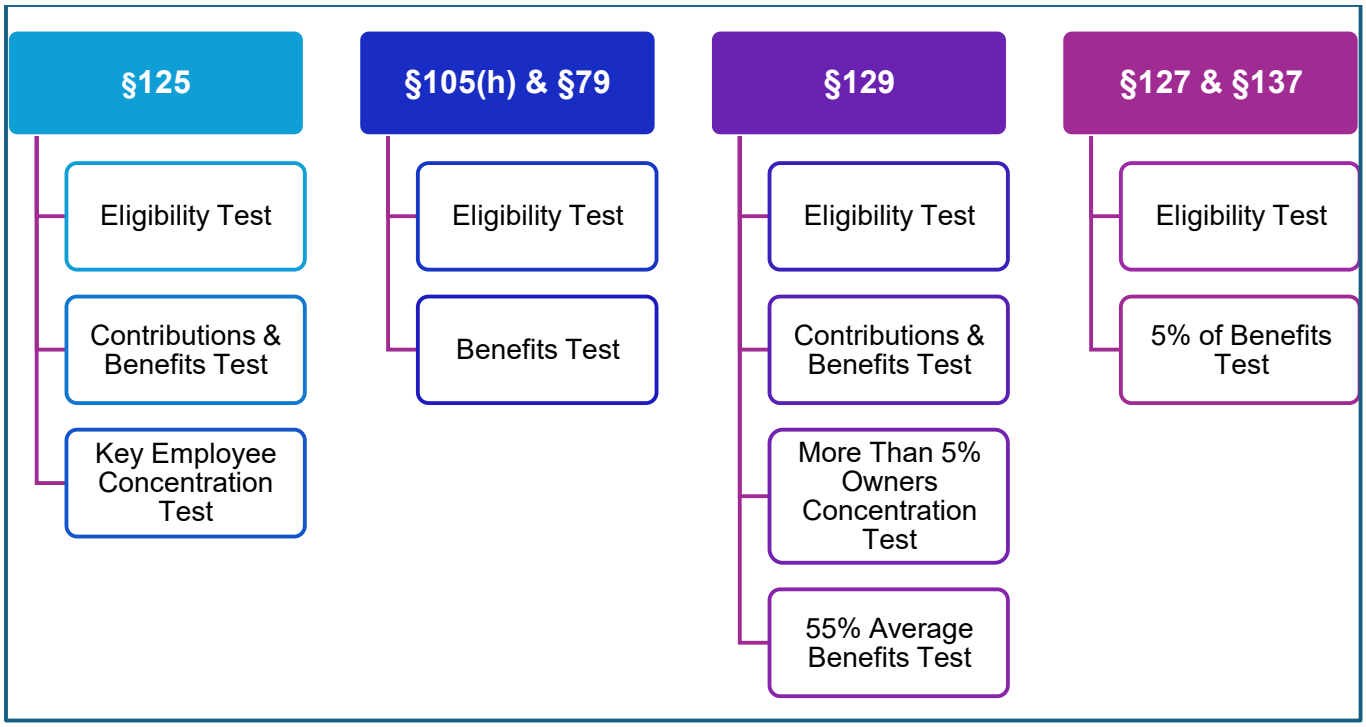
Highly Compensated	**§125** • Officers • >5% shareholders (only if also employees) • Highly compensated (2025 - $155,000 in 2024; 2026 - $160,000 in 2025; 2027 - $160,000 in 2026) **§129, §127 and §137** • >5% shareholders • Highly compensated (2025 - $155,000 in 2024; 2026 - $160,000 in 2025; 2027 - $160,000 in 2026) **§105(h)** • 5 highest paid officers • >10% shareholders (only if also employees) • Top 25% highest-paid employees
Key Employee	**§125 and §79** • Officers with annual compensation in excess of $230,000 for 2025 and $235,000 for 2026 • >5% owners (only if also employees) • >1% owners with annual compensation in excess of $150,000

Spouses and dependents of highly compensated individuals or key employees who are also employees may be considered highly compensated or key employees as well.

For employers with a significant number of highly compensated employees, the employer has the option to use the top-paid group election to reduce the number of highly compensated employees for purposes of §125, §127, §129 and §137. Under the top-paid group election, employees with compensation in excess of the applicable threshold will not be treated as highly compensated unless they are also in the top-paid 20% of employees. Employers who want to use this election must use it consistently for all applicable benefit discrimination testing, including for its retirement plan(s).

Discrimination Testing

Each of the nondiscrimination rules requires 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 consider whether there are enough non-highly compensated and non-key employees who are eligible to participate as well as actually benefiting (i.e., receiving tax-favored benefits).



To ensure compliance with benefit nondiscrimination rules, applicable discrimination tests should be run annually. Tests should be run early enough in the year to leave time to make corrections and ensure the plan is compliant before the end of the plan year. While annual testing is recommended, if testing is done and the plans are 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 approximately 6-8 years after the plan year ends).

Many TPAs and/or payroll vendors will run annual discrimination testing if they handle the administration for the employer's benefits. There are also vendors or attorneys who will perform discrimination testing as needed. Whoever performs the testing, make sure when they run testing all applicable benefits. For example, if the TPA handles only the health FSA and DCAP administration, make sure information is provided so that §125 discrimination testing includes all plans offered through the employer's cafeteria plan. NOTE: Testing annually without any further action may serve only as a record of discrimination and knowledge of such discrimination. Vendors who automatically run discrimination testing for employers who do not understand the rules or who choose not to address failed testing may not be beneficial.

Discrimination Testing Failures & Corrections

For a plan that fails one or more of the applicable discrimination tests, the options for correction will depend upon the timing of the discovery.

- After the close of the plan year, the employer no longer has the option to make corrections. Technically, the employer is required to treat some or all of the benefits provided to highly compensated or key employees as taxable (which may require issuing corrected Form W-2s and correcting underpaid payroll taxes). Instead, the employer might make adjustments only prospectively, but the employer would then leave itself open to discovery by the IRS at a future date, so we would recommend discussing this approach with counsel.

- If the failure is discovered prior to the end of the plan year, there is time to make appropriate 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 that all employer contributions are imputed as additional taxable compensation. However, in most cases the employer can bring a plan into compliance by simply reducing the amount of benefits provided to highly compensated or key employees on a tax-favored basis rather than requiring the full value to be treated as taxable. The following are generally the options for adjusting the amount of tax-favored benefit for highly compensated or key employees in the current plan year (a combination of these may be required):

    - For plan premiums:
        - Require that employee contributions be made after-tax for the remainder of the plan year;
        - Impute taxable income for employer contributions made during the remainder of the plan year; and/or
        - Include previously made contributions in the employees' taxable income.

    - For account-based plans (e.g., FSA, DCAP or HSA):
        - Limit further tax-favored contributions for the remainder of the plan year;
        - Return already contributed (but unused) amounts as taxable income; and/or
        - Include already reimbursed amounts in their taxable income.

For employers who struggle to pass discrimination testing for account-based plans, the employer should consider excluding highly compensated and key employees or capping their contribution amounts at a lower level than other eligible employees for future plan years (making it less likely that corrections would be needed mid-plan year).

Examples

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 fully insured 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 date of hire while hourly employees are eligible 1st of the month following 60 days from hire. In this scenario, it is necessary to consider §125 nondiscrimination rules because the benefit is run through the employer's cafeteria plan. This structure may be discriminatory under §125 depending upon the mix of highly and non-highly compensated employees in the salaried class.	**Correction:** To make a correction, there are really two options: (1) make the waiting period the same for salaried and hourly employees; or (2) require employees, or at least the highly compensated individuals, to make contributions after-tax for the first couple of months (i.e., the difference in the waiting periods).
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.	**Correction:** 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 on a taxable basis 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	**Correction:** If a correction is needed, it may be necessary to consider offering the same benefits to both locations.

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.	
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 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 §125 nondiscrimination rules apply because employee contributions are handled pre-tax through the cafeteria plan. Including this medical benefit within the cafeteria plan may cause a failure of §125 nondiscrimination tests if the employees receiving the most generous employer contribution are primarily 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.	**Correction:** 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 Benefits or Contributions for Owners or Independent Contractors Owners and independent contractors cannot participate in employer-sponsored benefits on the same tax-favored basis as employees. Any employer contribution must be imputed as additional taxable compensation and their contributions must be made after-tax. In addition, they are not permitted to participate in the employer's cafeteria plan, health FSA or HRA.	

For this purpose, the term "owner" includes a sole proprietor, partner in a partnership, or >2% shareholder in an S-Corp. In the case of a >2% S-Corp shareholder, the owner's spouse, children, parents, and grandparents are attributed ownership under §318 rules and therefore the same restrictions regarding participating on a tax-favored basis in the employer's benefits apply. NOTE: A C-Corp shareholder who is also a W-2 employee (dual status) is permitted to participate on a tax-favored basis in regard to employer contributions, and to the extent of the shareholder's W-2 wages through a cafeteria plan for any employee contributions. Although owners and independent contractors cannot participate on the same tax-favored basis, the good news is that they can be disregarded for purposes of compliance with benefit nondiscrimination rules (i.e., excluded when performing discrimination testing).	

Enforcement & Penalties

Benefit nondiscrimination rules are enforced by the IRS and apply only when benefits are provided on a tax-favored basis. Failure to comply with benefit nondiscrimination rules risks the highly compensated and key employees being taxed on benefits provided under the discriminatory plan. 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 payments made or 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. NOTE: Except for educational assistance programs and adoption assistance programs, failure to comply with the applicable nondiscrimination rules will not disqualify the entire plan or affect non-highly compensated employees; the tax penalty and any associated late penalties would affect only highly compensated and key employees.

There has not been much enforcement of the nondiscrimination rules over the past decade, however, for a plan that cannot pass applicable discrimination testing, the safer approach is to provide additional taxable compensation to highly compensated individuals versus providing them with richer tax-favored benefits in violation of applicable benefit nondiscrimination rules.