AssuredPartners

Health & Welfare Benefit Nondiscrimination Rules

December 2024

Many employers differentiate benefit eligibility, waiting periods, coverage, and employer contributions between classes of employees. The reasons for doing so vary greatly and can be impacted by the employer's location and industry. For example, some employers may offer higher employer contributions to lower paid employees to meet the affordability requirements under the (ACA) employer mandate, while many others offer something more generous to attract better talent into certain positions, especially management level and above.

Employers are generally permitted to structure plans with different eligibility, waiting periods, 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 applicable benefit nondiscrimination rules. Benefit nondiscrimination rules restrict the ability to favor highly compensated individuals or key employees on a tax-favored basis.***

Nondiscrimination rules are complex and widely misunderstood, which makes it hard for employers to navigate them. To make things simple, many employers choose to offer identical eligibility, benefits, and contributions to all employees (or at least to 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. For example, if employers choose to differentiate benefit offerings to favor the lower-paid employees (sometimes referred to as "reverse discrimination"), that shouldn't be a problem. It is also generally okay for employers to offer more generous benefits to a class of employees with a decent mix of highly and non-highly compensated employees. However, it is common for employers to offer something richer to a class consisting primarily of higher paid employees (e.g., management or executives), **which can put the tax-favored status of the benefits at risk for those same employees the employer is attempting to favor.**

For employers choosing to differentiate between classes of employees, we recommend that discrimination testing is performed ***(in advance of any coverage offering)*** to ensure the structure meets applicable benefit nondiscrimination rule requirements and does not risk additional taxes and penalties for the highly compensated and key employees.

Penalties for Discriminatory Plans

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 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 tax penalty and any associated late penalties would affect only highly compensated and key employees.

There has not been a much enforcement of the nondiscrimination rules over the past decade, however, for a plan that cannot pass applicable discrimination testing, the more conservative 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.

Applicable Codes

Benefit nondiscrimination rules are imposed by 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.

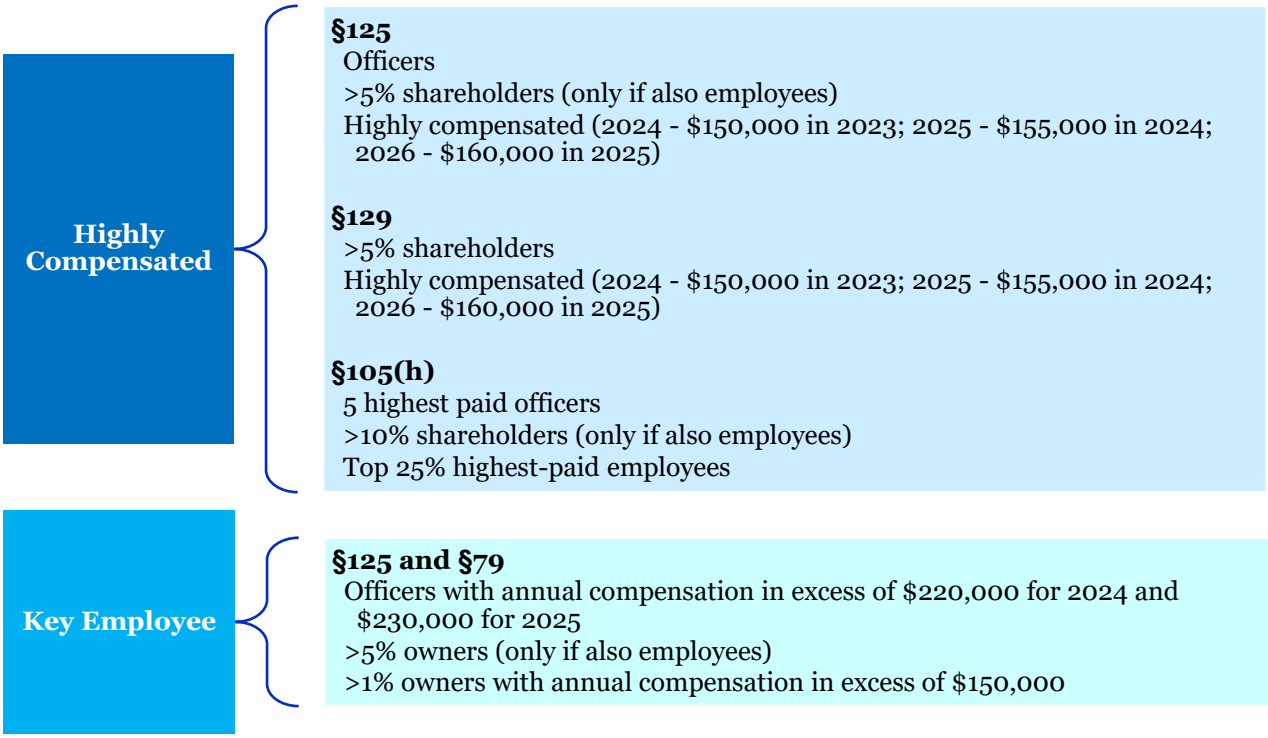
Code Section	Applicable Benefits
§125	Any benefits run through an Employer's cafeteria plan
§129	Dependent care account plans (DCAPs, DCRAs, etc.)
§105(h)	Self-funded group health plans, includes HRAs, HCFSAs, etc.
§79	Group term life and supplemental life insurance

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 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 with some small exceptions for further differentiation. If the HSA is run through the employer's cafeteria plan (i.e., employees are permitted to make pre-tax HSA contributions), then the 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.



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

Owners and Independent Contractors

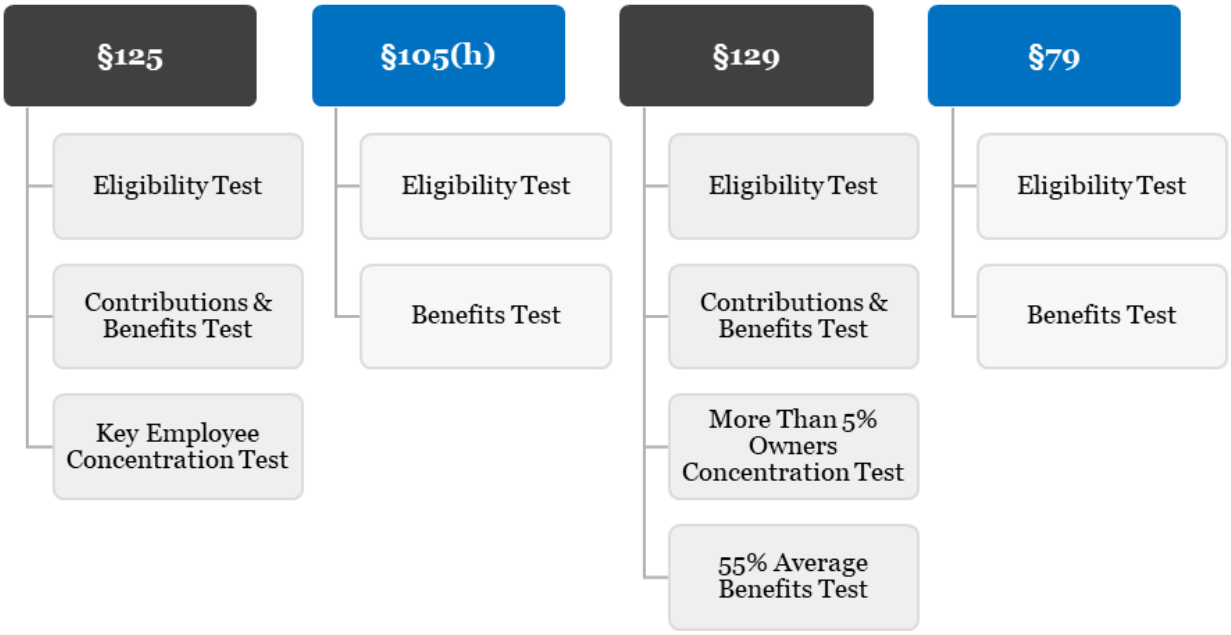
Owners and independent contractors cannot participate in employer-sponsored benefits on the same tax-favored basis as employees. In general, any employer contributions made for them must be imputed as additional taxable compensation and their contributions must be made after-tax. In addition, they are 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. In other words, it would be okay for the employer to offer more generous benefits or to fully cover the monthly premium solely for owners without running afoul of benefit nondiscrimination rules. ***Please discuss the income tax implications of a decision like this with your tax adviser.***

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).



§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 and to implement corrections as soon as practicable. 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 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 will run annual discrimination testing if they handle the administration for the employer's benefits. Make sure when they run such testing all applicable benefits are included. For example, if the TPA handles only the health FSA and DCAP/DCRA administration, make sure information is provided so that §125 discrimination testing includes all plans offered through the employer's cafeteria plan. If the TPA does not offer discrimination testing, or will not test benefits they do not administer, there are many vendors or attorneys who will perform

discrimination testing as needed. 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.

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	**Correction:**
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 and §105(h) 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.	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.	**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 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 a problem if most of the highly compensated and key employees are at the location receiving the richer benefit package.	**Correction:** 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 employees are eligible to participate,	**Correction:** To make a correction, the employer may need to adjust the criteria for which employees receive the more generous

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 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.	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 employees and the partners are eligible to participate in the group medical plan, but partners are not required to contribute anything toward the cost of coverage while other full-time employees are required to contribute 20%. 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 or §105(h) nondiscrimination rules.	