

Nondiscrimination Rules – Options for Highly Compensated Individuals

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Benefit nondiscrimination rules restrict the extent to which employers may favor highly compensated individuals and key employees on a *tax-favored basis*. §105(h) nondiscrimination rules apply to self-funded group health plans, and §125 nondiscrimination rules apply to all benefits run through the employer's cafeteria plan. It bears repeating...the IRS nondiscrimination rules apply only to the extent that the benefits are provided on a *tax-favored basis*. Therefore, even if the desire is to favor primarily highly compensated or key employees, there may be ways to do so without violating benefit nondiscrimination rules. Some ways are more attractive than others.

Benefits for Non-Employees

Non-employees (e.g., independent contractors, sole proprietors, partners, >2% S-Corp shareholders, board members/directors) are not permitted to participate in benefits on the same tax-favored basis that employees can. Their contributions toward benefits must be made after-tax, and employer contributions should be treated as additional taxable compensation. However, because they cannot participate on a tax-favored basis like employees, they are excluded for purposes of discrimination testing. In other words, it won't cause any problems under §105(h) or §125 benefit nondiscrimination rules to offer non-employees different waiting periods, benefits, or employer contributions.

Fully-Insured Benefits

Fully-insured benefits are not currently subject to their own nondiscrimination rules, but they would be included in §125 discrimination testing to the extent that they are included in the employer's cafeteria plan. The cafeteria plan is the vehicle that allows for employee contributions toward benefits to be handled on a pre-tax basis. When the employer contributes 100% of the premium, there is no need to run the benefit through the cafeteria plan. So, if the employer is offering the same benefits to all those who are eligible to participate in the cafeteria plan, with a difference only in the employer contributions toward premiums, the employer could contribute 100% of the premium for highly compensated individuals (for employee and dependent premiums) while contributing a lesser percentage for everyone else without negatively impacting discrimination testing if such individuals are then excluded from cafeteria plan eligibility. For example, the employer could contribute 100% of the medical, dental, and vision premiums for the executives while contributing 75% for all other eligible employees and avoid issues under §125 nondiscrimination rules by excluding all executives from cafeteria plan eligibility. It's not clear whether the executives may be excluded only for purposes of certain benefits (e.g., only the medical plan); the more conservative approach would be to exclude them completely, which would preclude making of pre-tax contributions toward other benefits not paid for by the employer (e.g., dental and vision premiums, health FSA,

HSA, DCAP). NOTE: This strategy works only if the employer is willing to contribute 100% of the premium cost for single and family coverage. If the employer doesn't want to cover the cost of dependent coverage, the employees will want to pay their portion of the cost pre-tax through the cafeteria plan.

Taxable Benefits

Finally, if the employer wants to differentiate eligibility, benefits, or contributions for employees under a self-funded group health plan, or wants to differentiate benefits without excluding employees from its cafeteria plan, the employer could simply provide the additional benefits on a taxable basis to avoid issues under §105(h) or §125 benefit nondiscrimination rules. For example, if the employer wants to offer management a shorter waiting period (e.g., 30 days versus the 60 days applicable to other eligible employees), the employer could provide the benefits on a taxable basis for the first month; or if the employer wants to contribute more toward coverage premiums for management (e.g., 75% versus 50% for other eligible employees), the employer could provide the additional 25% on a taxable basis.

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 of their 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. We generally recommend discrimination testing for employers choosing to differentiate between categories of employees to ensure that their structure meets applicable benefit nondiscrimination requirements.

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