Nondiscrimination Testing Review

Nondiscrimination rules applicable to health and welfare benefit plans are as varied as they are complex. These rules apply to benefit plans sponsored by employers. The following is a summary the most common nondiscrimination requirements applicable to health and welfare plans.

- Section 125 nondiscrimination requirements for employee pre-tax contributions;
- Section 105(h) nondiscrimination requirements for self-funded health plans; and
- Affordable Care Act nondiscrimination requirements for fully insured health plans;

There are additional nondiscrimination requirements not addressed in this brief that may also apply to your benefit programs, including rules for employer-paid group term life insurance and dependent care flexible spending account plans.

**Section 125 nondiscrimination requirements**

As one of the conditions to employees making their benefit plan contributions on a pre-tax basis, the employer’s Section 125 plan (sometimes referred to as a “Cafeteria Plan”) must not discriminate in favor of highly compensated employees (HCEs) and key employees with respect to eligibility, contributions, and benefits. In very general terms, HCEs include any officers of the company, five percent (5%) or more shareholders and highly compensated employees making more than the applicable wage threshold per year. The threshold varies by type of testing being performed. It is very important each year to determine who the company’s HCEs and key employees are for nondiscrimination testing purposes.

Cafeteria plans that do not cover all non-highly compensated employees (NHCEs), or offer better benefit packages or contribution arrangements to HCEs than to NHCEs, are at risk for violating the Section 125 nondiscrimination rules. In addition, qualified benefits provided to key employees cannot exceed 25% of the benefits provided to all employees under the plan.

Violating the Section 125 nondiscrimination requirements does not invalidate all tax benefits of a cafeteria plan. Even if the plan is discriminatory, NHCEs and non-key employees will not lose the tax advantages of the plan. Contributions may still be made on a pre-tax basis; however, HCEs and key employees will lose all of their favorable tax treatment under the plan, resulting in imputed income to the HCEs and key employees.

IRS regulations specify that the Section 125 nondiscrimination tests are to be performed as of the last day of the plan year. However, violation of the Section 125 nondiscrimination requirements cannot be corrected after the end of the plan year. Violation of the requirements could subject the employer to additional FICA taxes due to the imputed income to HCEs and key employees. The employer could also be subject to penalties for inaccurate withholding and reporting of taxes. Therefore, it is generally recommended that an employer do pretesting of the plan and testing early in the plan year to determine whether changes must be made to the plan in order to satisfy the nondiscrimination requirements.

**Section 105(h) nondiscrimination requirements**

Self-funded group medical plans are subject to the Section 105(h) nondiscrimination requirements. In addition to self-funded or level funded major medical plans, this nondiscrimination rule also applies to health reimbursement arrangements (HRAs) and health flexible spending account plans (FSAs).
Section 105(h) nondiscrimination testing requires testing of eligibility for benefits and the benefits provided. Like the Section 125 requirements, the Section 105(h) tests may be violated where the plans have different contribution or benefit structures for different groups of employees; however, there are major differences between the tests. For example, the Section 105(h) nondiscrimination rules provide that the top 25% of non-excludable employees are “highly compensated individuals” (HCIs) for testing purposes. Thus, unlike the Section 125 rules, a self-funded group health plan, regardless of the employer’s compensation structure, will have HCIs for this nondiscrimination testing. Certain broad categories of employees are excludable from the eligibility testing for Section 105(h), including employees who have not completed three years of service, part-time employees, seasonal employees, and employees who have not yet attained age 25.

Having a discriminatory self-funded medical plan can result in very severe tax consequences for HCIs. The penalty for violating the Section 105(h) nondiscrimination rules is that HCIs are taxed on the “excess reimbursements” not available to non-highly compensated employees. The employer sponsoring the plan could also have tax penalties for incorrect income and payroll tax withholding and payment in situations where highly compensated employees have additional taxable income due to the violation of the Section 105(h) nondiscrimination rules. As a reminder, HCIs subject to these rules include employees in the top 25% of compensation, the top highest paid officers and a shareholder with more than 10% value of employer stock, so a fairly broad section of the work force could be affected by these penalties for a discriminatory plan. Ideally, Section 105(h) nondiscrimination testing should be conducted right before the beginning of the plan year, around the middle of the plan year, and at the end of the plan year.

ACA nondiscrimination requirements for fully insured medical plans
Prior to the Affordable Care Act (ACA), there were no separate nondiscrimination requirements applicable to fully insured group medical plans. Due to the ACA, non-grandfathered fully insured group medical plans will for the first time be subject to separate nondiscrimination requirements. These new rules for fully insured plans are supposed to be “similar to” the Section 105(h) nondiscrimination rules for self-funded medical plans, as discussed above. However, the IRS has delayed enforcement of the nondiscrimination requirements for fully insured plans until further notice. It is possible the rules, when released, will result in changes to the Section 105(h) nondiscrimination rules applicable to self-funded medical plans.

There have not been any firm signals from the IRS as to when the guidance will be issued for the ACA nondiscrimination requirements applicable to non-grandfathered fully insured medical plans. The ACA nondiscrimination penalties for fully insured medical plans could be very harsh, with penalties of $100 per affected person per day. Unlike the current Section 125 and 105(h) penalties that fall primarily on highly compensated employees, the penalties for violating the ACA nondiscrimination rules for fully insured medical plans will fall directly on the employer.

Summary:
• Pretest and test early in the Section 125 plan year. Make changes as necessary during the plan year to satisfy the nondiscrimination requirements.
• Test self-funded group health plans just before the beginning of the plan year, the middle of the year and at the end of the year. Tax HCIs on “excess income”.
• Draft Cafeteria plan to allow mid-year adjustment of salary reductions of highly compensated and key employees to satisfy any of the Section 125 nondiscrimination requirements.
• Watch for IRS guidance about fully insured nondiscrimination requirements.

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