

Nondiscrimination Rules For Section 125 Plans and Self-Funded Health Plans

The IRS imposes nondiscrimination rules on Section 125 plans (also known as flexible benefit plans, cafeteria plans or pre-tax premium plans) and self-funded group health plans. The purpose of the rules is to prevent employers from favoring highly compensated employees to an impermissible degree. The general consequence of the failure of the tests is that the highly compensated employees will have taxable income relative to the discriminatory benefits they receive.

Section 125 Plans

There are three categories of nondiscrimination rules, which potentially apply to a Section 125 plan.

Category 1 - Plan as a Whole. Three nondiscrimination tests apply to the plan as a whole: the eligibility test, the contributions test, and the 25% concentration test.

If all full-time employees are eligible to elect the same benefits with the same employer subsidy toward the cost, then the first two tests will generally be satisfied. On the other hand, if there are differences between employee groups (for example, senior management gets free health coverage, and all other eligible employees are required to contribute), then the first two tests must be conducted. The results of these tests should help ensure that the group with more favorable coverage includes a sufficient number of non-highly compensated employees relative to the benefitting highly compensated employees. (Generally, “highly compensated” for this purpose means employees with annual compensation of at least \$120,000.)

THREE TESTS

- 1) Eligibility Test
- 2) Contributions and Benefits Test
- 3) Key Employee Concentration Test

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The 25% concentration test looks at the aggregate nontaxable benefits under the plan, which are provided to all participants, and prohibits more than 25% of those benefits from being provided to a subset of the highly compensated employees (certain owners and officers, known as “key

employees"). This third test is a numerical test and should be conducted every year, particularly for smaller employers where this test is more likely to pose an issue.

TWO TESTS

- 1) Eligibility Test
- 2) Benefits Test

Category 2 - Health FSAs. The second set of nondiscrimination tests applies only to health FSAs. A health FSA must pass two tests: an eligibility test and a benefits test. Under the current rules, if all full-time employees are eligible and are subject to the same contribution rules, then these tests would appear to be satisfied. While there have been proposed regulations suggesting a utilization component should be considered, those regulations have not been finalized.

Category 3 - Dependent Care FSAs. There are four tests which apply to dependent care FSAs. The first two, an eligibility test and a contributions or benefits test, are similar to the tests in the first two categories outlined in the previous sections above. The second two tests are the more-than-5%-owner test and the 55% average benefits test. Similar to the key employee concentration test for Cafeteria Plans outlined above in category one, the more-than-5% owner concentration test and the 55% average benefits test should be run every year.

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The more-than-5%-owner test prohibits more than 25% of the dependent care FSA benefits from being provided to more-than-5%-owners (or their spouses or dependents who are employees). The 55% average benefits test looks at all participants who are non-highly compensated employees (generally making less than \$120,000 per year). Their dependent care FSA benefits under the plan must be at least 55% of the average benefit provided to the highly compensated employees. If the employer has no highly compensated employees participating in the dependent care FSA, this test will automatically be satisfied. If not, it is critical for the employer to conduct this test each year to ensure compliance and take corrective action if needed. For example, upon testing failure, the employer could reduce the benefits of the highly compensated employees to avoid the inclusion of dependent care FSA benefits in the highly compensated employee's taxable income for the year. If corrective action is not taken, the consequence is that all of the dependent care FSA benefits of each highly compensated employee must be included in his/her taxable income for the year.

FOUR TESTS

- 1) Eligibility Test
- 2) Contributions and Benefits Test
- 3) More-than-5%-Owner Test
- 4) 55% Average Benefits Test

Each year, the employer should perform nondiscrimination testing on their Section 125 plan. If the employer's plan does not include health FSAs or dependent care FSAs the second two categories of nondiscrimination tests may not apply. If the employer has retained a third party administrator

(TPA) in connection with the plan, often the TPA will assist with the nondiscrimination testing. However, some TPAs provide only one or two of the necessary tests as part of their services. Employers should ask their TPA which tests will be performed, what steps the employer needs to take in the process and what the cost will be for this service. While compliance with most of the tests can generally be determined by reviewing the plan design, certain tests (such as the key employee concentration test, the more-than-5% owner concentration test, and the 55% average benefits test) should still be conducted annually to verify compliance.

Self-Funded Health Plans

Self-funded health plans are subject to nondiscrimination rules similar to the rules described above in connection with Section 125 plans. An employer's self-funded health plan will have to pass two nondiscrimination tests under Code Section 105(h)-the eligibility test and the benefits test. These tests prevent a self-funded health plan from favoring employees who are highly compensated individuals (HCI). The definition of HCI varies from the definition of 'highly compensated' employees in the Section 125 nondiscrimination testing rules. Under the self-funded health plan nondiscrimination rules, an HCI includes any employee who is among the highest paid 25% of all employees. This definition potentially causes employees with annual compensation below \$120,000 per year to be considered highly compensated. Again, the satisfaction of these tests can often be determined by plan design. If the plan is determined to be discriminatory, the consequence is additional taxable income to the highly compensated individual for the discriminatory benefit.

FOUR TESTS

- 1) Eligibility Test
- 2) Contributions and Benefits Test
- 3) More-than-5%-Owner Test
- 4) 55% Average Benefits Test

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The Affordable Care Act added nondiscrimination rules for non-grandfathered fully insured plans, which are similar to the rules applicable to self-funded group health plans. However, the IRS announced in 2011 that the rules would not be enforced until after regulations were issued. To date, regulations have not been issued, and it appears that the Trump Administration has no plans to issue regulations concerning this requirement.

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