

Benefits BRIEF



Nondiscrimination Testing for Group Health and Welfare Plans

• February 2022 •

Many employer-provided health and welfare benefits enjoy favorable tax treatment under the Internal Revenue Code (IRC). The primary reason for allowing this tax-favored treatment is to encourage employers to offer benefits not just to executives, but to rank-and-file employees, too. Therefore, as a condition of offering these benefits, employers must demonstrate compliance with the IRC's various nondiscrimination rules.

The Core Concepts of Testing

Nondiscrimination rules under the IRC are designed to prevent plans from providing more favorable tax-free benefits to certain individuals who are considered highly compensated or key to the business. To ensure that a plan is nondiscriminatory, Congress created specific nondiscrimination tests that an employer must satisfy.

The specific mechanics of the test vary depending upon the benefit arrangement being tested. In general, the testing process will identify employees that qualify as highly compensated or key, and will analyze plan eligibility, contribution and benefit levels, participation, and election amounts across the employee population. A plan's ability to pass testing will rely on a combination of plan design elements (over which the employer has control) and employee elections (over which the employer has little control).

These testing requirements apply to:

- IRC Sec. 125 Plans (Cafeteria Plans)
- Health Flexible Spending Arrangements (FSAs)
- Self-Insured Health Plans and Health Reimbursement Arrangements (HRAs)
- Dependent Care Assistance Plans (DCAPs)
- Group Term Life Insurance.

Where a plan fails nondiscrimination testing, the consequence is that some portion of the otherwise tax-free benefit provided to highly compensated and key employees will be imputed to them as taxable income. Importantly, there is no adverse consequence to the employer itself or to any employees not considered highly compensated or key. As a result, some employers may choose to operate their plan in a way that is discriminatory with the understanding that part of the tax benefit will be lost to a certain group of employees.

Test results are not submitted or reported to any federal agency. Instead, employers should keep on file their plans' test results from year to year. An employer may be called upon to produce test results and related documentation in the event of an audit by the Internal Revenue Service or the Department of Labor, or as part of the due diligence process in a business reorganization or capital raising venture.

Annual Testing Requirements and Beyond

Testing must be conducted on an annual basis and should be completed at or near the close of the plan year. This ensures that the data used to conduct testing – including employee population, participation levels, and election amounts – accurately reflect the full plan year.

While not required, additional testing at earlier points during the plan year may be beneficial in some instances. Plans that have historically had difficulty passing testing may benefit from a round of testing shortly after the start of the plan year, which will provide the employer with insight into any potential obstacles to achieving a passing result at the end of the year and allow ample opportunity to take corrective action. Additional testing (including testing hypothetical plans and designs) may also be advantageous where the employer is contemplating new benefit or contribution strategies, undergoing a significant reduction or addition in its workforce, or completing a merger or acquisition.

Employer Next Steps

The nondiscrimination rules are complex, and their application is often less than straightforward. For this reason, employers should ensure that a detailed testing process is in place and executed annually.

- Assess testing needs according to the various benefits offered to employees.
- Confirm the data used for testing is complete and accurate. This is particularly important if the employer is a member of a controlled group.
- Identify a partner that can not only complete testing but that can also competently and effectively analyze test results, as well as advise on corrective actions and strategies. Depending upon testing needs, this may involve more than one testing partner (for example, the TPA for a Health FSA and a separate testing vendor for a DCAP).

- Consider the need for more frequent testing throughout the year.
- Incorporate test results and patterns into the longer-term benefits planning process. For example, the consistent testing failure of a Health FSA driven by low participation may signal that it's time to discontinue it and replace it with a more effective offering, like an HSA or HRA.

ADDITIONAL RESOURCES

[Internal Revenue Code Sec. 105](#)

[Proposed regulations providing guidance on Cafeteria Plans](#)

[Webinar recording, September 20, 2018: Health and Welfare Plan Non-discrimination Rules: A Primer](#)

[Benefits Brief, December 2018: Nondiscrimination Rules for Section 125 Plans and Self-Funded Health Plans](#)