Benefits Insights

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Nondiscrimination Rules for Benefit Plans

Many employee benefits are excluded from employees' gross income and, thus, are not taxable when specific conditions are met. One of these conditions is often some type of nondiscrimination requirement, which ensures that the benefit plan does not discriminate in favor of certain highly compensated or key employees. It is important to take the applicable nondiscrimination rules into account when structuring your employee benefit plans in order to maintain your plans' tax advantage.

Rules Vary by Benefit

There is no universal set of nondiscrimination rules; they vary for each type of benefit. Key concepts that are often involved with nondiscrimination testing include:

- *Who is in the prohibited group?* This is the group that a plan cannot discriminate in favor of. It generally consists of highly compensated or key employees, but the definitions for these categories vary by benefit.
- *What eligibility classification standards apply?* This usually refers to the percentage of the employee population that is eligible for or receives a benefit from the plan.
- *Which employees can be excluded from the testing population?* For the purpose of meeting nondiscrimination criteria, certain employees can be excluded from the employee population count—usually those that have not met age or service requirements or are collectively-bargained.
- *What is the consequence of finding discrimination?* When discrimination is found, generally the members of the prohibited group will not receive the tax favor for the benefit. Sometimes, though, all employees are penalized and the benefit will be included in everyone's gross income

The rest of this document discusses the types of benefits that must comply with nondiscrimination rules, and provides a link to the individual tax code provision for each type of benefit (found on the Cornell University Law School website, which contains a directory of all U.S. laws).

Insured Group Health Plans

Under the Affordable Care Act (ACA), insured group health plans (except grandfathered plans) will be subject to nondiscrimination rules similar to those applicable to self-insured plans under Internal Revenue Code (Code) § 105(h). These rules were originally set to take effect for plan years beginning on or after Sept. 23, 2010. However, these nondiscrimination requirements for insured plans have been **delayed indefinitely**, pending the issuance of regulations. The regulations will specify the new effective date.

The ACA's nondiscrimination rules will not apply to "excepted benefits," such as plans providing limited-scope dental or vision benefits under a separate policy, or where coverage is elected by participants separately from the medical coverage.

Here is a somewhat simple breakdown of the two nondiscrimination tests required under Code § 105(h)(2):

Eligibility Test

A plan cannot discriminate in favor of highly compensated individuals (HCIs) as to eligibility to participate.

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To satisfy the eligibility test, a plan must benefit one of the following:

- Seventy percent or more of all non-excludable employees;
- Eighty percent or more of all non-excludable employees who are eligible to benefit, if 70 percent or more of all non-excludable employees are eligible to participate under the plan; or
- A nondiscriminatory classification of employees (this requires a bona fide business reason for any exclusion and a sufficient ratio of benefiting non-HCIs to benefiting HCIs).

For the eligibility test, an employer may exclude employees who have not completed three years of service, have not attained age 25, are part-time or seasonal, are collectively-bargained or are nonresident aliens who do not receive U.S.-source earned income.

Benefits Test

All benefits provided to the HCIs who are participating in the plan must be provided to all other participants. Benefits must be nondiscriminatory on the face of the plan and nondiscriminatory in operation.

The ACA provides for the application of "rules similar to" those in Code § 105(h) regarding the eligibility and benefits tests. This makes it somewhat unclear whether all rules—such as the Code § 105(h) regulations indicating that contributions are part of the benefits test—will apply in this context. More guidance on this would be helpful, but anything that is a gray area should be reviewed by legal counsel. Keep in mind that these rules DO NOT apply to grandfathered plans while they maintain their grandfathered plan status.

Self-funded Health Plans

Self-funded health plans pass the Code § 105(h) nondiscrimination rules if the plan does not discriminate in favor of HCIs with respect to eligibility or benefits. If discrimination exists in favor of HCIs, the excess reimbursements received by those employees must be included in their gross income. For details on these nondiscrimination requirements, see Code § 105(h).

Group-term Life Insurance

Generally, employer-provided group-term life insurance is excludable from employees' gross income, up to the face amount of $50,000. A group-term life insurance plan is nondiscriminatory if the plan does not discriminate in favor of key employees as to eligibility to participate and the type and amount of benefits.

If a group-term life insurance plan discriminates in favor of key employees, those employees are not eligible for the $50,000 exclusion and must include the entire coverage amount in their gross income. For details on these nondiscrimination requirements, see Code § 79(d).

Cafeteria Plans

A cafeteria plan offers two or more benefit choices to employees of either cash or qualified benefits. Usually, according to the constructive receipt rule, a taxpayer receives income when it is made available and he or she is eligible to receive it, not necessarily when the employee actually receives it. However, under a cafeteria plan, the availability of cash or benefits does not equal the receipt of income for tax purposes. This exception is only valid for a particular benefit if that benefit plan does not discriminate in favor of HCIs as to eligibility to participate or benefits offered.

If a cafeteria plan discriminates in favor of HCIs or key employees, each member of the prohibited group will lose the cafeteria plan's tax advantage. For details on these nondiscrimination requirements, see Code § 125.

Voluntary Employees' Beneficiary Associations (VEBAs)

A VEBA that is part of an employer plan is tax-exempt if the classification of employees who are eligible for benefits does not discriminate in favor of HCIs. However, benefits may represent a uniform percentage of employees' compensation, if the rate is equal among all employees. For details on these nondiscrimination requirements, see Code § 505.

Dependent Care Assistance Programs

An employee can exclude up to $5,000 of dependent care benefits from their gross income (if single or married and filing a joint tax return), or up to $2,500 (if married but filing separate tax returns). The plan is considered nondiscriminatory if the program's eligibility, contributions

and benefits provided do not discriminate in favor of HCIs or certain shareholders or owners. If discrimination is found in a dependent care assistance program, these individuals must include dependent care benefits in their gross income.

For details on these nondiscrimination requirements, see Code § 129(d).

Educational Assistance Programs

Employees can exclude up to $5,250 of amounts received for educational assistance programs from their taxable income. In order to be nondiscriminatory, the program must benefit employees who are eligible under an employer-determined classification that is not discriminatory in favor of HCIs. If an educational assistance program violates the nondiscrimination requirements, all participants lose favorable tax treatment for their educational assistance benefits. For details on these nondiscrimination requirements, see Code § 127.

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