

## Nondiscrimination Rules for Benefit Plans

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Many employee benefits are excluded from employees' gross income and thus are not taxable when specific conditions from the IRS are met. One of these conditions is often some type of nondiscrimination requirement, to ensure the benefit plan does not discriminate in favor of certain highly compensated or key employees. It is important to take such nondiscrimination rules into account to be certain that your tax-exempt benefit plans remain compliant with IRS regulations.

### Rules Vary by Benefit

There is no universal set of nondiscrimination rules; they vary by each type of benefit. Here are the key areas to make sure you understand regarding the provisions for any given benefit:

- *Who is in the prohibited group?* This is the group that a plan cannot discriminate in favor of. It generally consists of highly compensated and/or key employees, but the definition of those categories varies by benefit.
- *What eligibility classification standards apply?* This usually refers to what percentage of the employee population is eligible to or does 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 ones who have not met age or service requirements or are part-time.
- *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 will discuss types of benefits that have nondiscrimination provisions, and provide a link to the individual IRS code for each type of benefit (found on the Cornell University Law School Web site, which contains a directory of all of the U.S. codes).

### Insured Group Health Plans

Under health care reform, insured group health plans (except grandfathered plans) are going to have to follow the nondiscrimination rules of Code § 105(h)(2) for plan years beginning on or after September 23, 2010. A "group health plan" does not include "excepted benefits" (like 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 2 tests required by Code § 105(h)(2):



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## Eligibility Test

A plan must benefit one of the following:

- (a) 70% or more of all non-excludable employees;
- (b) 80% or more of all non-excludable employees who are eligible to benefit, if 70% or more of all non-excludable employees are eligible to participate under the plan; or
- (c) a nondiscriminatory classification of employees (this requires a bona fide business classification 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 health care reform law 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. Of course we would like more guidance, but anything that is a gray area should potentially be reviewed with 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 nondiscrimination rule if neither the plan nor the benefits provided discriminate in favor of highly compensated employees. If discrimination exists in favor of highly compensated employees, the excess reimbursements received by those employees must be included in their gross income.

For details on these nondiscrimination requirements, visit:

[www.law.cornell.edu/uscode/html/uscode26/usc\\_sec\\_26\\_00000105----000-.html](http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00000105----000-.html).

## 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. Such a plan is nondiscriminatory if the plan does not discriminate in favor of key employees for participation eligibility, and the type and amount of benefits do not discriminate in favor of key employees. If a group-term life insurance plan is discriminatory in favor of key employees, then those employees are not eligible for the \$50,000 exclusion and must include their entire coverage amount in their gross income.

For details on these nondiscrimination requirements, visit:

[www.law.cornell.edu/uscode/html/uscode26/usc\\_sec\\_26\\_00000079----000-.html](http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00000079----000-.html).



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## **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 redeems 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 highly compensated employees on the basis of eligibility to participate or benefits offered. If a cafeteria plan is discriminatory in favor of highly compensated employees or key employees, each member of the prohibited group will be taxed on the value of the maximum benefit offered (even if that benefit was not elected).

For details on these nondiscrimination requirements, visit:

[www.law.cornell.edu/uscode/html/uscode26/usc\\_sec\\_26\\_00000125----000-.html](http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00000125----000-.html).

## **Voluntary Employees' Beneficiary Associations (VEBAs)**

A VEBA that is part of an employer plan is exempt from tax if it meets nondiscrimination rules. The classification of employees who are eligible for benefits may not discriminate in favor of highly compensated employees. However, benefits may represent a uniform percentage of employees' compensation, if the rate is equal among all employees.

For details on these nondiscrimination requirements, visit:

[www.law.cornell.edu/uscode/html/uscode26/usc\\_sec\\_26\\_00000505----000-.html](http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00000505----000-.html).

## **Dependent Care Assistance Programs**

Employees can exclude up to \$5,000 of dependent care benefits from their gross income. The plan is considered nondiscriminatory if the program's eligibility, contributions and benefits provided do not discriminate in favor of highly compensated employees. If discrimination is found to exist in a dependent care assistance program, highly compensated employees are required to include their dependent care benefits in their gross income.

For details on these nondiscrimination requirements, visit:

[www.law.cornell.edu/uscode/html/uscode26/usc\\_sec\\_26\\_00000129----000-.html](http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00000129----000-.html).

## **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, it must benefit employees who are eligible under an employer-determined classification that is found by the IRS not to be discriminatory in favor of highly compensated employees.

For details on these nondiscrimination requirements, visit:

[www.law.cornell.edu/uscode/html/uscode26/usc\\_sec\\_26\\_00000127----000-.html](http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00000127----000-.html).