

Health and Welfare Nondiscrimination Testing: An Overview

Certain specified employer-provided benefits are eligible for tax exclusions under the Internal Revenue Code. Each exclusion comes with an important condition – in order for executives and other highly paid individuals to take advantage of the exclusion, an employer must be able to demonstrate that the benefit satisfies applicable nondiscrimination tests. Although the various tests include common elements, they can differ in significant respects. This *FYI In-Depth*, an overview of the various nondiscrimination tests, is the first in a series to help you understand how each test operates and what data you need to collect in order to conduct the tests.

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Background

Under Section 61 of Internal Revenue Code (Code), compensation in any form paid, or otherwise provided, by an employer to an employee constitutes taxable wages – unless it qualifies for a specific exclusion from income under a different Code provision. Exclusions are provided for certain employer-provided benefits – group term life insurance (Section 79), self-insured health benefits (Section 105), educational assistance (Section 127), dependent care (Section 129), and adoption assistance (Section 137). In addition, benefits offered through a cafeteria plan qualify for an income tax exclusion (Section 125).

To discourage employers from providing these tax-favored benefits only to executives and other highly paid individuals, Congress included a “nondiscrimination” requirement for each of these exclusions. Satisfaction of the requirements must be demonstrated through testing. Although the nondiscrimination requirements are

What about insured health benefits?

Self-insured health benefits are subject to the nondiscrimination requirements of Code Section 105(h). Insured health benefits are not subject to Section 105(h) and, prior to enactment of the ACA, were not subject to nondiscrimination rules. The ACA included a provision that would impose nondiscrimination requirements similar to Section 105(h) on non-grandfathered insured group health plans; however, in 2011, the IRS postponed application of these requirements until it issued guidance. See our [January 5, 2011 FYI](#). To date, no guidance has been forthcoming.

not the same for all the benefits, they share some, or all, of the following elements:

- A “prohibited group” of individuals in favor of whom the plan cannot discriminate
- An eligibility test to confirm that a sufficient number of employees not in the prohibited group are eligible for the benefit
- A benefits or contributions test to confirm that members of the prohibited group are not receiving benefits on more favorable terms than other employees
- A utilization test to confirm that members of the prohibited group are not benefiting disproportionately
- Categories of employees who can be excluded from testing
- Adverse tax consequences if the plan fails a discrimination test

What about VEBA – Section 505?

A voluntary employees’ beneficiary association (VEBA), a type of tax-exempt entity, can be used to provide certain benefits. For a VEBA to be tax-exempt, the benefits it provides must satisfy Code Section 505 nondiscrimination rules. However, if a VEBA benefit is subject to separate nondiscrimination requirements (e.g., Code Section 105(h) for self-insured health benefits), it must meet the discrimination requirements under the applicable Code section instead.

Recognizing these common elements may be helpful in demystifying nondiscrimination testing.

Common Elements in Nondiscrimination Testing

A general overview of each of the elements is set out below, with more details provided in the [table](#).

The Prohibited Group

There are two categories of prohibited groups recognized in the nondiscrimination rules – “highly compensated” individuals and “key employees.” An individual will be considered highly compensated and/or a key employee based on one or more of the following:

- Status as an officer
- Ownership interest
- Compensation
- Familial relationship to an individual in a prohibited group

Unfortunately, even though there are common elements among the various nondiscrimination tests, the specific methods for determining highly compensated or key employee status may differ by the type of test.

Eligibility Test

This test provides a generally objective standard for determining whether eligibility for a particular benefit has been extended in a nondiscriminatory manner. Although some benefits are subject to slightly different eligibility tests, most will be considered nondiscriminatory if they benefit a nondiscriminatory classification of employees. Generally, to satisfy this test, a plan must benefit a classification of employees that is reasonable and established under objective business standards. The classification must also satisfy a mathematical test that compares the

Which employers are subject to the nondiscrimination rules?

The nondiscrimination rules apply to all employers; status as a governmental or church employer is not relevant.

percentage of non-highly compensated employees eligible to participate to the percentage of highly compensated employees eligible to participate.

All members of a controlled group are treated as a single employer for eligibility testing purposes. This means that in testing a benefit offered by one employer in the group, employees from all related employers are taken into account. Employers need to be able to collect relevant demographic and benefit data regarding these other employees.

Who is the employer for testing purposes?

All employer members of a controlled group are treated as a single employer for eligibility testing purposes.

Benefits and Contributions Test/Utilization Test

With limited exceptions, all the benefits described above are subject to a contributions and benefits test. The purpose of this test is to confirm that plan participants who are members of a prohibited group do not receive benefits on more favorable terms than other participants. This is a facts-and-circumstances test that considers whether members of the prohibited group receive different or greater benefits – or pay less for the same benefits – than others.

The purpose of a utilization test is to confirm that members of the prohibited group are not disproportionately taking advantage of the tax exclusion applicable to the benefit. There are two types of utilization tests:

- A concentration test, which looks at whether the value of the benefit received by the prohibited group exceeds a specified percentage of total benefits
- An average benefits test, which looks at whether the average benefit received by employees not in the prohibited group is not less than a specified percentage of the average benefit received by members of the prohibited group

Cafeteria plans, dependent care assistance plans, educational assistance plans and adoption assistance plans are subject to utilization tests.

Excludable Employees

The nondiscrimination tests generally provide that certain employees may be disregarded when the tests are run. All of the tests permit exclusion of ineligible employees covered by a collective bargaining agreement where the particular benefit was the subject of good-faith bargaining. Some permit the exclusion of employees who have not satisfied certain age or service requirements (although it isn't clear whether they can be excluded if they are actually eligible to participate).

Tax Consequences if Nondiscrimination Test Failed

Generally, only members of the prohibited group are adversely affected if a plan fails a nondiscrimination test – they will lose the benefit of the applicable tax exclusion, or in the case of a failure of a Section 125 nondiscrimination test, lose the special exemption from the constructive receipt rules provided by that rule. Employees who are not in the prohibited group will still qualify for all of the tax advantages applicable to the benefit.

This general rule may not apply to educational or adoption assistance programs. It appears that these programs must satisfy the nondiscrimination tests as a condition of qualifying for the tax exclusion so that if a test is failed, all participants will have the benefits included in income.

In Closing

The various nondiscrimination rules applicable to health and welfare benefits are complicated. Future articles will discuss the tests applicable to a particular benefit in more depth.

Overview of Health and Welfare Benefit Discrimination Tests

Regulatory Basis	Component Tests	Compensation for Determining Highly Compensated/Key Employee Status for 2017 (Calendar Year Plans)
Section 125 (Cafeteria Plan)	<ul style="list-style-type: none"> • Eligibility Test • Contributions and Benefits Test • Key Employee Concentration Test 	<p>Highly compensated: 2016 compensation of at least \$120,000 and 2017 compensation of at least \$120,000 for those in first year of employment. Subject to top-paid group election.ⁱ</p> <p>Key employee: Officer with 2016 compensation of at least \$170,000; more than 1% owner with 2016 compensation of at least \$150,000.ⁱⁱ Limited to 50 officers for large employers. A governmental entity will have no key employees</p>
Section 129 (Dependent Care)	<ul style="list-style-type: none"> • Eligibility Test • Contributions and Benefits Test • More than 5% Owner Concentration Test • 55% Average Benefit Test 	Highly compensated: 2016 compensation of at least \$120,000. Subject to top-paid group election ⁱ
Section 105(h) (Self-insured health plans including HRAs and health FSAs)	<ul style="list-style-type: none"> • Eligibility Test • Benefits Test 	25% highest paid nonexcludable employees. Based on current plan year compensation
Section 79 (Group Term Life)	<ul style="list-style-type: none"> • Eligibility Test • Benefits Test 	Key employee: Officer with 2017 compensation of at least \$175,000; more than 1% owner with 2017 compensation of at least \$150,000. A governmental entity will have no key employees
Section 137 (Adoption Assistance)	<ul style="list-style-type: none"> • Eligibility Test • More than 5% Owner Concentration Test 	2016 compensation of at least \$120,000. Subject to top-paid group election ⁱ
Section 127 (Educational Assistance)	<ul style="list-style-type: none"> • Eligibility Test • More than 5% Owner Concentration Test 	2016 compensation of at least \$120,000. Subject to top-paid group election ⁱ

ⁱ Top paid group election. Subject to certain restrictions, an employer may elect to assign highly compensated status on to those individuals/participants who meet the applicable compensation threshold and, for the applicable year, were among the group consisting of the top 20% of nonexcludable employees when ranked on the basis of compensation during such year.

ⁱⁱ Key employee for cafeteria plan testing purposes. The proposed cafeteria plan regulations state that for testing purposes, a *key employee* is a participant who was a key employee at any time during the *preceding* plan year. However, IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*, seems to use current plan year status.

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