

# FYI<sup>®</sup> In-Depth

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## Overview of Nondiscrimination Testing for Educational and Adoption Assistance Programs

The Internal Revenue Code provides income tax exclusions for benefits received under employer-sponsored educational and adoption assistance programs. The exclusions come with an important condition — for employees to take advantage of the exclusions, an employer must be able to demonstrate that the benefits satisfy applicable nondiscrimination tests. This *FYI In-Depth* describes the nondiscrimination tests that apply to both educational and adoption assistance programs to help employers understand how each test operates and what data they need to collect to conduct the tests.

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## Background

Section 127 of the Internal Revenue Code (Code) provides an income tax exclusion for benefits received by an employee through an employer-sponsored educational assistance program. The maximum annual exclusion is \$5,250.

Educational assistance includes the employer's payment of expenses incurred by or on behalf of an employee for education, or the employer's provision of education to an employee. For this purpose, the term "education" includes any form of instruction or training that improves or develops the capabilities of an individual and is not limited to courses that are job-related or part of a degree program.

Section 137 of the Code provides an income tax exclusion for employer-provided adoption assistance benefits. The maximum benefit that can be paid in 2019 with respect to an adoption is \$14,080; this amount is reduced ratably for taxpayers with adjusted gross income of over \$211,160.

## Health and welfare nondiscrimination testing

This is the sixth in a series on health and welfare benefit nondiscrimination rules. Our **November 8, 2017** *FYI In-Depth* provided an overview of the various requirements.

(These amounts are indexed. See our [November 15, 2018 FYI Alert](#).) Adoption assistance benefits include reimbursement of qualified adoption expenses by the employer and amounts attributable to employee salary reduction contributions.

Section 127 subjects educational assistance programs to certain nondiscrimination tests to ensure that they are not provided disproportionately to members of a “prohibited group.” These tests have been incorporated by reference into Section 137, so that they also apply to adoption assistance programs. The tests are:

- **An eligibility test.** The program must benefit employees who qualify under an eligibility classification that does not discriminate in favor of highly compensated employees or their dependents.
- **A concentration test.** Individuals who own more than 5 percent of the stock, capital or profit interest in the employer and their spouses and dependents cannot receive more than 5 percent of the total benefits under the program.

Satisfaction of the requirements must be demonstrated through testing.

Unfortunately, there is little available guidance on how to conduct nondiscrimination testing of educational assistance and adoption assistance programs. Regulations under Section 127 that discuss discrimination testing were issued in 1983 and do not reflect changes made to the Code after that date. In addition, even those rules only set out the general framework for the tests, and the IRS has not issued additional guidance. For that reason, in some instances, assumptions must be made and analogies drawn from guidance issued for other nondiscrimination tests.

## Elements of nondiscrimination testing for educational and adoption assistance programs

A general overview of each of the elements is set out below.

### The prohibited group

There are two categories of prohibited groups in educational assistance program and adoption assistance program nondiscrimination testing. “Highly compensated employees” (HCEs) make up the prohibited group for the eligibility test while “5-percent owners and shareholders” are the prohibited group for the concentration test.

### Highly compensated employees

Status as an HCE for testing purposes is determined under the same definition used in identifying highly compensated employees for testing qualified retirement and dependent care assistance plans for discrimination, with one important modification — spouses and dependents of HCEs who are also employed by the employer are treated as HCEs.

Generally, under this definition, a highly compensated employee is an employee of an employer who meets either of these conditions:

- Was more than a 5-percent owner at any time during the plan year being tested or the preceding year
- For the preceding year, received compensation in excess of a specified threshold (i.e., for 2018 testing, this is compensation of at least \$120,000 in 2017)

For this purpose, “employer” includes not only the entity that employs the individual, but also all other entities that are members of the same controlled group of corporations as the employing entity or of trades or businesses under the same common control. “Employee” includes not only common-law employees, but also “leased employees.”

An employer with a significant number of employees who would have HCE status based on compensation may elect to limit HCEs to those employees who, in addition to meeting the compensation threshold, are also in the top 20 percent of all employees based on compensation during the preceding year. This top-paid group election will apply to the determination of HCE status for all nondiscrimination tests that use the Section 414(q) definition of HCE, including those for qualified plans, and across all members of the controlled group.

#### Five-percent owners

An individual is a 5-percent owner of the employer for a particular year if at any time during such year, he or she owns more than 5 percent of the value of the outstanding stock of the corporation or stock possessing more than five percent of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a 5-percent owner is any employee who owns more than 5 percent of the capital or profits interest in the employer.

#### Eligibility test

To satisfy the eligibility test, an educational assistance program or adoption assistance program must benefit a classification of employees that does not discriminate in favor of HCEs or their dependents who are also employees. In determining whether a group of employees is benefiting under an educational assistance or adoption assistance program, consideration is given not only to the plan's general eligibility requirements, but also to other conditions, such as the types of benefits offered, that might affect the availability of the benefit under the program. For example, if all employees are eligible for educational assistance, but benefits are only available for courses of study leading to postgraduate degrees in certain fields, only those employees able to pursue that course of study would be considered actually eligible for educational assistance under the program. However, programs will not be considered discriminatory simply because HCEs utilize different types of benefits available under the program or because benefits are conditioned on attaining a minimum grade or remaining employed for a specified period after completing the course.

**Any discrimination concerns if all employees are eligible?**

Yes. Plan design is also considered in determining whether a program satisfies the eligibility test. For example, an educational assistance program available to all employees that only reimburses post-graduate courses in certain subjects could potentially fail the eligibility test if few non-HCEs would have the prerequisites to take those courses.

The Section 127 regulations refer to the nondiscriminatory classification test under Code Section 410(b), used for qualified plans. Under this test, the classification of employees eligible to participate must be reasonable and based on objective business considerations. In addition, the classification must satisfy a mathematical test that compares the percentage of non-HCEs eligible to participate to the percentage of HCEs eligible to participate.

The eligibility test generally is run on a controlled group basis. This means that nonexcludable employees from all related employers are taken into account when

running the tests. While it isn't entirely clear, it appears that the special Code Section 410(b) provision on acquisitions and dispositions applicable to qualified plans also applies to the eligibility test. Under that provision, a plan will be deemed to satisfy the eligibility test through the last day of the first plan year following an acquisition or disposition if it satisfied the eligibility test immediately prior to the transaction and there are no significant changes to the plan or coverage (except for the transaction).

**Excludable employees**

Ineligible employees covered by a collective bargaining agreement where educational assistance program or adoption assistance program benefits were the subject of good faith bargaining may be excluded from eligibility testing. Because the Section 127 regulations refer to Code Section 410(b), arguably employees under age 21 or who have not completed at least one year of service, as of the end of the plan year, also may be excluded from those tests — however it is unclear whether they must be ineligible to participate in the program to be excluded.

**Concentration test**

The purpose of this test is to confirm that principal shareholders and owners of the employer are not disproportionately receiving educational assistance or adoption assistance benefits. To satisfy this test, no more than five percent of the amounts paid or incurred by the employer for educational assistance program benefits or adoption assistance program benefits during the year may be provided to 5-percent owners of the employer.

**When to run the tests**

Neither Section 127 nor Section 137 specify when the nondiscrimination tests should be run. Ideally, an employer would conduct testing before, during, and immediately after the close of the plan year. However, most employers do not do this. Those that do not should consider, even before the beginning of the plan year, whether their plan design will likely pass the eligibility test based on their demographics and that of other members of their controlled group.

The concentration test should be run before the end of the plan year so that appropriate action can be taken before year's end if the program fails this test.

### Tax consequences if nondiscrimination test failed

Unlike other benefits, where only members of the prohibited group lose the tax benefit if a program is discriminatory, satisfaction of the applicable nondiscrimination rules is a qualification requirement for educational assistance and adoption assistance programs. This means that if a program is discriminatory, the exclusion is not available to *any* participants and any benefits received during the year will be included in the employee's income.

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### In closing

Employers need to be aware of the nondiscrimination tests applicable to educational and adoption assistance programs and take action to ensure:

- All employers in the controlled group are included in testing.
- All required eligibility and benefits tests are satisfied.
- Testing is completed before the end of the plan year to allow time for any needed corrections.

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