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A resource guide for health and welfare nondiscrimination testing

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Certain employer-provided benefits are eligible for tax exclusions under the Internal Revenue Code. Each exclusion comes with an important condition — for executives and other highly paid individuals to take advantage of the exclusion, an employer must 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* discusses the general principles behind the nondiscrimination tests as well as the specific tests applicable to particular benefits. It's intended to be a consolidated easy-reference document and contains an overview of health and welfare benefit discrimination tests in a summary table.

Health and welfare nondiscrimination testing: an overview

After identifying the benefits that are subject to nondiscrimination testing under the Internal Revenue Code (Code) and explaining the rationale for the nondiscrimination requirements, this *FYI In-Depth* describes the elements common to all nondiscrimination testing, such as a prohibited group, an eligibility test, and a benefits and contributions/utilization test, and provides more details in the following table:

Overview of health and welfare benefit discrimination tests

Regulatory basis	Component tests	Compensation for determining highly compensated/key employee status for 2020 (calendar year plans)
Section 129 (Dependent care)	• Eligibility test • Contributions and benefits test • More than 5% owner concentration test • 55% average benefit test	Highly compensated: 2019 compensation of at least $125,000. Subject to top-paid group election[i]
Section 125 (Cafeteria plan, including employer and employee health savings account (HSA) contributions)	• Eligibility test • Contributions and benefits test • Key employee concentration test	Highly compensated: 2019 compensation of at least $125,000 and 2020 compensation of at least $130,000 for those in first year of employment. Subject to top-paid group election[i] Key employee: Officer with 2019 compensation of at least $180,000; more than 1% owner with 2019 compensation of at least $150,000[ii]; limited to 50 officers for large employers; governmental entity will have no key employees
Section 105(h) (Self-insured health plans including HRAs and health FSAs)	• Eligibility test • Benefits test	25% highest paid nonexcludable employees; based on current plan year compensation
Section 79 (Group term life)	• Eligibility test • Benefits test	Key employee: Officer with 2020 compensation of at least $185,000; more than 1% owner with 2020 compensation of at least $150,000; governmental entity will have no key employees
Section 127 (Educational assistance)	• Eligibility test • More than 5% owner concentration test	2019 compensation of at least $125,000; subject to top-paid group election[i]
Section 137 (Adoption assistance)	• Eligibility test • More than 5% owner concentration test	2019 compensation of at least $125,000; 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.

Background

Under Section 61 of the 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 celeasrtain 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).

What about VEBAs – 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.

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 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
- Categories of employees who can be excluded from testing
- An eligibility test to confirm that a sufficient number of employees not in the prohibited group are eligible for the benefit
- A contributions or benefits 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
- Adverse tax consequences if the plan fails a discrimination test

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. To date, no guidance has been forthcoming.

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

Common elements in nondiscrimination testing

A general overview of each element is set out below, with more details in the overview 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 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

Who is the employer for testing purposes?

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

What is a "leased employee"?

A worker who is an employee of a leasing organization will be treated as a "leased employee" of the entity for which he or she is performing services (the "recipient") if:

- The services are provided pursuant to an agreement between the recipient and the leasing organization.
- The worker has provided services to the recipient on a substantially full-time basis for at least a year.
- The services are performed under primary direction or control by the recipient.

A worker is considered to have performed services on a substantially full-time basis for at least one year if during any consecutive 12-month period, the worker either:
(1) performed at least 1,500 hours of service for the recipient; or
(2) performed at least 75% of the number of hours of service customarily provided by an employee of the recipient.

demographic and benefit data regarding these other employees. “Employee” includes not only common-law employees, but also “leased employees.”

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.

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.

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 a nondiscrimination test is 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, and in this *FYI In-Depth*, we discuss the tests applicable to each particular benefit in more depth.

Dependent care nondiscrimination testing

The Code provides an income tax exclusion for benefits received under employer-sponsored dependent care assistance programs. For highly compensated employees to take advantage of the exclusion, an employer must be able to demonstrate that the benefit satisfies applicable nondiscrimination tests. This section describes the nondiscrimination tests that apply to dependent care assistance program (DCAPs), how each test operates, and what data you need to collect in order to conduct the tests.

Background

Section 129 of the Code provides an income tax exclusion for benefits received through an employer-sponsored DCAP. The maximum annual exclusion depends on an employee's federal income tax filing status — $5,000 for most filers, but only $2,500 for employees whose status is "married, filing separately." DCAP benefits include not only reimbursements from a dependent care flexible spending account, but also direct payment of expenses by the employer and the fair market value of on-site dependent care facilities to the extent not paid for by the employee on an after-tax basis.

Section 129 subjects DCAP benefits to the following nondiscrimination tests to ensure that they are not provided disproportionately to members of a "prohibited group":

- **An eligibility test**. The DCAP must benefit employees who qualify under an eligibility classification that does not discriminate in favor of highly compensated employees.
- **A contributions and benefits test**. The contributions or benefits provided under the DCAP may not discriminate in favor of employees who are highly compensated employees.
- **The "5-percent owner" test**. Not more than 25% of the total benefits under the DCAP can be provided to individuals who own more than 5% of stock, capital or profit interest in the employer.
- **The "55 percent average benefits" test**. The average benefits provided to non-highly compensated employees must be at least 55% of the average benefits provided to highly compensated employees.

Satisfaction of the requirements must be demonstrated through testing. If a test is failed, the exclusion for DCAP benefits will not be available to highly compensated employees (or more than "5-percent owners", as applicable) and any dependent care benefits they receive during the year will be includible in their income.

Unfortunately, guidance on how to conduct the DCAP tests is limited. Code Section 129 only sets out the general framework for the tests and the IRS has not issued regulations to provide any specifics. For that reason, in some instances, assumptions must be made and analogies drawn from guidance issued for other nondiscrimination tests.

Elements of DCAP nondiscrimination testing

Here's a general overview of each of the DCAP nondiscrimination testing elements.

The prohibited group

There are two categories of prohibited groups in DCAP nondiscrimination testing — "highly compensated employees" (HCE) and "5-percent owners." Status as an HCE for DCAP testing purposes is determined using the same definition of highly compensated employee that is used in identifying highly compensated employees for testing qualified retirement plans [e.g., 401(k) and defined benefit plans] for discrimination. Generally, under this definition, a highly compensated employee is an employee of an employer who meets either of these conditions:

- Was 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 2020 testing, this is compensation of at least $125,000 in 2019)

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% 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.

An employee 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% of the value of the outstanding stock of the corporation or stock possessing more than 5% 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% of the capital or profits interest in the employer.

Excludable employees

Ineligible employees covered by a collective bargaining agreement where the DCAP benefits were the subject of good faith bargaining may be excluded from the eligibility and "55 percent average benefits" tests. 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 DCAP in order to be excluded. Employees whose compensation is less than $25,000 can be excluded from the "55 percent average benefits" test if the DCAP is "funded" through salary reduction contributions.

Eligibility test

In order to satisfy the eligibility test, a DCAP must benefit a classification of employees that does not discriminate in favor of HCEs or their dependents. Because there is no specific guidance on how this requirement is satisfied, many practitioners apply 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 DCAP 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).

Which DCAPs are at risk for failing the eligibility test?

DCAPs that exclude certain categories of employees from participation (e.g., part-time, hourly) or that are only available to employees of one member of a controlled group may fail the eligibility test.

Contributions and benefits test

The purpose of this test is to confirm that DCAP benefits are not available to HCEs or their dependents on more favorable terms than to other employees. This is generally 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. There is no quantitative test for determining whether this requirement is satisfied.

The majority of DCAPs are flexible spending arrangements funded solely through salary reduction and are provided on the same terms to all eligible employees (or limits are imposed only on the amounts that HCEs can contribute to pass the "55 percent average benefits" test). For this reason, most DCAPs will automatically satisfy the contributions and benefits test. However, if one member of a controlled group makes separate employer contributions to the DCAPs (e.g., "seed" money or matching contributions) of its employees and others do not, the plan could potentially fail this test. Similarly, an employer that provides on-site daycare to employees at below-market rates at some locations, (such as corporate headquarters) but not others, might be at risk. Although there is no clear guidance, it appears that different plan or benefits structures may be tested separately under this test if they can satisfy the eligibility test on their own.

"5-percent owner" test

The "5-percent owner" test is a utilization test. The purpose of this test is to confirm that principal shareholders and owners of the employer are not disproportionately receiving DCAP benefits. To

satisfy this test, not more than 25% of the amounts paid or incurred by the employer for DCAP benefits during the year may be provided to “5-percent owners” of the employer.

“55 percent average benefits” test

The “55 percent average benefits” test is also a utilization test. To satisfy this test, the average dependent care benefit received by non-HCEs cannot be not less than 55% of the average dependent care benefit received by HCEs. The “55 percent average benefits” test is the most easily failed of the DCAP non-discrimination tests.

The average benefits test is performed by dividing the average benefit received by non-HCEs by the average benefit received by HCEs. The average benefit for non-HCEs is determined by dividing the total amount of DCAP benefits received by nonexcludable non-HCEs by the total number of nonexcludable non-HCEs of all entities under common control. The same process is used to determine the average benefit received by HCEs. If the result is at least 55%, the DCAP passes the test; if less than 55%, it fails. Although there is no clear guidance, the conservative approach is to take into account all nonexcludable employees, including those who are not eligible to participate in the DCAP.

Unlike the eligibility test, there is no special provision for acquisitions and dispositions — the average benefit test must be satisfied for the plan year of the transaction. The “55 percent average benefits” test can be run on a separate line of business basis, but only if certain conditions are met. One condition is that the employer submit an election to be treated as a qualified separate line of business for retirement plan purposes as well as for purposes of the “55 percent average benefits” test.

What steps can be taken to avoid failure?

Because HCEs typically participate in the DCAP at a much higher rate than non-HCEs, it is not unusual for a plan to fail the “55 percent average benefits” test. To reduce the likelihood of failure, an employer may consider capping HCE DCAP elections at an amount below the $5,000 maximum. Some employers cap HCE elections during open enrollment, before the plan year starts, to help pass the test. Others wait to cap HCEs until tests are conducted during the plan year. There are advantages and disadvantages to each approach. If an employer expects to fail the tests, or has capped HCEs, tests should be conducted as early in the year as practical.

If the plan is at risk of failing the eligibility test, the group eligible for the plan would need to be expanded. Use of the excludable employee categories can also help test results.

When to run the tests

Section 129 does not specify when the nondiscrimination tests should be run. Ideally, they would be run 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 and contributions and benefits tests based on their demographics and that of other members of their controlled group.

The discrimination tests based on utilization (the “5-percent owner” test and the “55 percent average benefits” test) should be run before the end of the plan year so that appropriate action can be taken

before year's end if the plan fails these tests. Unlike 401(k) plans, it is not possible to make a corrective distribution from a dependent care flexible spending account after the close of the plan year.

Tax consequences if a nondiscrimination test is failed

Generally, only members of the prohibited group are adversely affected if a plan fails one of the DCAP nondiscrimination test — they will lose the benefit of the applicable tax exclusion and have the value of the benefit included in their income. Employees who are not in the prohibited group will still qualify for all of the tax advantages applicable to the benefit.

In closing

Employers need to be aware of all of the DCAP nondiscrimination tests and take action to ensure:

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

Cafeteria plan nondiscrimination testing

Section 125 of the Code provides an exception to the "constructive receipt" rule — without Section 125, wages that employees forgo to pay for nontaxable benefits through a cafeteria plan would be included in income. For highly compensated and key employees to take advantage of the exclusion, an employer must be able to demonstrate that the cafeteria plan satisfies applicable nondiscrimination tests. This section describes the nondiscrimination tests that apply to cafeteria plans to help employers understand how each test operates and what data they need to collect in order to conduct the tests.

Background

Generally, individuals are cash-basis taxpayers, meaning that they recognize income in the year in which they receive a payment and not when their right to the payment accrues. However, to prevent taxpayers from manipulating when they recognize income, the IRS created the "constructive receipt" rule. That rule provides that a taxpayer who has the unrestricted right to receive taxable income in one year must recognize income in that year, even if the taxpayer gives up the right to receive it. Section 125 provides an exception to the constructive receipt rules when an individual is given the choice between receiving taxable income (i.e., cash) and nontaxable benefits through a cafeteria plan — as long as the employee elects to forego the cash before the right to receive it is earned (and chooses instead to apply the funds to nontaxable qualified benefits), the employee will not recognize the forgone cash as taxable income. Without a cafeteria plan, an employee would be taxed on the cash he/she could have received even if the amounts were then applied to qualified benefits.

Who is the employer for Section 125 testing purposes?

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

Cafeteria plans are subject to the following nondiscrimination tests to ensure a plan does not disproportionately benefit members of a "prohibited group":

- **An eligibility test.** The cafeteria plan must benefit employees who qualify under an eligibility classification that does not discriminate in favor of highly compensated individuals.
- **A contributions and benefits test.** The contributions or benefits provided through the cafeteria plan may not discriminate in favor of highly compensated participants.
- **A "key employee" concentration test.** No more than 25% of the aggregate statutory nontaxable benefits provided to all employees through the cafeteria plan can be provided to key employees.

If any test is failed, the constructive receipt exception will not apply to highly compensated participants or key employees, as applicable, and they will have the maximum amount of cash and taxable benefits that they could have elected through the cafeteria plan included in their income. This is the case even if they elected only nontaxable benefits. There are no adverse tax consequences to employees not in the prohibited group.

Elements of Section 125 nondiscrimination testing

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

The prohibited group

There are two prohibited groups in Section 125 nondiscrimination testing — "highly compensated individuals" (HCI) and "key employees." The definition of "highly compensated individual" is similar, but not identical, to the definition of "highly compensated employee" (HCE) set out in Code Section 414(q) used for dependent care assistance plan and qualified retirement plan [e.g., 401(k) and defined benefit plan] nondiscrimination testing. A highly compensated individual is defined as:

- A more than "5-percent owner" (determined without attribution of ownership by family members, partnerships, etc.) at any time during the plan year being tested or in the preceding plan year
- An officer during the preceding plan year (or during the current plan year if in his or her first year of employment)
- An employee with compensation in excess of a specified threshold in the preceding plan year (e.g., for 2020 testing, compensation of at least $125,000 in 2019) and for an employee in his or her first year of employment, has compensation above the threshold applicable to the current plan year ($130,000 in 2020)
- The spouse or dependent of one of the individuals described above

Comparison of Section 125 HCI and Section 414(q) HCE definitions	
Section 125	**Section 414(q)**
Individual in first year of employment can be HCI if current year compensation exceeds threshold	Current year compensation not taken into account in HCE determination, based only on prior plan year compensation
>5% owner status based only on ownership interest of individual	>5% owner status takes into account ownership interests of family members and other entities
Officer in current or preceding year is an HCI	Officer status not basis for being HCE

For testing purposes, "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 trades or businesses that are under the same common control. "Employee" includes not only common-law employees, but also "leased" employees.

An employer with a large number of employees who would be HCIs based on compensation may elect to limit HCIs to those employees who, in addition to meeting the compensation threshold, are also in the top 20% of all employees based on compensation during the preceding year (or on compensation during the current year if in the first year of employment). This top-paid group election will apply to the determination of HCI status for all nondiscrimination tests that use the Section 414(q) definition of highly compensated employees, including those for qualified plans, and across all members of the controlled group.

For purposes of Section 125 discrimination testing, an employee is a key employee for 2020 if he or she is:

- An officer with 2019 compensation of at least $180,000 (limited to 50 officers)
- A more than 1% owner with 2019 compensation of at least $150,000
- A more than 5% owner, regardless of compensation

A key employee covered by a collective bargaining agreement is treated as a key employee.

Excludable employees

The following employees are excluded from the eligibility test:

- Those covered by a collective bargaining agreement if there is evidence that cafeteria plan benefits were the subject of good-faith bargaining
- Those who are nonresident aliens and receive no earned income from the employer that constitutes income from sources within the United States
- Those participating in the cafeteria plan under COBRA

In addition, if the plan provides that only employees with at least three years of service can participate, employees with less than three years of service may be excluded.

Eligibility test

The Section 125 discrimination rules generally incorporate the nondiscriminatory classification test under Code Section 410(b) that applies to qualified retirement plans; however, this test is modified by substituting “highly compensated individuals” and “highly compensated participants” for “highly compensated employees”. A plan will satisfy the eligibility nondiscrimination test if it benefits a group of employees who qualify under a reasonable classification (based on objective business criteria) established by the employer and the group of employees included in the classification satisfies the safe harbor percentage test or the unsafe harbor percentage component of the facts and circumstances test set out in regulations under Section 410(b). These are mathematical tests that compare the percentage of non-HCIs eligible to participate to the percentage of HCIs eligible to participate.

Examples in the proposed regulations suggest that each benefit option and each payment level is treated as if it were a separate plan for purposes of running the eligibility test. In one example, although a cafeteria plan offered the same health coverage to all participants, it failed the eligibility test because only highly compensated participants received flex credits to offset part of the employee's share of the cost and thus paid less through salary reduction for the coverage. In another example, a cafeteria plan failed the eligibility test when only non-highly compensated participants could elect the high deductible health plan option while only highly compensated participants could elect the low deductible health plan option. This was the case even though the highly compensated participants had to pay more for their coverage than non-highly compensated participants.

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 conducting 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 Section 125 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).

Contributions and benefits test

Section 125 provides that a cafeteria plan will not discriminate with respect to contributions and benefits if either qualified benefits and total benefits, or employer contributions allocable to statutory nontaxable benefits and employer contributions allocable to total benefits, do not discriminate in favor of highly compensated participants. To satisfy these requirements, each similarly situated participant must be given a uniform opportunity to elect qualified benefits and employer contributions (benefit availability).

In addition, highly compensated participants must not disproportionately elect qualified benefits or utilize employer contributions for qualified benefits while other participants elect permissible taxable benefits or to receive employer contributions as permissible taxable benefits (benefit election).

What is meant by "similarly situated"?

In determining which participants are similarly situated, employers may take into account reasonable differences in plan benefits offered to employees working in different geographical locations or to employees with family coverage versus employee-only coverage.

The benefit election test is an objective utilization test. Qualified benefits are disproportionately elected by highly compensated individuals if the aggregate qualified benefits they elect, calculated as a percentage of their compensation, exceed the aggregate qualified benefits elected by non-highly compensated participants, calculated as a percentage of their compensation. Whether employer contributions are disproportionately utilized by highly compensated individuals is determined in a similar manner, substituting "aggregate employer contributions" for "aggregate qualified benefits."

Safe harbors

There are two safe harbors applicable to the contributions and benefits test.

Health benefit safe harbor. A cafeteria plan providing medical benefits will not be treated as discriminatory with respect to contributions and benefits if:

- Contributions on behalf of each participant either include an amount that equals 100% of the cost of the health coverage under the plan of the majority of similarly situated highly compensated participants, or equal or exceed 75% of the cost of the participant having the highest cost benefit coverage under the plan, and
- Contributions or benefits in excess of those described above bear a uniform relationship to compensation.

This safe harbor is limited to major medical coverage and does not apply to dental coverage or health flexible spending arrangements.

Premium-only plan safe harbor. A cafeteria plan that offers an election between cash and payment of the employee's share of the employer-provided health insurance premiums as its sole benefit will satisfy the contribution and benefits test as long as it passes the reasonable classification and safe harbor percentage tests under Section 410(b).

Key employee concentration test

The key employee concentration test is a utilization test. The purpose of this test is to confirm that key employees are not disproportionately receiving nontaxable benefits through the cafeteria plan. To satisfy this test, not more than 25% of the statutory nontaxable benefits provided through the cafeteria plan to all employees during the plan year may be provided to key employees.

What are "statutory nontaxable benefits"?

Statutory nontaxable benefits are qualified benefits offered through a cafeteria plan that are excluded from gross income (e.g., health and dependent care benefits). They also include employee group-term life insurance coverage that is includable in income solely because the coverage exceeds $50,000.

Permissive disaggregation and aggregation

The Section 125 proposed regulations permit the disaggregation or aggregation of cafeteria plans in running the nondiscrimination tests if certain conditions are met.

Permissive disaggregation. Cafeteria plans that allow employees with less than three years of service to participate in the plan are permitted to disaggregate the plan into two separate plans for nondiscrimination testing purposes — e.g., one plan for employees with less than three years of service and one for employees with three or more years of service. If a plan is disaggregated into two separate plans, the two plans must be tested separately for both the eligibility test and the contributions and benefits test.

Permissive aggregation. An employer that sponsors more than one cafeteria plan may aggregate two or more plans for nondiscrimination testing purposes. The combined plan must satisfy both the eligibility and the contributions and benefits test as if it were a single plan. This means that the

combined plan must give each similarly situated participant the same opportunity to elect qualified benefits and the actual elections by highly compensated participants may not be disproportionate.

When to run the tests

The Section 125 proposed regulations state that the nondiscrimination tests must be performed as of the last day of the plan year taking into account all nonexcludable employees or former employees who were employed on any day of the plan year. But ideally, the tests would be run 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 and contributions and benefits tests based on their demographics and that of other members of their controlled group.

In closing

Employers need to be aware of all of the Section 125 nondiscrimination tests and take action to ensure that:

- All employers in the controlled group are included in testing
- The nondiscrimination tests are satisfied
- Testing is completed before the end of the plan year to allow time for any needed corrections

Nondiscrimination testing of self-insured health benefits

The Code provides an income tax exclusion for employer-provided payments of healthcare expenses, whether made through insured coverage or self-insured coverage. For highly compensated individuals and participants to take advantage of the exclusion, an employer must be able to demonstrate that the benefit satisfies applicable nondiscrimination tests. This section describes the nondiscrimination tests that apply to self-insured health plans to help employers understand how each test operates and what data they need to collect to conduct the tests.

Background

Section 105(b) of the Code sets out the income tax exclusion for employer-provided payments of healthcare expenses. Section 105(h) of the Code subjects *self-insured* healthcare plans to the following nondiscrimination tests to ensure that benefits are not provided disproportionately to members of a "prohibited group":

- **An eligibility test.** The plan must satisfy a numerical test or benefit a sufficient percentage of employees who qualify under an eligibility classification that does not discriminate in favor of highly compensated individuals.
- **A benefits test.** The benefits provided under the plan may not discriminate in favor of highly-compensated participants.

Satisfaction of the requirements must be demonstrated through testing. If either test is failed, a highly compensated participant will have any "excess reimbursements" included in his or her income for the year. The determination of "excess reimbursements" depends on whether the plan fails the eligibility test or the benefits test. This is discussed in the following section.

Which benefits are subject to Section 105(h)?

The Section 105(h) nondiscrimination rules apply to any self-insured plan that pays for or reimburses healthcare expenses. This includes not only plans providing medical, dental and vision benefits, but also health flexible spending accounts and health reimbursement arrangements. Health savings accounts are not subject to Section 105(h), although the self-insured, high-deductible health plans associated with them are. Executive physicals are also exempt.

Section 105(h) does not apply to insured health benefits, although an ACA provision imposes similar nondiscrimination requirements on non-grandfathered insured group health plans. However, in 2011, the IRS postponed application of those requirements until it issues guidance. To date, no guidance has been issued.

Elements of nondiscrimination testing

Here's a general overview of the nondiscrimination testing elements related to self-insured health benefits.

The prohibited group

The prohibited group for Section 105(h) nondiscrimination testing consists of "highly compensated individuals" (HCIs) and "highly compensated participants" (HCIs who are participants, "or HCPs"). Status as an HCI is determined under a different definition of "highly compensated" than is used in identifying highly compensated employees for cafeteria plan or dependent care assistance program testing and for testing qualified retirement plans. Under the Section 105(h) definition, an HCI is an individual who, during the plan year in which the benefit is received, is:

- One of the five highest paid officers
- A "10-percent owner," or
- Among the highest paid 25% of all employees during the plan year not including otherwise excludable employees who are not participants in any self-insured medical reimbursement plan of the employer. Fiscal year plans can use compensation in the calendar year in which the plan year ends.

Who is the employer for Section 105(h) testing purposes?

All members of a controlled group are treated as a single employer for eligibility testing purposes. Thus, in testing self-insured health benefits offered by one employer, employees from all related employers are counted, which increases the possibility of failing the test. Employers need to be able to collect relevant demographic data on these other employees.

For this purpose, "employer" includes not only the entity employing the individual, but also all other entities that are members of the same controlled group of corporations as the employing entity or trades or businesses that are under the same common control.

An employee is a "10-percent owner" of the employer for a particular year if at any time during such year, he or she owns more than 10% of the value of the corporation's outstanding stock or stock possessing more than 10% of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a "10-percent owner" is any employee who owns more than 10% of the capital or profits interest in the employer.

Excludable employees

Section 105(h) provides that the following employees may be disregarded in identifying the highest paid 25% of all employees if they are not otherwise participating in the plan:

- Collectively bargained employees who are not eligible to participate in the plan, if health benefits were the subject of good-faith collective bargaining
- Employees who have not completed three years of service at the beginning of the plan year
- Employees who have not attained age 25 by the beginning of the plan year

- Part-time employees who customarily work fewer than 35 hours a week, if other employees doing similar work have substantially more hours. An employee whose customary weekly employment is less than 25 hours may automatically be considered part-time for purposes of the exclusion
- Seasonal employees whose customary annual employment is less than nine months if other employees in similar work with the employer have substantially more months. An employee whose customary annual employment is less than seven months may automatically be considered seasonal for purposes of the exclusion
- Nonresident aliens with no U.S.-source earned income from the employer

Section 105(h) also provides that these employees may be excluded from the eligibility test. Except for collectively bargained employees, it does not appear that the employees must be ineligible to participate in the plan as a prerequisite to being excluded from eligibility testing. Additional guidance would be welcome.

Don't be confused!

The definitions of part-time and seasonal employee for Section 105(h) purposes are different than those used in applying the "lookback measurement method" for determining full-time employee status under the ACA.

Eligibility test

The Section 105(h) eligibility test is similar to the test applicable to qualified retirement plans — a self-insured health reimbursement plan must satisfy one of the following three alternative tests:

- **The 70% test.** The plan must benefit at least 70% of all nonexcludable employees.
- **The 70%/80% test.** The plan must benefit at least 80% of all nonexcludable employees eligible to participate if at least 70% of all nonexcludable employees are eligible.
- **Nondiscriminatory classification test.** The plan must benefit a classification of employees that does not discriminate in favor of HCIs. Generally, the classification must be reasonable and based on objective business considerations. In addition, the classification must satisfy a mathematical test that compares the percentage of non-HCIs benefiting to the percentage of HCIs who benefit.

What does "to benefit" mean for the eligibility test purposes?

It appears that for purposes of the percentage tests, "to benefit" means to actually participate in the plan. For the nondiscriminatory classification test, "to benefit" could mean eligible to participate.

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

Benefits test

The purpose of the benefits test is to confirm that benefits are not available to HCPs or their dependents on more favorable terms than to other employees. This is generally a facts-and-circumstances test that considers, for example, whether HCPs receive different or better benefits than others — or pay less for the same benefits. A plan cannot be discriminatory on its face or in operation.

Restructuring

An employer that sponsors more than one self-insured plan may run the eligibility and benefits tests separately for each plan or, at its option, designate them as a single plan and run the tests on that basis. A determination that the combined plans fail the tests does not preclude a determination that one or more of the separate plans satisfies the requirements. The regulations provide that if there is only one plan document, the document must specify which plans are to be treated as separate plans for testing purposes.

What about retirees?

Self-insured retiree health coverage generally qualifies for the Section 105(b) exclusion. However, regulations provide that for purposes of the benefits test, retired participants who were highly compensated while employed will be HCPs, and that the income tax exclusion will not apply to them unless all other retired participants are provided the same type of benefits with the same dollar limits. The regulations do not specifically address the treatment of retirees for purposes of the eligibility test. Note that retirees are not treated as employees in determining the highest paid 25% of all employees solely because they receive plan benefits.

When to run the tests

Section 105(h) does not specify when the nondiscrimination tests should be run. Ideally, they would be run 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 and benefits tests based on their demographics and that of other members of their controlled group.

Tax consequences if a nondiscrimination test is failed

If a plan fails one of the nondiscrimination tests, only highly compensated participants (HCPs) will be adversely affected — they will lose the benefit of the applicable tax exclusion and have the value of any “excess reimbursements” included in their income. Non-HCPs will still qualify for all the tax advantages applicable to the benefit.

The amount of the excess reimbursement depends on which test is failed. If a plan fails the eligibility test, the HCP’s “excess reimbursement” is determined by multiplying the benefits received by the HCP during the year by a fraction. The numerator of the fraction will be the amount of total benefits paid to or for all HCPs for the plan year while the denominator will be the total amount of benefits paid to all participants for the plan year. If the plan fails the benefits test, the entire amount of the discriminatory benefit received by the HCP will be considered an excess reimbursement and included in income.

Which health plans are at risk for failing the benefits test?

Health plans with different waiting periods, contribution rates or that provide different benefits for different groups of employees may fail the benefits test.

In closing

Employers need to be aware of the Section 105(h) non-discrimination tests and act to ensure that:

- All employers in the controlled group are included in testing,
- Both the eligibility and benefits tests are satisfied, and
- Testing is completed before the end of the plan year.

Nondiscrimination testing of group term life insurance

The Code provides an income tax exclusion for the value of the first $50,000 of employer-provided group term life insurance coverage. For key employees to take advantage of the exclusion, an employer must be able to demonstrate that the benefit satisfies applicable nondiscrimination tests. This section describes the nondiscrimination tests for group term life insurance to help employers understand how each test operates and the data they need to collect to conduct the tests.

Background

Section 79 of the Code provides an income tax exclusion for the value of the first $50,000 of employer-provided group term life insurance coverage. The value of employer-provided coverage over $50,000 is included in the gross income of employees and is subject to tax. The taxable amount of employer-provided group term life insurance is commonly referred to as "imputed income," because employees are taxed as if they had received the taxable value of the coverage in cash.

Section 79 imposes the following nondiscrimination tests on employer-provided group term life insurance coverage to ensure that benefits are not provided disproportionately to "key employees":

- **An eligibility test.** The plan must satisfy a numerical test or benefit a sufficient percentage of employees who qualify under an eligibility classification that does not discriminate in favor of "key employees."
- **A benefits test.** The benefits provided under the plan may not discriminate in favor of key employees.

When is group term life insurance considered "employer-provided"?

Group term life insurance is employer-provided if the policy is "carried directly or indirectly" by the employer. A policy is "carried" by an employer if (1) the employer contributes towards the cost of coverage directly or employees pay for coverage through salary reduction, or (2) the rates charged employees straddle the so-called "Table I" rates.

To ensure a uniform method for calculating the cost of group term life insurance that could be included in an employee's income, Section 79 regulations include Table I rates that set out the cost per $1,000 for one month's group term life insurance protection, generally applied to five-year age brackets.

Satisfaction of the requirements must be demonstrated through testing.

Under a special grandfather rule, group term life coverage provided to certain retirees who became age 55 on or before January 1, 1984 is not subject to either the Section 79 nondiscrimination rules or the $50,000 exclusion. This special rule does not apply to individuals who retired on or after December 31, 1986 if the plan is discriminatory. In addition, plans maintained by churches for certain church employees are exempt from the nondiscrimination rules. However, this exemption does not apply to employees of church-supported educational institutions above the secondary school level

(other than schools for religious training) or of church-supported non-profit medical or hospital facilities.

Elements of nondiscrimination testing

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

The prohibited group

Unlike other nondiscrimination tests, highly compensated individuals are not included in the prohibited group. Instead, the prohibited group for group term life nondiscrimination testing is limited to "key employees." A key employee is an employee who, at any time during the current plan year, is:

- An officer of the employer having an annual compensation greater than a specified threshold that is indexed annually for inflation — $185,000 for 2020
- A "5-percent owner" of the employer, or
- A "1-percent owner" of the employer having an annual compensation from the employer of more than $150,000.

No more than 50 employees (or, if less, the greater of 3 or 10% of the employees) must be treated as officers.

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

An employee 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% of the value of the outstanding stock of the corporation or stock possessing more than 5% 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 10% of the capital or profits interest in the employer.

Can retirees be key employees?

Yes. For purposes of nondiscrimination testing, a key employee includes a retiree who was a key employee when he or she retired.

Excludable employees

Section 79 permits the following employees to be disregarded in determining whether group term life insurance coverage satisfies the eligibility test:

- Collectively bargained employees who are not eligible to participate in the plan, if benefits were the subject to good faith collective bargaining
- Employees who have not completed three years of service at the beginning of the plan year

- Part-time employee or seasonal employees
- Nonresident aliens with no U.S. source earned income from the employer

Except for collectively bargained employees, it does not appear that the employees must be ineligible to participate in the plan as a prerequisite to being excluded from eligibility testing. Additional guidance would be welcome.

Eligibility test

To satisfy the Section 79 eligibility test, the group term life insurance coverage must satisfy one of the following:

- **Cafeteria plan eligibility test.** If group term life insurance coverage is offered through a cafeteria plan that satisfies the cafeteria plan eligibility test, the coverage satisfies the Section 79 eligibility test.
- **70% test.** The plan must benefit at least 70% of all nonexcludable employees.
- **The 85% test.** At least 85% of all nonexcludable employees eligible to participate are non-key employees.
- **Nondiscriminatory classification test.** Under this test, the plan must benefit a classification of employees that does not discriminate in favor of key employees.

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

Group term life insurance that covers both active and former employees generally must satisfy the eligibility tests for each group separately, except to the extent that the former employees qualify for the special retiree grandfather rule. However, in applying the test for retiree-only coverage, only retired employees (and not all former employees) must be considered.

Required and permissive aggregation. All group term life insurance policies covering one or more common key employees are considered a single plan for nondiscrimination testing purposes. In addition, an employer may treat two or more policies that do not cover a common key employee as a single plan — for example, if an employer has one policy that covers only key employees and a second policy that covers only non-key employees, the two policies can be considered together.

Benefits test

The purpose of the benefits test is to confirm that benefits are not available to key employees on more favorable terms than to other employees. This is generally a facts-and-circumstances test that considers, for example, whether key employees receive different or better benefits — or pay less for the same benefits — than others. A plan will not fail the benefits test merely because the amount of life insurance for employees under the plan bears a uniform relationship to the total compensation or the basic or regular rate of compensation for those employees.

When to run the tests

Section 79 does not specify when the nondiscrimination tests should be run. Ideally, they would be run 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 and benefits tests based on their demographics and that of other members of their controlled group.

Tax consequences if a nondiscrimination test is failed

If a plan fails one of the nondiscrimination tests, key employees will lose the income tax exclusion of the value of the first $50,000 of employer-provided group term life insurance coverage. Instead, they will have the greater of either the actual cost of all their *employer-provided* coverage or the Table I rates for that coverage included in their income (coverage paid for by the employee on an after-tax basis is not taken into account). Non-key employees will still qualify for all tax advantages applicable to the benefit.

Although amounts included in a key employee's income are not subject to federal income tax withholding, they are subject to withholding for FICA taxes. The IRS has stated that an employer may treat the imputed income amounts as paid either by the pay period, by the quarter, or on any other basis so long as the amounts are treated as paid at least as often as once a year.

In closing

Employers need to be aware of the Section 79 non-discrimination tests and act to ensure that:

- All employers in the controlled group are included in testing,
- Both the eligibility and benefits tests are satisfied, and
- Testing is completed before the end of the plan year.

Nondiscrimination testing for educational and adoption assistance programs

The Code provides income tax exclusions for benefits received under employer-sponsored educational and adoption assistance programs. For highly compensated employees to take advantage of the exclusions, an employer must be able to demonstrate that the benefits satisfy applicable nondiscrimination tests. This section 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.

Background

Section 127 of the 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 2020 with respect to an adoption is $14,300; this amount is reduced proportionally for taxpayers with adjusted gross income of over $214,520. (These amounts are indexed.) 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% of the stock, capital or profit interest in the employer and their spouses and dependents cannot receive more than 5% 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

Below is a general overview of each of the elements that relate to nondiscrimination testing for educational and adoption assistance programs.

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 2020 testing, this is compensation of at least $125,000 in 2019)

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% 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% 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% 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.

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

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.

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 5% 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 a nondiscrimination test is 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.

What happens if a test is failed?

Unlike other benefits, if an educational and adoption assistance program is deemed discriminatory, the exclusion is not available to *any* participants, and any benefits received during the year will be included in the employee's income.

Educational and adoption assistance programs guidance

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.

In closing

Running nondiscrimination tests regularly enables employers to demonstrate compliance and reduces the likelihood that they will face adverse tax consequences. In addition, testing results can create opportunities to improve benefit strategy and design.

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