

Non-Discrimination Rules & Testing: What You Should Know About Your Benefit Package

By Michelle Cammayo

Many arrangements exist in the IRC Section Code(s) that allow plans to enjoy favorable tax treatment. To enjoy this favorable tax treatment, the IRS imposes rules to prevent plans from being designed in such a way that they discriminate in favor of individuals who are highly compensated employees (HCEs) or are otherwise key employees (KEY) in the organization.

Throughout my 13 years in the industry, I have found that many HR & Benefit Professionals alike are not clear on the rules or how the plans are tested. This article will provide a general summary. Each IRC Code Section below has its own testing and number of tests that must be performed before issuing a pass or fail. Failures are more common with regards to the Section 125, 105 and 129 which is what this article will expand upon.

IRS Section	What	Testing	Safe Harbors	Fail
Section 105	Self-funded plans, i.e., HRA or HealthCare FSA	Eligibility test and Benefits test	Yes; if more than 70% of non-excludable employees participate in the plan, you pass OR if more than 70% of eligible employees are non-excludable, and more than 80% of those eligible participate in the plan, you pass	Automatic failure if plan eligibility is NOT based on: job category, exempt status, geographic location or similar business criteria Fails if there is a higher participation rate among HCEs than among non-HCEs.
Section 125	Cafeteria Plan aka Premium Only Plan aka the tool that allows an employer to take pre-tax deductions from employees for their cost of premiums	Contributions & Benefit test, 25% Key employee test, & Eligibility test	100% employer-paid components are not included.	Automatic failure if the waiting period is shorter for HCEs compared to non-HCEs or if better plans are offered to Executives (HCEs) vs. Non-Executives (non-HCEs)
Section 129	Dependent Care FSA	Many tests: Once excluded employees are removed for testing purposes, If average non-HCE election is 55% or less of average HCE election, plan will fail	Avoid failure by prohibiting HCEs from electing, limit HCEs elections below calculated amount (cannot increase elections mid-year if results are better than anticipated), monitor beginning, middle and end of plan year	If average non-HCE election is 55% or less of average HCE election (excluding non-HCEs earning < \$25K), plan will fail

Other IRC Section of Note that are subject to Non-Discrimination Rules

Section 127 Educational Assistance

Section 137 Adoption Assistance

Section 79 Group Term Life

Section 223 – HSA Comparable Contributions Test

Section 117 – Qualified Tuition Reductions

Section 132 – Commuter Benefits

If your company has not tested before, at least in your tenure, you're not alone. I encourage all employers to be aware of any potential penalties.

In the years since the Affordable Care Act became the "Law of the Land", I've noticed a common misconception among my peers and those working in HR or concerned with such matters. Here's the best way to sum it up:

Myth: My company can pay 90% for Executives and only 75% for Non-Executives with regards to premium for their group health plan. We allow pre-tax contributions to pay for the coverage. That's still okay until the ACA rules are finalized, right?

Truth: Section 125 Non-Discrimination regulations prohibit this. If your company has a Section 125 plan, and it is favoring the highly compensated, your plan is out of compliance and subject to penalty.

More Info: The Affordable Care Act included a provision (Section 2716) that would subject Section 105(h) non-discrimination testing rules to non-grandfathered, fully insured plans, and that provision has since been delayed until further guidance from the IRS. This set our benefits world afire because many companies were (and still are) classing out executives to receive better benefits for less cost out of their paycheck. If an employer does not have a Section 125 plan, the non-discrimination rules would not apply as the regulations are still pending. However, the majority of employers have a Section 125 so non-discrimination testing rules already exist.

If Section 125 already had non-discrimination regulations, why did the ACA propose Section 105(h) regulations for these plans as well? Some fully-insured plans do not have a Section 125; therefore, non-discrimination rules would be introduced for the first time through the pending 105(h) regulations. In addition, the 105(h) non-discrimination regulations make it difficult to circumvent the rules unlike the Section 125 regulations.

The simple way to circumvent Section 125 issues is to remove any employee contributions or take those contributions on a post-tax basis. This removes the employee(s) from the testing since they do not participate in the Section 125 plan.

The reason this should be important in your company is three-fold:

1. In the event of an IRS audit, the auditor will likely request a copy of the test and results. This is usually done as part of the payroll audit and non-compliance will result in penalties.
2. IRS has issued proposed regulations requiring annual testing for the Section 125 & 105. This is still in the proposed status so not required yet but testing once a year for now is best practice to avoid penalties in the event of an audit.
3. Failing the test makes for very unhappy key employees because the highly compensated must have the cost of the benefits imputed (back taxes and interest on money owed) to correct the failure.

Would you like to learn more? Please contact [Michelle Cammayo](#). She works for [Bolton & Company](#), one of the nation's largest employee-owned insurance consultancies.



Michelle Cammayo has more than a decade of Employee Benefits experience specializing in all lines of health and welfare benefits, including Medical, Dental, Vision, Basic and Voluntary Life, Short and Long-Term Disability and Employee Assistance Programs. Her primary roles and responsibilities include carrier negotiations, strategic oversight, and educating HR staff and employees with regards to employee benefit packages and/or solutions.

With an established track record of providing solutions to clients' unique challenges, Michelle leads with a forward-thinking philosophy and proactive approach to all areas of benefit program management. She has driven the process on Wellness Initiatives, Health Fairs, Employee Benefit Communication Campaigns and Technology Solutions for a number of our clients, and has implemented and serviced alternative funding contracts, including level funding, graded preferred funding, self-funding with stop loss, minimum premium contracts and participating contracts. She also has extensive, hands-on experience with several HRIS systems.