



This Webinar Will Start Momentarily.
Thank you for joining us.



Nondiscrimination Rules Overview

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*Presented by the Regulatory and
Legislative Strategy Group*



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The Applicable Rules: An Overview



The Applicable Rules

Cafeteria Plans

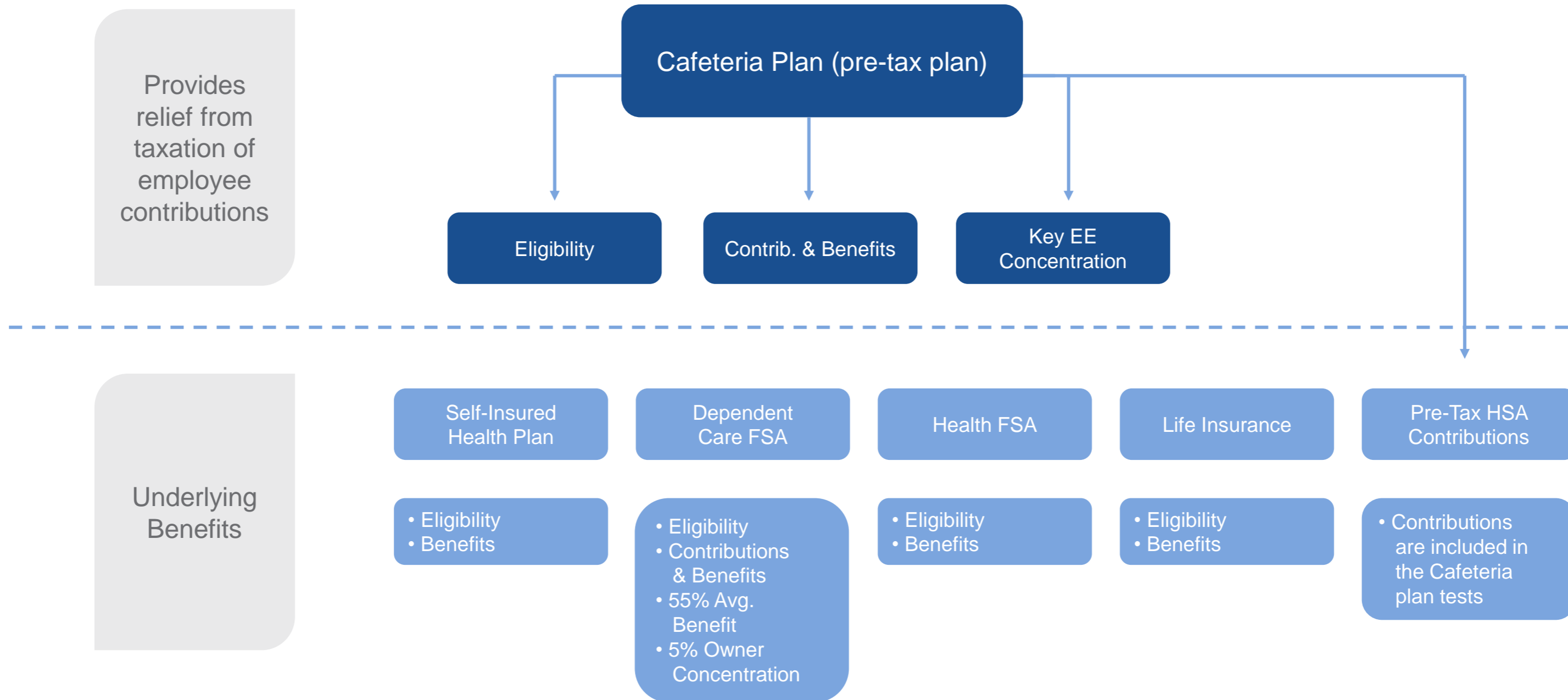
- Overall nondiscrimination rules (Section 125)

Benefit Plans

- Self-insured health plans (Section 105)
- Health care FSAs (Section 105)
- Dependent care assistance plans (Section 129)
- Fully-insured medical plans (ACA)
- Group term life insurance (Section 79)



The Big Picture



Our Focus for Today

Cafeteria Plan Nondiscrimination Tests

- Eligibility test
- Contributions and benefits test
- Key employee concentration test

Health FSA Nondiscrimination Tests

- Eligibility test
- Benefits test

Dependent Care Assistance (DCAP) Tests

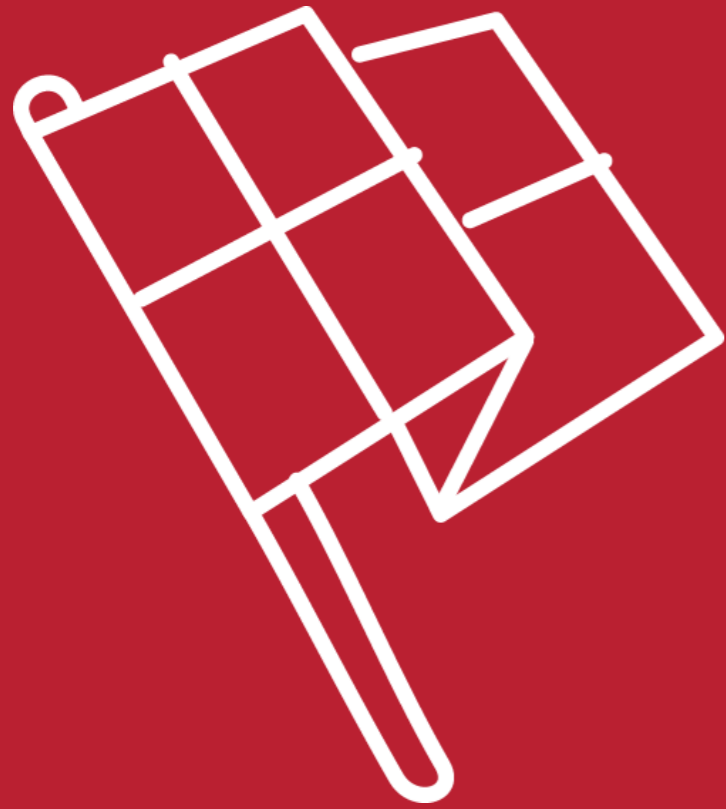
- Eligibility test
- Contributions and Benefits test
- More-than-5% Owners Concentration test
- 55% Average Benefits test

The Basic Requirement

Plans must not discriminate in favor of highly compensated or key employees, in terms of:

- Eligibility
- Contributions
- Availability of Benefits
- Plan Operation

“Red Flags”



Issues to look out for:

- Providing different dates of entry for different classes of employees
- Providing a greater benefit to HCEs
- Reduced premium contributions based on age or years of service
- Low utilization of the dependent care FSA by non-HCEs
- Availability of benefits based on job classification

Cafeteria Plans



Partners and Sole Proprietors

Sole proprietors, partners and shareholders of a Subchapter-S corporation holding more than 2% ownership are not employees under the code

- They are ineligible to participate in the employer's cafeteria plan and participate in benefit plans on an after-tax basis (so nondiscrimination requirements generally do not apply to them)
- Ownership of Subchapter-S corporation's shares is also attributed to spouses and children, and they are also ineligible to participate



Cafeteria Plans (§125)

Why the Rules Exist:

- To encourage employers to provide tax-favored benefits to rank-and-file employees
- Prevent plans from providing *highly compensated* and *key employees* with disproportionate benefits in terms of:
 - » Eligibility
 - » Contributions
 - » Benefits
 - » Favorable tax treatment

§125 Salary Reduction Plans:

Tax-favored treatment of employee contributions for employer-sponsored qualified benefits

- Medical, dental and vision
- Health Flexible Spending Accounts
- Dependent Care Assistance Plans (DCAPs)
- Health Savings Accounts
- Life Insurance and Disability Insurance (not as common as other benefits)

Cafeteria Plans (§125)

WHO IS A HIGHLY COMPENSATED EMPLOYEE (HCE)?

- An officer of the company (based on facts and circumstances, not job title)
 - » Determined based on preceding plan year (or current plan year if the HCE was not employed in the preceding year)
- An employee who owns 5% or more of the voting power or value of all classes of stock of the employer
 - » During current or preceding plan year
 - » Ownership attribution rules do not apply
- An employee earning more than a threshold amount and, if elected by employer, was in the top 20% highest paid employees (top-paid group)
 - » Determined based on preceding plan year (or current plan year if the HCE was not employed in the preceding year)
 - » \$150,000 or more for 2023; \$155,000 or more for 2024 (used for 2025 plan year testing)
 - » Special rules for non-calendar year plans
- Spouses and dependents of any of the foregoing

Cafeteria Plans (§125)

WHO IS A KEY EMPLOYEE?

- An officer earning \$215,000 or more in 2023;
\$220,000 or more in 2024
 - » Subject to a maximum number of officers
- A 5% or more owner
- A 1% or more owner with compensation of \$150,000
(not indexed)
- Based on preceding plan year data
- Ownership attribution rules apply



Nondiscrimination Rules



Generally, include in testing all employees who are not in an excludable class – regardless of eligibility to participate

Excludable classes of employees:

- Employees subject to a collective bargaining agreement
- Non-resident aliens with no U.S.-sourced income
- Former employees on COBRA

Separate testing may be done for:

- Employees with three or more years of employment and employees with less than three years of employment

Eligibility Rule

“

“In the case of a highly compensated participant,” the exclusion from gross income “shall not apply to any benefit attributable to a plan year for which the plan discriminates in favor of highly compensated participants as to eligibility to participate”

Code §125(b)(1)(A)

Purpose: To determine whether an appropriate mix of HCEs and non-HCEs is eligible for benefits

Eligibility Tests

Measures:

- Length of service (employment requirement) – same for all employees?
- Entry date requirement
- Nondiscriminatory classification test with two requirements:
 - » Objective business classification (not favoring HCEs) may be used to determine eligibility
 - Based on underlying business reason for classification
 - Example: Salaried, hourly, full-time, part-time, type of job, geographic location, division, subsidiary, business unit or profit center
 - Family vs. employee only coverage
- Sufficient ratio of non-HCEs to HCEs eligible to participate in the cafeteria plan (using safe harbor percentage test or unsafe harbor percentage test)

Include all employees, including leased employees, with some exceptions.

Eligibility Tests

Eligibility Requirements:

- Are all employees eligible to participate subject to the same waiting period?

Entry Date Requirements:

- Is the entry date the same for all classes of employees?
- If not eligible earlier: Any employee who has completed three years of service who has satisfied any conditions for participation must be permitted to participate no later than the first day of the next plan year

Safe/Unsafe Harbor Percentage Tests



A classification is not discriminatory for a plan year if, and only if, the group of employees included in the classification benefiting under the plan satisfies either a “safe harbor percentage test” or an “unsafe harbor percentage” test for the plan year.

- Determine the Plan's Non-HCI Concentration Percentage
- Determine the Safe Harbor % From the Nondiscriminatory Classification Table
 - » If the plan's Ratio Percentage is 50% or more, the plan automatically passes the Safe Harbor Percentage Test.
 - » If the plan's Ratio Percentage is less than 50%, the plan might still pass if the Ratio Percentage exceeds the applicable Safe Harbor Percentage (found in a special table).
- If the plan fails the Safe Harbor Percentage Test, then the plan may pass the Unsafe Harbor Percentage component of the Facts and Circumstances Test

Table

Non-HCl Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage
0–60	50.00	40.00
61	49.25	39.25
62	48.50	38.50
63	47.75	37.75
64	47.00	37.00
65	46.25	36.25
66	45.50	35.50
67	44.75	34.75

Example

Non-HCl concentration % is 65%. Safe Harbor % = 46.25%.

Generally, the greater the concentration of non-HCIs, the easier it is to pass.

Example

Employer does not allow union employees in plan but did bargain for benefit.

100 employees, 60 union
(No 125 plan for union employees)

- 40 in testing group: 16 HCEs,
- 24 NHCEs
- 16 HCEs are eligible
- 12 NHCEs are eligible

Figure NHCE %: NHCE Eligible/NHCE
Total = $12/24 = 50\%$

Figure HCE%: HCE Eligible/HCE
Total = $16/16 = 100\%$

Ratio%: $\text{NHCE\%} / \text{HCE \%} = 50/100 = 50\%$



What percentage of the NHCEs are eligible to participate?

50%



What percentage of the HCEs are eligible to participate?

100%



What is the ratio of eligible NHCEs to eligible HCEs?

**NHCE/HCE
= 50/100 or
50%**



Is the ratio within the “safe harbor” for eligibility?

Yes – equal to or greater than 50%

Contributions & Benefits Test

The safe harbor from constructive receipt “shall not apply to any benefit attributable to a plan year for which the plan discriminates in favor of...highly compensated participants” as to contributions and benefits. (Code §125(b)(1)(B))

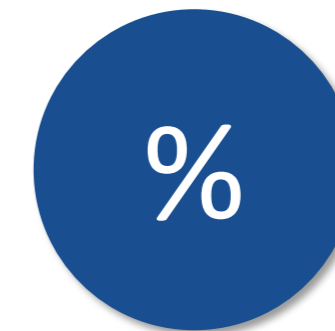
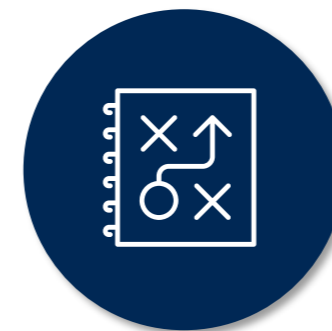
- **Availability:** Can HCEs get more plan benefits (or employer contributions) than non-HCEs?
- **Utilization:** Do the HCEs actually take benefits (or employer contributions) disproportionately when compared to non-HCEs?
 - » Disproportionate election if the aggregate qualified benefits/employer contributions elected by HCEs, measured as a percentage of the aggregate compensation of HCEs, exceed the aggregate qualified benefits/employer contributions elected by non-HCEs measured as a percentage of the aggregate compensation of non-HCEs
- Safe harbor may be available (see slide 25)

Key Employee Concentration Test

The income exclusion does not apply to any benefit for which the qualified benefits provided to key employees exceed 25% of qualified benefits provided for all employees under the plan.

Collectively-bargained plans, and plans of governmental employers, are not subject to the 25% key employee concentration test

- The test ensures that key employees do not receive more than 25% of total qualified benefits under the plan
- If key employees receive more than 25%, they are taxed as though they received all available taxable benefits under the plan
 - » Generally, contributions rather than actual expense reimbursements are taxed



Example

Non-Key EEs	Pre-Tax Deductions	Employer Contribution
1	500	2,000
2	1,500	2,000
3	4,000	2,000
4	0	2,000
5	0	2,000
6	1,000	2,000
7	2,000	2,000
8	0	2,000
9	1,000	2,000
10	0	2,000
TOTAL	10,000	20,000

Key EEs	Pre-Tax Deductions	Employer Contribution
1	3,000	2,000
2	1,000	2,000
3	5,000	2,000
Total	9,000	6,000

1

What is the total benefit value for key employees (key employees' contribution + employer's contribution)?

\$15,000

2

What is the total benefit value for non-key employees (non-key employees' contribution + employer's contribution)?

\$30,000

3

What percentage of the total benefits (key + non-key) go to the key employees?

33%

4

Does the plan pass or fail this test?

Fail

Safe Harbors

Premium Only Plan Safe Harbor

- Applies if following conditions satisfied:
 - » Plan offers as its sole benefit an election between cash and payment of the employee share of the premium for employer-provided accident and health insurance (e.g., medical, dental, vision, etc.)
 - No HSA contributions, health FSA or dependent care FSA
 - » Plan passes the safe harbor percentage test for eligibility
 - » Example in regulations also suggests that same benefits must be available to all participants
- If met, plan satisfies the Contributions & Benefits and Key Employee Concentration tests

Safe Harbor for Plans Providing Medical Coverage

- Employer contributions under plan must meet a 100% / 75% test and an excess contribution test (contributions in excess of this percentage are uniformly related to compensation)
- If met, the entire plan automatically satisfies Contributions and Benefits test

Self-Insured Health Plans & Health FSAs



Self-Insured Health Plans (§105-106)

Plans Subject to the Rule:

- Self-insured medical, dental and vision plans (funded or unfunded)
- Health FSAs (limited and general purpose)

Health Reimbursement Arrangements (HRAs)
(but not part of the Cafeteria Plan)

Sources of Applicable Law:

- **§105:** determines whether **benefits received** under accident and health plans for employees, former employees, spouses and dependents can be excluded from employees' taxable income...
- **§106:** determines whether **employer contributions** for accident and health plans can be excluded ...

Highly Compensated Individual (HCI)

One of five highest-paid officers

- “Officer” not specifically defined in the regulations, but look at responsibilities, not just job titles) in the current year (no look-back)

Among the top 25% compensated of all employees (unless they are not eligible and are in excludable class)

- “Compensation” is not defined – reasonable definition applies
- Current year compensation used

More than 10% shareholder (at the time the benefit is provided during the plan year)

- Attribution rules apply (e.g., spouses and dependents of shareholders are deemed to own proportionate share of ownership interest)

Potential Discrimination Problems

Treating separate employee groups differently:

- Plan eligibility
- Different entry dates (waiting periods) or employment requirements (hours of service)
- Separate plan benefits
- Different employer contributions

Based on:

- Different groups of eligible employees, by:
 - » Job classification (salaried vs. hourly, executives vs. non-executives, part-time vs. full-time)
 - » Division or entity (when different standards apply to companies that are members of the same control group or location)
 - » Seniority (length of service) or percentage of compensation (if Highly Compensated Individuals pay less than non-HCIs)

Nondiscrimination Tests

Self-Insured Health Plan Nondiscrimination Tests

1

Eligibility Test

2

Benefits Test

Eligibility test excludable employees (if not participating):

- Employees who have not completed three years of service;
- Employees who have not attained age 25;
- Part-time or seasonal employees;
- Collectively bargained employees; and
- Nonresident aliens with no U.S. source income.

Eligibility Test



Purpose

To determine whether an appropriate mix of HCEs and non-HCEs is eligible for benefits

Measures

- Length of service (employment requirement) – Same for all employees?
- Entry date requirement
- Nondiscriminatory classification test requiring:
 - » Objective business classification (not favoring HCEs) may be used to determine eligibility
 - » Sufficient ratio of Non-HCEs to HCEs eligible to participate in the plan

Eligibility Test

“

“A self-insured medical reimbursement plan satisfies the requirements of [the discrimination rules] only if...the plan does not discriminate in favor of highly compensated individuals as to eligibility to participate.”

(Code §105(h)(2)(A))

Does the plan benefit:

- At least **70% of all employees** (70% test), or
- **80% or more** of all employees who are **eligible** to benefit, **if 70% or more are eligible** (70% / 80% test), or
- A sufficient ratio of employees who are non-HCIs vs. HCIs who qualify under **a bona fide business classification** the IRS does not find to be discriminatory (reasonable classification)
 - » Typically need to pass the safe harbor percentage test or the unsafe harbor percentage test

Benefits Test

“

“A self-insured medical reimbursement plan satisfies the requirements of [the discrimination rules] only if...the benefits provided under the plan do not discriminate in favor of participants who are highly compensated individuals.”

(Code §105(h)(2)(B))

“

“A self-insured medical reimbursement plan does not meet the [Benefits Test] unless all benefits provided for participants who are highly compensated individuals are provided for all other participants.”

(Code §105(h)(4))

Benefits Test

- Plan must not discriminate, either on its face (based on design) or in actual operation
 - Only plan participants are tested
 - All benefits provided to HCIs must be provided to all other participants
 - There is either no required contribution, or the contribution is identical for all participants
 - All the benefits for dependents of HCIs must also be available to dependents of all non-HCI participants
 - Plan disaggregation might help
- **“Permitted” Discrimination**
 - Fully insured health plans (Section 125 cafeteria plan rules will still apply)
 - Plan covering Executive Physicals at no cost

Dependent Care FSAs



Statutory Provisions

“

“The contributions or benefits provided under the plan shall not discriminate in favor of employees who are highly compensated employees (within the meaning of section 414(q)) or their dependents.”

(Code §129(d)(2))

“

“The program shall benefit employees who qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of employees described in paragraph (2), or their dependents.”

(Code §129(d)(3))

Statutory Provisions

“

“Not more than 25 percent of the amounts paid or incurred by the employer for dependent care assistance during the year may be provided for the class of individuals who are shareholders or owners (or their spouses or dependents), each of whom (on any day of the year) owns more than 5 percent of the stock or of the capital or profits interest in the employer.”

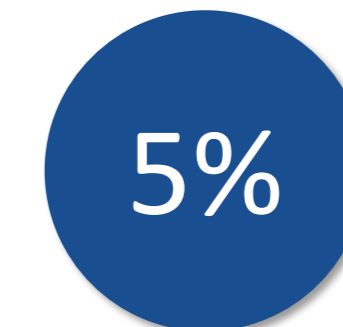
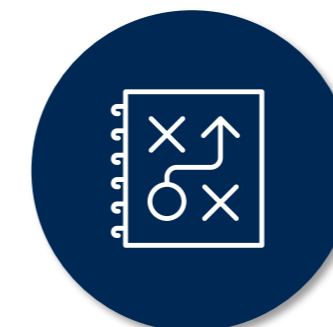
(Code §129(d)(4))

Highly Compensated Employees

WHO IS A HIGHLY COMPENSATED EMPLOYEE (HCE)?

- An employee who owns 5% or more of the voting power or value of all classes of stock of the employer in the current or preceding plan year
 - » Attribution rules apply
- Compensation threshold: \$150,000 or more for 2023; \$155,000 or more for 2024
 - » Determined based on preceding plan year

Similar to, but not the same as, HCE definition that applies under Section 125



Dependent Care Assistance Plans (DCAPs) (§129)

Eligibility Test

- Ensures that a reasonable percentage of non-HCEs are eligible to participate in the DCAP
- If not enough non-HCEs can get in, the DCAP will fail the Eligibility Test

Contributions and Benefits Test

- Ensures that HCEs or their dependents are not eligible to receive better benefits and are not authorized to make lower contributions for equal benefits

5% Owner Concentration Test

- Ensures that the total amount of dependent care assistance provided to >5% owners and shareholders does not exceed 25% of the benefit provided to all employees

55% Average Benefits Test

- Ensures that HCEs do not participate disproportionately in the Dependent Care FSA. The 55% Average Benefits Test focuses on the average (per capita) benefit received by HCEs as compared to that received by non-HCEs

Dependent Care Assistance Plans (DCAPs) (§129)

Generally, includes testing all employees who are not in an excludable class

- Excludable classes of employees (not required to be included in testing) for purposes of eligibility and 55% average benefits tests:
 - » Employees not included in a dependent care FSA who are members of a collective bargaining unit
 - » Employees not included in a dependent care FSA who are under age 21
 - » Employees not included in a dependent care FSA who have less than one year of service
 - » Self-employed (e.g., partners, 2% S corp shareholders)?
- Excludable employees for just 55% average benefits test
 - » Employees who earn less than \$25,000

Eligibility Test



Purpose

To determine whether an appropriate mix of HCEs and non-HCEs is eligible for benefits

Nondiscriminatory classification test requiring:

- Objective business classification (not favoring HCEs) may be used to determine eligibility
- Sufficient ratio of non-HCEs to HCEs eligible to participate in the cafeteria plan (Safe Harbor percentage test)
- Count all employees eligible at any time during the plan year

Contributions & Benefits Test

Availability: Can HCEs get more plan benefits (or employer contributions) than non-HCEs?

- Does the employer offer HCEs better benefits or the same benefits on better terms?



EXAMPLE 1

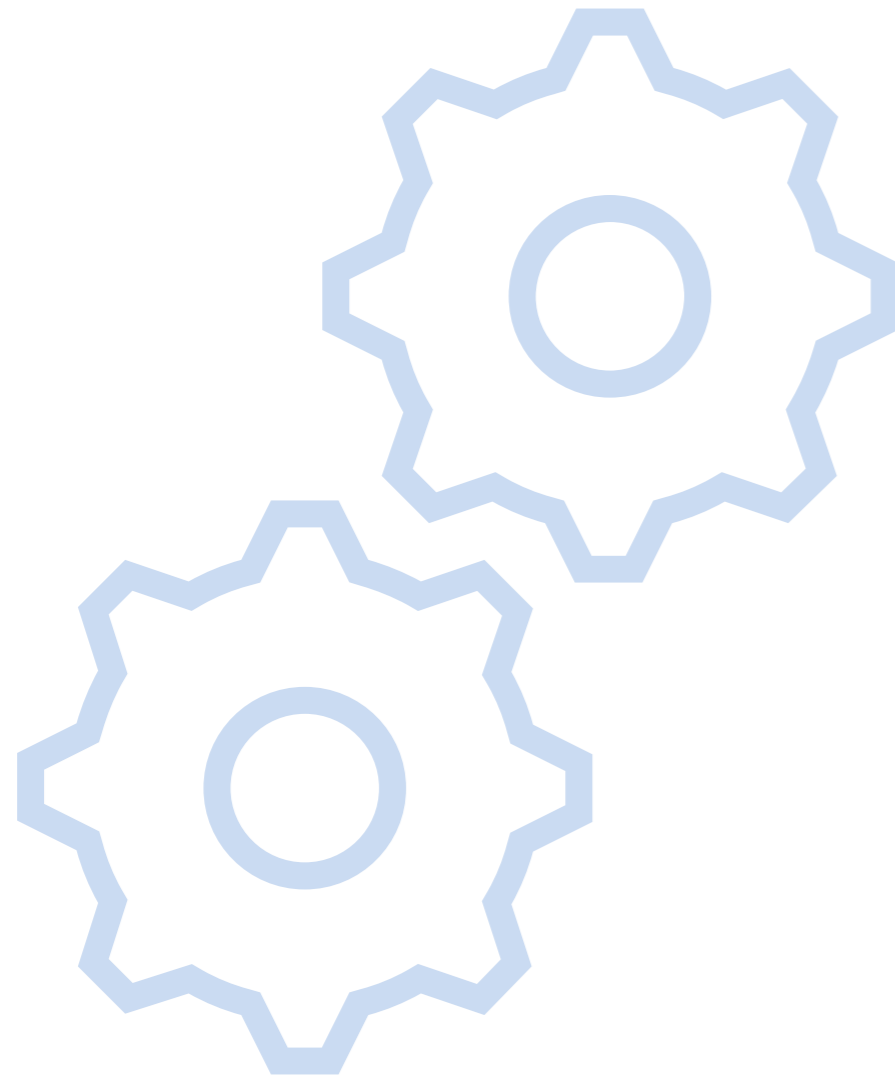
HCEs are eligible to elect full annual limit; non-HCEs have a lower cap on their elections



EXAMPLE 2

Employer matches dependent care expenses for HCEs; non-HCEs are eligible to salary reduce but receive no match

5% Owners Concentration Test



No more than 25% of the benefits may be provided to shareholders or owners

- Shareholders or owners owning more than 5% of the employer and their spouses and dependents
- Includes terminated employees
- Determines the total DCAP benefits and to ensure certain owners do not receive more than 25% of dependent care benefits
- This is a utilization test

Example

Total dependent care benefits paid to all employees = \$115,000

Benefits paid to 5% owners must not exceed \$28,750

$(\$115,000 \times 25\% = \$28,750)$

1

What is the total benefit paid to all employees?

\$115,000

2

What is maximum that may be paid to 5% (or more) owners of the company?

\$28,750

55% Avg. Benefits Test

Average benefits provided to non-HCEs must be at least 55% of average benefits received by HCEs

Code §129(d)(8):

- “A plan meets the requirements of this paragraph if the average benefits provided to employees who are not [HCEs] under all plans of the employer is at least 55% of the average benefits provided to [HCEs] under all plans of the employer.”
- Employees earning less than \$25,000 may be disregarded for purposes of this test

Note: Because lower-paid individuals may receive greater tax advantages if they use the Dependent Care Tax Credit, rather than a DCAP, this is the test that is most frequently failed

Example

	HCE	NHCE
Benefits	\$25,000	\$90,000
# of Employees	10	90* must include all employees
Average Benefit	\$2,500	\$1,000
Required NHCE	X	\$1,375

1

How many HCEs does the company have?

10

2

What is the total value of benefits available to the HCEs?

\$25,000 Avg. Benefit = 2,500

3

How many NHCEs does the company have?

90

4

What is the total value of benefits available to the NHCEs?

\$90,000 Avg. Benefit = \$1,000

5

Using the test formula of the average HCE benefit times 0.55, does the plan pass or fail this test?

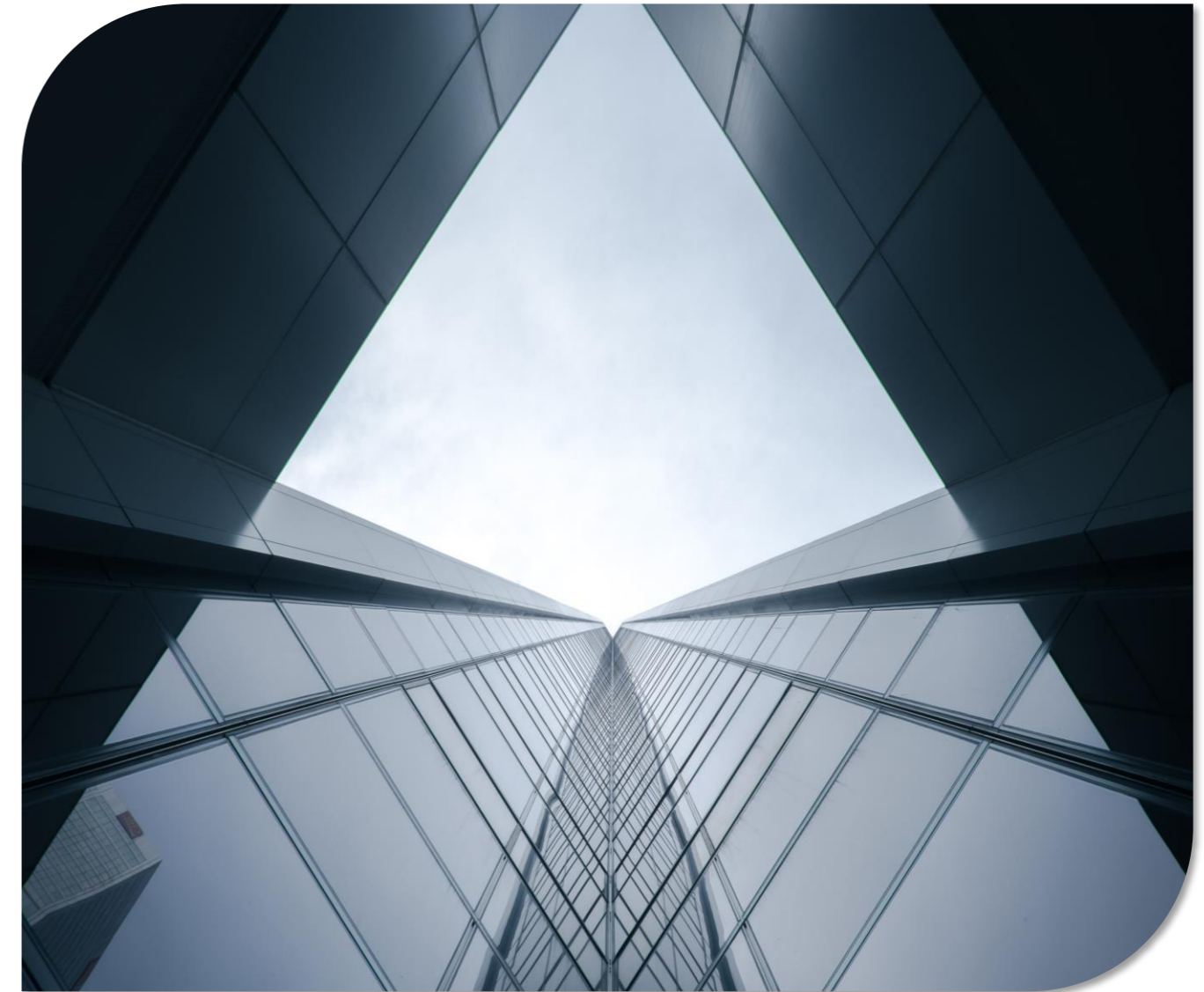
Fail - must have \$1,375 average to be at 55% of HCE)

If the Plan Is Discriminatory

If a plan discriminates, either on its face or in actual practice:

- Highly compensated participants lose tax-favorable treatment
 - » The benefits received under the DCAP are taxable income
 - » Plan sponsors may correct by adjusting HCP and owner elections before the end of the plan year
 - » No retroactive corrections after the end of the year

Benefits for non-HCPs retain tax-favored status



Life Insurance & Disability Plans



Life Insurance

Nondiscrimination Requirements

- May not discriminate in favor of “key” employees (slide 14)
- Eligibility test - In general, a plan is discriminatory unless:
 - » It benefits 70% or more of all employees;
 - » At least 85% of all employees who are participants under the plan are not “key” employees;
 - » It benefits employees who “qualify under a classification set up by the employer and found by the [IRS] not to be discriminatory in favor of key employees” (i.e., a reasonable classification similar to 125 test); or
 - » In the case of a plan which is part of a cafeteria plan, the requirements of Sec. 125 are met.
- Benefits test
 - » Plan is discriminatory “unless the type and amount of benefits available under the plan do not discriminate in favor of participants who are key employees” (i.e., “all benefits available to participants who are key employees are available to all other participants”)
 - » Either a facts and circumstances test or satisfaction of a Safe Harbor:
 - The amount of life insurance for covered employees bears a uniform relationship to the total compensation or the basic or regular rate of compensation of such employees.
 - All covered employees receive the same fixed amount of coverage.
 - Plan contains no group of employees that, if tested separately, would fail to satisfy the eligibility test. The group subject to separate testing consists of a key employee and all other participants (including other key employees) who receive, under the plan, an amount of insurance (as a multiple of compensation) that is equal to or greater than the amount of insurance received by such key employee.

Disability Insurance

There are no nondiscrimination requirements specific to disability plans.

- However, if paid for by employees on a pre-tax basis under the cafeteria plan, included in cafeteria plan nondiscrimination testing.



When should testing be done?



Testing Requirements

Is testing required?

The plan must be nondiscriminatory on each day of the plan year

- *“(1) In general. Nondiscrimination testing must be performed as of the last day of the plan year, taking into account all non-excludable employees (or former employees) who were employees on any day during the plan year.” Prop. Reg. 1.125-7(j)*
- *“(1) In general. In the case of amounts paid to a highly compensated individual under a self-insured medical reimbursement plan which does not satisfy the requirements of paragraph (2) **for a plan year**, subsection (b) shall not apply to such amounts to the extent they constitute an excess reimbursement of such highly compensated individual.” Code §105(h)(1).*
- To minimize need for retroactive adjustments to HCP elections, more frequent testing may be advisable:
 - » Prior to the beginning of the plan year
 - » Several months before the end of the plan year
 - » Immediately after close of the plan year
 - » After any significant shift in employee population/participation that impact outcome of testing

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