SECTIONS 105 AND 125 NONDISCRIMINATION RULES: A GUIDE FOR EMPLOYERS

Generally, employers that sponsor group health plans have flexibility to design the terms of plan eligibility, benefits, and contributions as they desire, so long as the plans do not violate Title VII- or HIPAA-type discrimination rules (i.e., discrimination based on age, sex, gender, disability, pregnancy, claims history, health or disability status, medical condition, etc.). Plans that are designed to offer the same benefits equally to all employees will generally satisfy nondiscrimination rules. However, employers that wish to vary plan eligibility criteria, benefits, or contributions for different employee populations will need to review the nondiscrimination rules of IRC Sections 105 and 125. Both sets of rules generally prohibit plan designs that intentionally or unintentionally favor highly compensated employees (HCEs, as further defined below).

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Employers, human resource managers, plan administrators, and company executives should be aware of the nondiscrimination rules under both Sections 105 and 125. This publication examines the types of plans subject to both sets of rules, the nondiscrimination requirements, problematic plan designs, timing of testing, the definition of HCE, the types of tests that must be satisfied, and the consequences of a discriminatory plan design. It includes a chart of **IRS Limits on Retirement Benefits and Compensation**, including the HCE and key employee thresholds for current and prior years (Appendix A) and a **Sample Employee Communication** for notifying HCEs of benefit election adjustments that may be required to satisfy nondiscrimination testing (Appendix B).

Note: While not the focus of this publication, dependent care FSAs, also called dependent care assistance programs (DCAPs), are subject to a different set of nondiscrimination rules, found in IRC Section 129. The DCAP nondiscrimination rules also prohibit the favoring of HCEs and contain the same general eligibility and benefits tests; however, there are some significant differences from the Sections 105 and 125 rules. Importantly, the DCAP rules have a specific utilization test, called the 55% average benefits test, which leaves employers particularly vulnerable to nondiscrimination failures. For further information regarding DCAP nondiscrimination rules, see the PPI publications **Section 129 Nondiscrimination Rules: A Guide for Employers** and **Quick Reference Chart: Nondiscrimination Rules**. For further information about the application of Section 79 nondiscrimination rules to employer-provided group term life insurance – another popular employee benefit – see the PPI publication **Group Term Life Insurance: A Guide for Employers**.

TYPES OF PLANS SUBJECT TO NONDISCRIMINATION RULES

Section 105 applies exclusively to self-insured plans. (The ACA, as drafted, actually applies Section 105 to fully insured non-grandfathered plans, but the IRS has delayed implementation and enforcement of that ACA provision until further notice.) Self-insured plans include any type of major medical plan (HMO, PPO, HDHP, etc.), health FSAs and HRAs.

Section 125 applies to both self-insured and fully insured plans if employees can pay any required cost-share contribution to the plan on a pre-tax basis via salary reduction. Because most employers sponsor a Section 125 plan, Section 125 nondiscrimination rules apply in most situations. That includes the Section 125 plan itself (including a so-called "POP," or premium only plan), health FSAs, and employer/employee pre-tax HSA contributions.

GENERAL REQUIREMENTS AND PROBLEMATIC PLAN DESIGNS

Generally speaking, both Sections 105 and 125 prohibit plan designs that favor HCEs. If eligibility, benefits, and contributions are available to all employees on the same terms, then the plan design likely satisfies both Sections 105 and 125 nondiscrimination rules. But if there is variance in eligibility, employer contributions towards premiums, benefits, waiting periods, or any other plan terms, then the nondiscrimination rules may be implicated. The following plan designs may be problematic when it comes to Sections 105 and 125 nondiscrimination:

- Longer waiting periods for lower paid employees
- A richer benefit plan available only to a group of supervisors or managers
- Higher employer contribution amounts for higher paid employees
- Coverage of certain benefits available only to highly paid employees or executives
- Higher HRA reimbursements for higher paid employees
- Lower deductibles or other cost-sharing requirements for higher paid employees

GENERAL CONCEPTS: CONTROLLED GROUPS AND TESTING TIMEFRAME

Controlled Groups (Companies Under Common Ownership)

Generally, the Sections 105 and 125 nondiscrimination testing rules apply on a per plan basis, and single employer plans are tested on their own. That said, the controlled group and affiliated service group rules of Section 414(b), (c), and (m) are expressly applied to Sections 105 and 125 nondiscrimination testing. This means that where two or more employers are under common ownership, employees of all employers must be included in determining the HCE group and in performing the nondiscrimination tests. Employers should confer with legal counsel as needed to determine whether a group of companies is under common ownership.

When to Perform Nondiscrimination Testing

The rules do not prescribe a specific date or timeframe for performing nondiscrimination testing; they simply provide that the plan must not be discriminatory as of the last day of the plan year. The tests take into account all non-excludable employees who were employed on any day during the plan year, including employees who are no longer active as of the testing date. To help ensure that the plan will pass testing, a general best practice is to perform nondiscrimination testing shortly after open enrollment (prior to the start of the plan year) or early in the plan year. This gives employers ample time to determine whether additional steps must be taken before the end of the plan year.

Employers should also monitor and revisit the testing at least once during the year, particularly if there are significant changes in employee composition, such as new hires, salary changes, etc. Finally, employers should perform the tests (or confirm prior tests) at the end of the year to confirm compliance by the last day of the plan year. Also, if the employer is involved in a business reorganization (such as a merger or acquisition), the testing should be reviewed as part of the reorganization process. For further discussion of nondiscrimination testing and other compliances concerns in the context of mergers and acquisitions, see the PPI publication **Health Benefits Compliance Considerations in Mergers and Acquisitions: A Guide for Employers**.

Definition of Highly Compensated Employee

For purposes of determining which employees and individuals are HCEs, the definition of HCE under Section 105 is different than that under Section 125, as outlined in the following chart:

HCE Under Section 105*	HCE Under Section 125
One of the five highest paid officers	Any officer
More-than-10% shareholder/owner	More-than-5% shareholder/owner
Among highest-paid 25% of all employees	Compensation in excess of the indexed threshold for HCEs (see Appendix A)

*As a technical matter, Section 105 uses the term "highly compensated individuals" (HCIs) to describe the parties in whose favor the plan cannot discriminate, whereas Section 125 uses the term "highly compensated employees" (HCEs). In practice, the terms are often used interchangeably except where specific distinctions between the two are material to the discussion. For readability, this publication uses HCE throughout.

As noted in the chart, the definition of HCE under Section 105 is generally broader than under Section 125, as it includes the top-25%-paid employee group. In addition, while Section 125 explicitly directs employers to use the prior plan year's compensation amounts in determining whether an employee has compensation in excess of the indexed threshold, Section 105 has no such explicit direction. (Most employers use the current plan year compensation when determining whether an officer is one of the five highest paid officers.) Also, the rules for determining which employees are HCEs by virtue of their status as officers or shareholders differ between Sections 105 and 125. Employers should be aware of these differences in administering both sets of nondiscrimination tests.

Employers with a high percentage of HCEs may use a special rule called the "Top-Paid Group Election". This election allows the plan to designate as HCEs the highest-paid 20% of all employees. Under this election, the plan tests these top 20% earners as the only HCEs. Importantly, employers that make this election must use it for nondiscrimination testing of all qualified benefits, including retirement plans. Employers should ask their nondiscrimination testing vendor to review the breakdown of HCEs and non-HCEs before implementing the Top-Paid Group Election.

DETAILS OF THE NONDISCRIMINATION TESTS

High Level Overview of Sections 105 and 125 Testing

Nondiscrimination testing is implicated any time an employer varies plan eligibility, benefits, contributions, waiting periods, or plan design cost-sharing (e.g., deductibles and co-insurance). Generally, both Sections 105 and 125 allow a variance based on bona fide business classifications, provided the result does not favor HCEs. At a high level, the assessment of a potentially discriminatory plan design breaks down into two questions: 1) Is the variance based on a business classification; and 2) Does the result of the variance favor HCEs?

On the first question, bona fide business classifications include those based on an objective business purpose (in other words, there must be a business reason for forming the classification — it can't be formed solely to divide employees with respect to benefit offerings). Examples of allowable classifications include different geographic locations, offices, business lines, job titles, or hourly work expectations. Other examples include salaried versus hourly, part-time versus full-time, or union versus non-union. With that in mind, if the answer to the first question is no, then the plan design is considered discriminatory and therefore not allowed (see more on the consequences of discriminatory plan designs below). On the other hand, if the answer to the first question is yes, then the employer can proceed to the second question.

On the second question, the employer must examine the employee classification that is receiving the superior benefit (i.e., shorter waiting period, higher employer contribution, richer plan design, etc.), and determine whether that classification has numerically more HCEs than non-HCEs (i.e., more than 50% of the participants are HCEs). If the answer to the second question is yes, then the plan design is likely considered discriminatory and therefore not allowed (see more on the consequences of discriminatory plan designs below). On the other hand, if the answer to the second question is no, then the plan design is likely nondiscriminatory and therefore allowed.

These two questions help determine whether additional testing is necessary.

Section 105 Testing

Under Section 105, a plan must satisfy two tests to be considered nondiscriminatory: the eligibility test and the benefits test.

Eligibility Test

With respect to the eligibility test, a plan must not discriminate in favor of HCEs as to eligibility to participate. A plan that satisfies any one of the following three alternative tests will pass the eligibility test:

- **Alternative Test 1:** The plan must actually benefit 70% or more of all employees (i.e., 70% or more of all employees must be enrolled in the plan).
- **Alternative Test 2:** 70% or more of all employees must be eligible to participate in the plan; of those eligible to participate, 80% or more must actually benefit under the plan.
- **Alternative Test 3:** The plan is designed to benefit a classification of employees that is found by the Secretary of the Treasury (i.e., the federal government) not to be discriminatory in favor of HCEs. This is known as the "reasonable classification test."

With respect to Alternative Tests 1 and 2, certain employees may be excluded from the calculations. Excludable employees include:

- Employees with less than three years of service
- Employees who have not attained age 25 as of the testing date
- Part-time employees (generally, employees who work less than 25 hours per week; the threshold may be 35 hours per week in some circumstances)
- Seasonal employees (generally, employees who work less than seven months per year; the threshold may be nine months per year in some circumstances)
- Employees covered by a collective bargaining agreement (if health benefits have been a subject of good faith bargaining)
- Nonresident aliens with no US-source income

Exclusion of employees in any of these categories is optional, and excluded employees may be disregarded when applying the eligibility test (and also the benefits test, as outlined in more detail below). However, an otherwise excludable employee who is eligible for and participating in the plan must be included in the testing.

With respect to the reasonable classification test (Alternative Test 3), IRS regulations simply provide that the classification must be reasonable and must not favor HCEs. Without explicit direction, many practitioners believe a plan will satisfy the reasonable classification test if it satisfies the two-step nondiscriminatory classification test applied under Section 410(b). The first step requires that the classification of employees is based upon a bona fide employment classification consistent with the employer's usual business practice. Examples of such bona fide classifications include full-time versus part-time status; current versus former employee status; union versus nonunion status; different geographic location, occupation type, or business line; and date of hire. (Note that under Section 125, fully insured plans are permitted to classify employees based on salary, age, or length of service; however, these classification criteria are explicitly prohibited under Section 105 and therefore cannot be used for self-insured plans.) The second step requires that the classification of employees also be considered nondiscriminatory based on a certain safe harbor percentage rate described in IRS regulations. Since this test involves making a determination based on the facts and circumstances of each particular case, employers that seek to satisfy the reasonable classification test should consult with their testing vendor or legal counsel.

Although the eligibility test prohibits a plan from discriminating in favor of HCEs as to "eligibility to participate," each of the three alternative tests is phrased in terms of who benefits under the plan. This naturally leads to the question: what does it mean to benefit? To benefit, must the employee simply be eligible to participate in the plan, or must the employee actually elect to participate? While Alternative Tests 1 and 2 clearly distinguish between eligibility for versus actual participation in a benefit plan, Alternative Test 3 is less clear. While both interpretations may find support in the regulations and other IRS guidance, cautious employers will likely take the approach that actual participation is required for an employee to be deemed to benefit under the plan. Under this more cautious approach, an employee who waives participation in an eligible benefit is treated as a nonparticipant rather than as a zero-dollar participant.

Eligibility Test Examples

As an example of Alternative Test 1, consider the following:

ABC Corp. sponsors a self-insured medical plan and has 10 employees; five are HCE supervisors, two are non-HCE office managers, and three are non-HCE administrative assistants. ABC Corp. provides 100% medical plan coverage at no cost to all five HCE supervisors and the two non-HCE office managers (seven in total), all of whom are enrolled in the plan. The plan satisfies the 70% test (Alternative Test 1), since 70% of the employees actually benefit from the plan.

As an example of Alternative Test 2, consider the following:

XYZ Corp. sponsors a self-insured medical plan and has 10 employees; five are HCE supervisors, two are non-HCE office managers, and three are non-HCE administrative assistants. All five HCE supervisors and the two non-HCE office managers (seven in total) are eligible to participate. However, only six of the seven eligible employees elect to participate in the plan. The plan satisfies the 70%/80% test (Alternative Test 2), since 70% or more of all the employees are eligible to participate in the plan and 80% or more of the eligible employees (six out of seven is greater than 80%) actually elect coverage.

Benefits Test

With respect to the benefits test, both HCEs and non-HCEs (and any dependents) must generally be provided with the same benefits. Certain excludable employees (as defined above) may be excluded for purposes of the benefits test, which examines the actual receipt of benefits. As a reminder, an otherwise excludable employee who is eligible for and participating in the plan must be included in the testing. The benefits test has two components: facial discrimination and operational discrimination.

Generally, to pass the benefits test as it relates to discrimination on the plan's face, the following must be true:

- Employer contribution levels must not favor HCEs.
- Maximum benefit and employer contribution levels may not vary based on age, compensation, or years of service. (This rule applies to Section 105 plans but does not apply to Section 125 plans.)
- Types and amounts of reimbursable medical expenses must not favor HCEs.
- The waiting period for benefits must be the same for all employees

Thus, any plan design where the employer varies premium contributions or benefit levels based on age, compensation, or years of service would be discriminatory on its face. Similarly, plans with disparate (different length) waiting periods would be discriminatory. That said, although the benefits test contains an explicit prohibition on disparate waiting periods, many industry experts believe that disparate waiting periods are allowed, so long as the result doesn't intentionally or unintentionally favor HCEs. So, for example, if there are different waiting periods for an employer's downtown location as compared to its uptown location, the disparate waiting periods may be permissible if the result doesn't favor HCEs (meaning, at a high level, that the location with the shorter waiting period has more non-HCEs than HCEs). Similarly, although Section 105 explicitly says employer premium contribution levels cannot vary based on compensation, a design that requires higher paid employees to pay a higher amount toward premiums would be permissible (since the result is that lower paid employees receive the superior benefit, a result that is in line with the discrimination rules generally).

Overall, any plan design that does not meet the four requirements bulleted above requires additional scrutiny to ensure it is not discriminatory on its face.

Discrimination in operation may occur any time the operation of the plan favors HCEs over non-HCEs. This can occur where the duration of a particular benefit coincides with the period during which more HCEs than non-HCEs can utilize such benefit. For example, if an HCE needed emergency surgery, and the plan was amended temporarily to provide coverage for that particular surgery such that only the HCE (and no non-HCEs) would benefit from the amended coverage, the plan would be discriminatory in operation.

Section 125 Testing

Section 125 has the same basic eligibility and benefits tests as Section 105 (as described above and except as otherwise noted), including the three alternative tests to satisfy the eligibility test and the facial/operation components of the benefits test. However, there are some notable differences when performing the tests themselves, the biggest of which is the differences in excludable employees. In addition, the Section 125 testing adds a third test, called the key employee concentration test.

Section 125 Excludable Employees

In performing the Section 125 eligibility and benefits tests, employers can exclude the following employees:

- Employees covered by a collective bargaining agreement (if health benefits have been a subject of good faith bargaining)
- Nonresident aliens with no US-source income
- Employees participating in the cafeteria plan as COBRA participants

Notably, unlike Section 105, employers cannot exclude employees with less than three years of experience, part-time or seasonal employees, or employees who have not attained age 25. Thus, Section 125 testing will include a broader swath of employees, as compared to Section 105 testing.

Key Employee Concentration Test

The key employee concentration test, which is unique to Section 125, is meant to ensure that key employees do not receive more than 25% of the aggregate benefits offered through the cafeteria plan. In a sense, this test is a utilization test: it looks at the actual benefits provided via Section 125. It does this by determining the total value of nontaxable benefits provided under the cafeteria plan (whether funded by true employer contributions or employer contributions made through employee salary reduction elections) and determining whether key employees receive more than 25% of the total value. Importantly, a key employee is an officer with annual compensation in excess of the specified threshold (see Appendix A), a more-than-5% shareholder/owner or a more-than-1% shareholder/owner with compensation in excess of $150,000 (not indexed). The term "officer" generally refers to administrative executives with high-level decision-making authority, such as C-suite individuals. Whether an individual is an officer for purposes of the key employee definition is a facts and circumstances determination that employers should make in consultation with legal counsel.

Note that collectively bargained (union) plans and plans of governmental entities are the only exceptions to the key employee concentration test rules (i.e., governmental entities and employers with a union population do not have to perform the key employee concentration test for the excepted populations).

CONSEQUENCES OF A DISCRIMINATORY PLAN DESIGN

Under both Sections 105 and 125, a discriminatory plan design results in adverse tax consequences (i.e., HCEs are generally taxed on their "excess reimbursements"). The exact amount of the taxable excess reimbursement depends on the type of nondiscrimination test failure (i.e., eligibility or benefits test failure). For eligibility test failures, the excess reimbursement is determined through a somewhat complicated equation. Basically, it is determined by multiplying the benefits received by the HCE during the plan year by a fraction. The numerator of the fraction is the amount of total benefits paid to or for all HCEs for the plan year, while the denominator is the total amount of benefits paid to all participants for the plan year (including plan year participants who are no longer active employees when the testing is performed). For benefits test failures, the entire amount of the discriminatory benefit received by the HCE constitutes an excess reimbursement and must therefore be included in the HCE's taxable income. See Appendix B, **Sample Employee Communication**, for a sample notice to HCEs whose benefit elections must be adjusted to satisfy nondiscrimination testing.

Importantly, non-HCEs are not affected by a discriminatory plan design; they still qualify for all of the tax advantages associated with the plan. In addition, there are no monetary penalties for employers for offering a discriminatory plan design; the consequence is borne solely by the affected HCEs.

SUMMARY

Employers of all sizes and types must consider Sections 105 and 125 nondiscrimination rules, particularly if the employer imposes any variance among employees with respect to eligibility, contributions, or benefits. Employers must ensure that the plan design doesn't intentionally or unintentionally favor HCEs. Employers must therefore identify which employees are HCEs and ensure that the eligibility, benefits, and key employee concentration tests are completed before the end of the plan year. All employers in a controlled group should be included in the nondiscrimination testing.

PPI BENEFIT SOLUTIONS

APPENDIX A

IRS Limits on Retirement Benefits and Compensation

	2024	2023	2022
401(k) and 403(b) plan elective deferrals	$23,000	$22,500	$20,500
Catch-up contributions (age 50 and older)	$7,500	$7,500	$6,500
Annual compensation limit	$345,000	$330,000	$305,000
Highly compensated employee threshold*	$155,000	$150,000	$135,000
Key employee compensation threshold*	$220,000	$215,000	$135,000
Defined contribution 415 limit	$69,000	$66,000	$61,000
Defined benefit 415 limit	$275,000	$265,000	$245,000
SIMPLE employee contribution limit	$16,000	$15,500	$14,000

See **www.irs.gov** for more information.

*In general, compensation means total compensation from the employer, including bonuses or commissions as well as contributions made through a 401(k) plan (or similar retirement plan) or through a cafeteria plan or qualified transportation benefit plan.

The chart above is excerpted from the PPI publication **Employee Benefits Annual Limits**. See that publication for other annual limits that affect group health plans.

PPI BENEFIT SOLUTIONS

APPENDIX B

Sample Employee Communication

To: [Personalized Name of Affected HCE Plan Participant]

Subject: Nondiscrimination Testing for [Name of Benefit Plan] for Plan Year [YYYY]

In order for [Name of Company] to pass nondiscrimination testing for the above-referenced benefit plan, we are required from time to time to take corrective measures that include reducing the pre-tax benefit plan contributions of highly compensated employees. This action allows us to maintain the plan's favorable tax status and safe harbor provisions.

Based on the most recent nondiscrimination tests, we have determined that we must reduce your benefit plan election for the referenced plan year as follows:

[Insert details of original and revised plan year election amounts]

If you have already contributed more than the revised plan year amount as of the date of this notice, the excess amount will be returned to you as taxable income as soon as administratively practicable.

Please contact the Human Resources department at [HR email contact] if you have any questions.