

NONDISCRIMINATION RULES: QUICK REFERENCE CHART

Section 125/Cafeteria Plans, Section 105 (for Self-Insured Plans/HRAs/Health FSAs), Dependent Care FSAs, and Group Term Life Insurance

Nondiscrimination rules are meant to discourage employers from providing tax-favored benefits disproportionately to executives and other highly compensated employees (HCEs) and/or key employees.

At a high level, under general federal income taxation principles, compensation in any form that is paid or provided by an employer to an employee constitutes taxable income (wages), unless a section of the Internal Revenue Code (IRC) provides a specific income exclusion rule. Several IRC sections include exclusions for certain employer-provided benefits. Those include group term life insurance (Section 79), self-insured health benefits, including HRAs and health FSAs (Section 105), and dependent care FSAs, also called dependent care assistance programs (DCAPs) (Section 129). In addition, qualified benefits offered through a cafeteria plan (e.g., pre-tax salary reduction contributions towards health insurance premiums, DCAPs, or health FSAs) qualify for an income tax exclusion (Section 125).

That said, each of those IRC sections comes with some strings attached. Of primary importance are the so-called nondiscrimination rules, which are meant to discourage employers from providing tax-favored benefits disproportionately to executives and other highly compensated employees (HCEs) and/or key employees. To satisfy the IRS, employers that rely on income exclusion rules must demonstrate, through nondiscrimination testing, that the benefit plan design does not intentionally or unintentionally favor HCEs/key employees. While the nondiscrimination rules and testing procedures are not uniform for every plan or benefit type, they share the following elements:

- A prohibited group of individuals (HCEs/key employees) in whose favor the plan cannot discriminate
- Categories of employees who can be excluded from testing (if not eligible for benefits)
- An eligibility test to ensure that a sufficient number of non-HCEs/key employees are eligible to participate in the plan or benefit
- A benefits test to ensure that HCEs/key employees are not receiving benefits and/or employer contributions on more favorable terms than non-HCEs/key employees
- A utilization test to ensure that HCEs/key employees are not disproportionately benefiting from the plan
- Adverse tax consequences in the event that the plan fails a required nondiscrimination test

The **Nondiscrimination Rules Quick Reference Chart** on the next page outlines the component nondiscrimination test for each IRC section and the corresponding HCE or key employee definitions. 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 other IRC sections use 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. 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.

For further information specifically on Sections 105 and 125 nondiscrimination rules DCAP nondiscrimination rules, respectively, see the PPI publications **Sections 105 and 125 Nondiscrimination Rules: A Guide for Employers** and **Section 129 Dependent Care Assistance Program Nondiscrimination Rules: A Guide for Employers**. For further information about the application of Section 79 nondiscrimination rules to employer-provided group term life insurance, see the PPI publication **Group Term Life Insurance: A Guide for Employers**.

Nondiscrimination Rules: Quick Reference Chart

Plan Type	IRC Section	Component Tests	Compensation/Definition for Determining HCE/Key Employee Status
Section 125/Cafeteria Plans (including premium-only plans (POPs), health FSAs, DCAPs, and employer/employee contributions to HSAs)	Section 125	<ul style="list-style-type: none"> • Eligibility Test • Benefits Test • Key Employee Concentration Test 	<p>HCE:</p> <ul style="list-style-type: none"> • Any officer • More-than-5% owner/shareholder • Any employee with compensation in excess of the indexed threshold (\$155K for 2024; \$160K for 2025; TBD for 2026) <p>Key Employee:</p> <ul style="list-style-type: none"> • Officer with compensation in excess of the specified threshold (\$220K for 2024; \$230K for 2025; TBD for 2026) • More-than-1% owner/shareholder with compensation in excess of \$150K (not indexed)
Self-Insured Group Health Plans (including HRAs and health FSAs)	Section 105	<ul style="list-style-type: none"> • Eligibility Test • Benefits Test 	<p>HCE:</p> <ul style="list-style-type: none"> • One of the five highest-paid officers • More-than-10% owner/shareholder • Among highest-paid 25% of all employees
Dependent Care FSAs (also called dependent care assistance programs, or DCAPs)	Section 129	<ul style="list-style-type: none"> • Eligibility Test • Benefits Test • More-than-5% Owner Concentration Test • 55% Average Benefits Test • Eligibility Test • Benefits Test 	<p>HCE:</p> <ul style="list-style-type: none"> • Employee with compensation in excess of the indexed threshold (\$155K for 2024; \$160K for 2025; TBD for 2026)
Group Term Life Insurance (GTLI)	Section 79		<p>Key Employee:</p> <ul style="list-style-type: none"> • Officer with annual compensation in excess of the specified threshold (\$220K for 2024; \$230K for 2025; TBD for 2026) • More-than-5% owner/shareholder • More-than-1% owner/shareholder with compensation in excess of \$150K (not indexed)