SECTIONS 105 AND 125 NONDISCRIMINATION RULES: A GUIDE FOR EMPLOYERS

Employers, human resource managers, plan administrators, and company executives should be aware of the nondiscrimination rules under both Sections 105 and 125.

Generally, employers that offer self-insured group health plans or benefits through a cafeteria plan have broad discretion in designing plan eligibility, benefits, and contributions. However, this flexibility is subject to nondiscrimination requirements under IRC Sections 105(h) and 125, which aim to prevent tax-favored treatment that disproportionately benefits highly compensated employees (HCEs). Plans that offer the same eligibility and benefits to all employees are more likely to satisfy the nondiscrimination rules, but employers should be mindful that uniform design alone does not guarantee compliance — particularly if participation patterns suggest that only highly compensated or key employees are effectively able to take advantage of the benefits. Employers that wish to vary plan terms across employee groups must carefully evaluate whether the plan design could result in impermissible discrimination in favor of HCEs or key employees. Failure to comply with these rules may result in adverse tax consequences for the favored individuals.

Employers and those implementing or administering self-insured group health plans, including health savings accounts (HSAs) and health flexible spending arrangements (FSAs), and/or qualified benefits through a cafeteria plan should be familiar with the nondiscrimination provisions underSections 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 **Dependent Care Assistance Program Nondiscrimination Rules: A Guide for Employers** and **Nondiscrimination Rules: A Quick Reference Chart**. 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 125 nondiscrimination rules apply to "qualified benefits" offered through a cafeteria plan, including both self-insured and fully insured medical coverage, health FSAs, and health reimbursement arrangements (HRAs). (For a list of qualified cafeteria plan benefits, see the NFP publication Midyear Election Change Events: A Guide and Matrix for Employers.) Section 125 applies whenever employees pay required cost-share contributions on a pre-tax basis through salary reduction under a cafeteria plan (often referred to as a "Section 125 plan" or

Flex Plan"). Because most employers sponsor a cafeteria plan as a way to fund benefits, these nondiscrimination rules apply in most cases, including to premium-only plans (POPs), health FSAs, and 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 under Section 414 apply, meaning employees of all commonly owned or affiliated employers must be aggregated when identifying HCEs and performing the 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. For a discussion of informal midyear election change events when a plan is found to be discriminatory, see the PPI publication **Midyear Election Change Events: A Guide and Matrix for Employers**.

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 or salary changes. 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 compliance 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% owner/shareholder	More-than-5% owner/shareholder
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 meets the IRS's "reasonable classification" standard, meaning the classification is based on objective business criteria and does not favor HCEs.

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. 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 three non-HCE administrative assistants are not eligible for 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 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, all of 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 could be problematic if HCEs participate in the plan. Similarly, plans with waiting periods of different lengths, as permitted under the ACA, could be discriminatory. However, cost-sharing that is inversely related to a percentage of salary, such that non-HCEs receive a superior benefit, would seem to be permissible. In addition, 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 consistent with the nondiscrimination rules generally). For further discussion of cost-share contribution strategies, see the PPI publication **Cost-Share Contribution Models: A Guide for Employers**.

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. Generally, though, contributions and benefits must be available on a nondiscriminatory basis and HCEs may not select more nontaxable benefits (e.g., health coverage) than non-HCEs. For purposes of cost-sharing, this means HCEs may not disproportionately benefit, directly or indirectly, from a lower cost-share than non-HCEs. For example, the cost of a health insurance premium paid through a cafeteria plan may not be lower for HCEs than for non-HCEs. Additionally, the premium, based as a uniform percentage of compensation, may not disproportionately benefit HCEs. Under the cafeteria plan rules, cost-sharing arrangements that disproportionately benefit non-HCEs would be permissible.

All of that said, 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% owner/shareholder, or a more-than-1% owner/shareholder 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 for HCEs. For self-insured plans, HCEs may lose the tax exclusion for employer-paid premiums or be taxed on "excess reimbursements." The amount of taxable excess reimbursement depends on the type of test failure. For eligibility test failures, the excess is calculated using a formula that compares the benefits received by HCEs to those received by all participants. For benefits test failures, the full value of the discriminatory benefits received by the HCE is taxable.

For cafeteria plans, a failure of the nondiscrimination rules results in the loss of favorable tax treatment for the affected HCEs or key employees. In such cases, the value of the discriminatory benefits (e.g., pre-tax premiums, FSA contributions) must be included in the employee's gross income.

In both cases, the plan remains valid for non-HCEs, but employers must report and withhold taxes appropriately for those employees who lose the exclusion. 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.

Although the rules do not expressly permit corrective action for testing failures discovered during the plan year, informally the IRS has acknowledged that adjustments, such as reducing HCE elections, may be permissible. Any such action must be supported, however, by plan documentation. Employers are encouraged to test early and consult with legal counsel or third-party administrators to proactively address any compliance concerns. For a discussion of informal election change events that include nondiscrimination failures, see the NFP publication Midyear Election Change Events: A Guide and Matrix for Employers. See Appendix B, Sample Employee Communication, for a sample notice to HCEs whose benefit elections must be adjusted to satisfy nondiscrimination testing.

SUMMARY

To preserve the tax advantages for all participants in self-insured health plans and cafeteria plans, employers must ensure compliance with the nondiscrimination rules under Sections 105 and 125. This requires identifying HCEs and applying the relevant statutory tests: the eligibility test, the benefits/contributions test, and the key employee concentration test (under Section 125). All entities within a controlled group must be included for testing purposes. While uniform eligibility rules may reduce the risk of discrimination, employers should be aware that actual participation patterns, particularly under Section 125's utilization-based tests, can still result in a discriminatory outcome.

PPI BENEFIT SOLUTIONS

APPENDIX A

IRS Limits on Retirement Benefits and Compensation

	2026	2025	2024
401(k) and 403(b) plan elective deferrals	TBD	$23,500	$23,000
Catch-up contributions (age 50 and older)	TBD	$7,500*	$7,500
Annual compensation limit	TBD	$350,000	$345,000
Highly compensated employee threshold**	TBD	$160,000	$155,000
Key employee compensation threshold**	TBD	$230,000	$220,000
Defined contribution plan limit under Section 415	TBD	$70,000	$69,000
Defined benefit plan limit under Section 415	TBD	$280,000	$275,000
SIMPLE employee contribution limit	TBD	$16,500	$16,000

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

"*New effective 1/1/2025: individuals who attain age 60, 61, 62, or 63 in 2025 can make catch-up contributions up to $11,250 in 2025.

**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.

PPI BENEFIT SOLUTIONS