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NONDISCRIMINATION RULES

Employers often consider offering different levels of benefits to different classes of employees. Most human resources professionals, however, balk at these proposals. Their general reaction is that these arrangements are discriminatory. Although caution is certainly warranted, employers should understand that *different* does not necessarily mean *discriminatory*. A number of laws dictate what may be discriminatory in employee benefit plans.

This *Benefit Advisor* reviews the following rules that affect life and health benefits:

- Internal Revenue Code Section 105(h) nondiscrimination rules
- Section 125 nondiscrimination rules
- Section 79 related to group term life insurance plans
- Dependent care FSA nondiscrimination rules

In many cases, employers will know whether their plans discriminate only if they test them as the above rules require. Adding these tests to annual benefit plan processes is, therefore, critical. Many of these tests need to be conducted at an IRS control group level, not based an employer at the EIN (employer identification number) level.

It is always safest to offer the same benefit options under the same terms to all your employees. However, even if you offer the same options to all employees, you may still have to conduct the tests.

INTERNAL REVENUE CODE SECTION 105(H) NONDISCRIMINATION RULES

Section 105(h) rules currently apply only to self-funded medical plans. Under the Affordable Care Act (ACA), however, these nondiscrimination rules are proposed to apply to fully insured, non-grandfathered group health plans. In addition, the ACA included a different penalty for fully insured discriminatory plans. The ACA proposed penalty for fully insured plans that discriminate is $100 a day for each

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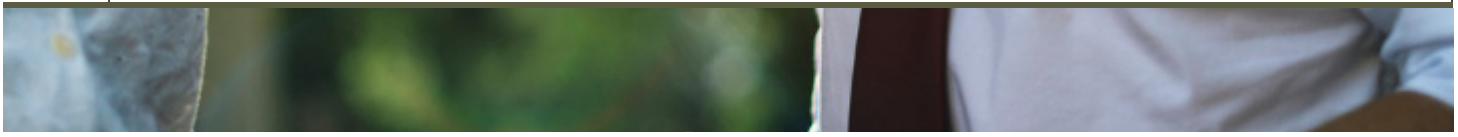
We welcome your comments and suggestions regarding this issue of our Benefit Advisor. For more information, please contact your Account Manager or visit our website at www.mma-mi.com.



person affected. The effective date of the application of these rules to fully insured plans is to be determined by regulations. No regulations have been issued to date. It is unclear if these rules will ever apply to fully-insured plans.

The Section 105(h) non-discrimination requirements for self-funded group health plans including health reimbursement arrangements (HRAs) and medical flexible spending accounts (FSAs) are as follows:

- A plan can't discriminate in favor of highly compensated employees (HCEs) in eligibility
- A plan cannot favor HCEs in benefits

Specific tests will show whether the plan discriminates in eligibility or benefits. The first step should always be to identify your HCEs. For these tests, HCEs are defined as:

- One of the five highest paid officers
- A shareholder who owns more than 10 percent of the employer's stock
- The highest paid 25 percent of all employees (excluding employees who do not participate in the employer's plan)

Determining HCEs and testing should be performed on an IRS controlled group basis.

Eligibility Test

A self-funded plan needs to pass one of the following three eligibility tests in order to be considered non-discriminatory in eligibility:

- The 70% test
- The 70%/80% test
- The nondiscrimination reasonable classification test

For all eligibility tests, employers can exclude the following employees:

- Those employed for fewer than three years
- Those under age twenty-five
- Those who bargain collectively (union members) or who are nonresident aliens
- Those who are part-time or seasonal employees. Part-time in this case means working fewer than 35 hours a week if other employees work substantially more hours each week

The 70 percent test means the plan benefits 70 percent or more of non-excludable employees. This test is simple. If 100 non-excludible employees are eligible for the plan, 70 of these employees must be covered to pass.

The 70 percent/80 percent test is a little more complicated. To pass this test, at least 70 percent of all non-excludible employees must be eligible for the plan. Of the 70 percent who are eligible, 80 percent must elect coverage. For example, if the employer has 100 non-excludible employees and 70 of those employees are eligible for the plan, 80 percent of the 70 (or 56 employees) must elect coverage to pass this test.

If a plan can't pass either of the above tests, there is a third option: the reasonable classification test. For this test, the plan must be found to benefit a non-discriminatory class of employees. This test is based on the facts and circumstances of each case.

Benefits Test

This test determines whether the plan discriminates in favor of HCEs in either benefits or in actual operation. To put it simply, if a plan provides a benefit to an HCE that other plan participants do not receive, the plan fails the benefits test. This test is not limited to benefit plan coverage. A plan can be discriminatory:

- If an employer subsidizes an HCE's cost at a higher rate
- If the plan has shorter waiting periods for HCEs
- If the plan extends COBRA for a longer period of time for HCEs

When a self-funded plan is found to favor HCEs, the HCEs must pay tax on the discriminatory benefit amounts.

Self-funded medical plans cannot discriminate in favor of HCEs. When should employers perform these non-discrimination tests? The rules do not cover timing, but it makes sense to conduct these tests whenever there is a difference in benefits across plans or if all full-time employees are not eligible.

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SECTION 125 NONDISCRIMINATION RULES

According to the proposed regulations issued in 2007, employers sponsoring Section 125 plans must perform the nondiscrimination tests on the last day of every plan year. That day would show all the activity under the plan that year. The testing must take into account all non-excludable employees and former employees for the year.

The problem with testing as of the last day of the plan year is that you have no time to allow HCEs and key employees to revise their elections to avoid losing their tax-favored status under the 125 plan. As a result, employers often conduct the tests at least once early in the year to find any trouble spots. However, they still must conduct the tests again at the end of the year. Dependent care FSAs are subject to different nondiscrimination tests than the other 125 plan benefits.

To be considered non-discriminatory, a cafeteria plan must pass three different tests:

1. Key employee test
2. Eligibility test
3. Contribution and benefits test

Key Employee Test

This test requires your plan to compare the rate key employees benefit from the plan to the rate all employees benefit from the plan.

For this test, key employees are defined as:

- An officer with compensation greater than $175,000 in 2017 and 2018
- 5 percent or more owner in the company
- 1 percent owner with annual compensation over $150,000

Income from the previous year determines who is a key employee. In some cases, family members may also fall into the 5 percent and 1 percent owner category.

A plan will fail this test if key employees as a whole benefit from the plan at a rate more than 25 percent higher than all other employees participating in the cafeteria plan.

Eligibility Test

The eligibility and contribution/benefits test look at covered HCEs (not just key employees). HCEs are defined differently under Section 125. For these tests, HCEs are:

- Employees who are officers of the company
- Employees who are a 5 percent or more shareholder
- Employees who receive compensation greater than $120,000 in 2018 and are among the top 20 percent of employees ranked by compensation
- Employees that are an HCE's spouse or dependent

The employer must meet the following three requirements to pass the eligibility test.

1. Employment requirement – No one can be required to work more than three years to participate in the plan and the same requirements to participate must apply to all employees.
2. Entry requirement – A plan must allow employees that complete the employment requirement to participate in the plan no later than the first day of the first plan year after they complete the plan's employment requirement.
3. The plan must meet the non-discrimination classification requirements (if the plan covers a classification of employees the employer has established).

Contributions and Benefits Test

A cafeteria plan cannot favor HCEs in either contributions or benefits. To pass this test, the plan must:

- Give each similarly situated participant the same opportunity to elect qualified benefits. Once the participant elects benefits, the total benefits cannot disproportionately benefit HCEs.
- Give each similarly situated participant the same options in employer contributions and actual elections without disproportionately benefiting HCEs.

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In addition, the plan can't favor HCEs in actual operation. You cannot offer a tax-favored benefit under the plan that only HCEs would take advantage of or benefit from.

The IRS also considers health FSAs to be self-funded medical plans. Therefore health FSAs must pass both the 105(h) nondiscrimination tests and the Section 125 nondiscrimination tests.

GROUP TERM LIFE INSURANCE PLANS

Section 79 of the Internal Revenue Code details the tax implications for employer-sponsored group term life insurance. For employer sponsored life insurance to be tax-favored, the plan needs to meet the Section 79 requirements. Your employees may have to pay taxes on the value of the following types of employer-sponsored group term life insurance:

- Employer-paid group term life benefits that exceed $50,000
- Discriminatory employer-paid term life plans
- Employer-sponsored voluntary life coverage
- Employer-sponsored voluntary life insurance paid for with pre-tax dollars under a Section 125 plan

Employers need to review their employer-paid term life plans to ensure they don't favor HCEs. If the plan does favor HCEs, the HCEs must pay taxes on it. HCEs are not allowed the $50,000 exemption for employer-sponsored term life insurance coverage.

Marsh & McLennan Agency | Michigan publishes an annual *Benefits Advisor* devoted to analyzing the Section 79 requirements. This Benefit Advisor can be found on our website at http://mcgraw-wentworth.com/resources/benefits-advisor. This *Advisor* is published annually in November.

DEPENDENT CARE FSA NONDISCRIMINATION RULES

Section 129 of the Internal Revenue Code covers dependent care FSA nondiscrimination requirements. It requires dependent care FSAs to pass:

- Eligibility test
- Contributions and benefits test
- More than 5 percent owners' concentration test
- 55 percent average benefits test

These tests are similar to those that apply to Section 125 plans.

Eligibility Test

The FSA must benefit employees who qualify under an eligibility classification that does not favor highly compensated employees.

Contributions and Benefits Test

The contributions or benefits provided under the dependent care FSA may not favor highly compensated employees.

More Than 5 Percent Owners' Concentration Test

Not more than 25 percent of the total benefits under the dependent care FSA can be provided to anyone who owns more than 5 percent of stock, capital or profit interest in the employer.

55 Percent Average Benefits Test

The average benefits provided to non-highly compensated employees must be at least 55 percent of the average benefits provided to highly compensated employees

For this test, a highly compensated employee (HCE) is an employee who meets either of these conditions:

- Is a 5 percent owner at any time during the plan year being tested or the preceding year
- Received compensation higher than the indexing threshold in the preceding year (for 2018 and 2017 this is compensation of at least $120,000)

If an employer fails these tests, HCEs as well as more than 5 percent owners will have to pay tax on any dependent care FSA benefits. Like the Section 125 tests, an employer should test early in the year. If the tests indicate a problem, HCEs and more

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than 5 percent owners should be given the opportunity to revise their dependent care account elections. By drawing down the election to the point the employer passes these tests, these HCEs can have a tax-favored benefit on the lower account election. Also, pointing out discrimination issues may allow HCEs to elect the full dependent care FSA limit under a spouse's plan. This presumes their spouses are not considered HCEs at their employer.

CONCLUDING THOUGHTS

Many of these tests are more complicated than these summaries indicate. Because employers find it difficult to perform the tests on their own, they use vendors to conduct them.

For self-funded plans, when to conduct 105 (h) nondiscrimination tests is not particularly clear. The plan simply has to ensure it does not discriminate. Attorneys often conduct these tests.

Typically, the administrator of your flexible spending accounts will offer to do the nondiscrimination tests on the Section 125 plan and the dependent care accounts for a reasonable fee. It makes sense to test at least twice during the year. If you conduct the tests early in the plan year, you can determine whether there is discrimination. HCEs can then modify elections to help the plan pass. Even if you tested earlier in the year, the tests must be done again as of the last day of the plan year.

The Section 79 nondiscrimination tests are fairly straight-forward and most employers can complete those tests internally.

In summary, many employers are under the impression that if they offer different benefits to different employees their plans are automatically discriminatory. However, that is not always the case. Employers must conduct the actual tests for the various benefits they offer to determine whether there is an issue. Often, if a plan fails a nondiscrimination test, the consequence is that HCEs have to pay tax on all or some of the benefits the plan offers.

Please contact your Marsh & McLennan Agency | Michigan team member with any questions. MMA

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