



NONDISCRIMINATION RULES FOR BENEFIT PLANS

Many employee benefits are excluded from employees' gross income and, thus, are not taxable when specific conditions are met. One of these conditions is often some type of nondiscrimination requirement, which ensures that the benefit plan does not discriminate in favor of certain highly compensated or key employees. It is important to take the applicable nondiscrimination rules into account when structuring your employee benefit plans in order to maintain your plans' tax advantage.

RULES VARY BY BENEFIT

There is no universal set of nondiscrimination rules; they vary for each type of benefit. Key concepts that are often involved with nondiscrimination testing include:

- + **Who is in the prohibited group?** This is the group that a plan cannot discriminate in favor of. It generally consists of highly compensated or key employees, but the definitions for these categories vary by benefit.
- + **What eligibility classification standards apply?** This usually refers to the percentage of the employee population that is eligible for or receives a benefit from the plan.
- + **Which employees can be excluded from the testing population?** For the purpose of meeting nondiscrimination criteria, certain employees can be excluded from the employee population count—usually those that have not met age or service requirements or are collectively-bargained.
- + **What is the consequence of finding discrimination?** When discrimination is found, generally the members of the prohibited group will not receive the tax favor for the benefit. Sometimes, though, all employees are penalized and the benefit will be included in everyone's gross income.

The rest of this article discusses some of the types of benefits that must comply with nondiscrimination rules.

SELF FUNDED HEALTH PLANS – SECTION 105(h) TESTING

Self-funded health plans pass the Code § 105(h) nondiscrimination rules if the plan does not discriminate in favor of HCIs with respect to eligibility or benefits. If discrimination exists in favor of HCIs, the excess reimbursements received by those employees must be included in their gross income. In addition to self-funded health plans, 105(h) testing also applies to General Health and Limited Purpose Flexible Spending Accounts.

CAFETERIA PLANS – SECTION 125 TESTING

A cafeteria plan lets employees choose between receiving their regular pay or using that money to pay for certain benefits before taxes are taken out. Normally, if an employee has the option to take cash, the IRS treats that amount as taxable income, even if they choose benefits instead. But cafeteria plans are a special exception: employees aren't taxed on the money they use for qualified benefits. However, this tax advantage only applies if the plan follows non-discrimination rules. If a cafeteria plan discriminates in favor of HCIs or key employees, each member of the prohibited group will lose the cafeteria plan's tax advantage.

DEPENDENT CARE ASSISTANCE PROGRAMS – SECTION 129 TESTING

For plan years starting in 2026, an employee can exclude up to \$7,500 of dependent care benefits from their gross income (if single or married and filing a joint tax return), or up to \$3,750 (if married but filing separate tax returns). The plan is considered nondiscriminatory if the program's eligibility, contributions and benefits provided do not discriminate in favor of HCIs or certain shareholders or owners. If discrimination is found in a dependent care assistance program, these individuals must include dependent care benefits in their gross income.

This summary is not intended to be exhaustive nor should any discussion or opinions be construed as legal advice. Readers should contact legal counsel for legal advice.

