

Nondiscrimination Testing

In general, group health plans and cafeteria plans may not discriminate in favor of highly compensated individuals (HCIs). Nondiscrimination testing must be done annually unless a safe harbor exemption applies.

Section 125 Nondiscrimination Testing: Cafeteria Plan Rules

- Cafeteria Plans must not discriminate in favor of highly compensated individuals or participants and Key Employees with regard to eligibility and benefits.
- If a plan fails the testing, HCIs and Key Employees lose their tax-free status provided by the plan.

Highly Compensated Individuals (HCIs): HCIs are defined as:

- An Officer.
- More than 5% shareholders.
- Highly compensated means for the preceding plan year (or current year for new hires) the individual had compensation in excess of \$160,000 in 2025 (\$160,000 in 2026) and if elected by the employer, was in the top paid group of employees, or
- A spouse or dependent of any of the above.

Key Employee: Any employee (or former employee, including a deceased employee) who, during the plan year was:

- An officer with annual compensation in excess of \$230,000 in 2025 (\$235,000 in 2026).
- A more than 5% owner of the employer; or
- A more than 1% owner of the employer with annual compensation greater than \$150,000.

Section 125 Nondiscrimination Tests: Three testing requirements must be satisfied:

- 1. Eligibility Test:** The plan cannot discriminate in favor of HCIs as to eligibility to participate in a plan and can't impose different waiting periods that favor HCIs.
- 2. Contributions and Benefits Test:** The plan can't discriminate in favor of HCIs as to contributions and benefits under the plan (can't provide HCIs better benefits).
- 3. Key Employee Concentration Test:** If benefits provided to Key Employees exceed 25% of the total of all such benefits provided for all employees under the cafeteria plan, the plan will fail the key employee concentration test.

Health FSA: If a Health FSA is part of a cafeteria plan, it must satisfy its own nondiscrimination requirements. A Health FSA must also satisfy the Section 105(h) eligibility and benefits tests (see below). Note that the definition of highly compensated for purposes of these tests is different from the definition that applies for the purposes of the cafeteria plan test.

Section 105(h) Nondiscrimination Testing:

- Group health plans must not discriminate in favor of HCIs.
- Applies to both self-insured and fully insured plans.
- Rules prohibit discrimination with respect to both eligibility and benefits offered under the plan.

- If a plan fails the testing:
 - Self-insured Plans: HCIs must include the excess benefits provided to them in gross income.
 - Fully insured plans: plan may be subject to a civil monetary penalty of \$100 per day per individual discriminated against (not being enforced until guidance issued).

Highly Compensated Individuals (HCI): HCIs are defined as:

- One of the five highest-paid officers;
- A shareholder who owns more than 10% of the value of the stock of the employer; or
- Among the highest paid 25% of all employees.

***Note: This is a different definition of a HCI than Section 125, note that this is the definition used for purposes of testing Health FSAs.**

Nondiscrimination Tests: Two testing requirements must be satisfied. Plan must first satisfy the Eligibility Test, then the Benefits Test:

- 1. Eligibility Test:** Plan must satisfy one of three eligibility tests. Plan sponsors may exclude from consideration, but it appears if they are eligible to participate in the GHP, they may not be excluded for testing purposes:
 - Employees who have not completed 3 years of service;
 - Employees who have not attained age 25;
 - Part-time or seasonal employees;
 - Employees covered by a collective bargaining agreement (Unions); and
 - Employees who are nonresident and receive no earned income from the employer which constitutes income from sources within the US.
- 2. Benefits Test:** All benefits provided to HCIs and their dependents who are participating in the plan must be provided to all other non-HCIs and their dependents. To pass, the plan must satisfy all of the following requirements:
 - Identical employee and employer contributions at each benefit level;
 - Maximum benefit level and type of benefits available do not vary based on age, years of service or compensation;
 - Same type of benefits available to HCIs are offered to non-HCIs; and
 - Any waiting periods imposed do not favor HCIs;
 - Cannot discriminate in favor of HCIs in actual operation of the plan.
 - Examples that would fail:
 - Providing coverage to only HCIs (executive-only medical plans);
 - Not imposing a waiting period on HCIs but require non-HCIs to satisfy a 60-day waiting period;
 - Providing 100% employer contribution toward coverage for HCIs (or dependents) and only 80% for non-HCIs.