FAQ: Can an employer vary group health plan benefits and contributions by class?

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Generally, an employer can vary benefits and contributions by bona fide employment classifications.

However, even where such classifications exist, the employer should ensure that the variations comply with the applicable nondiscrimination rules. Section 125 nondiscrimination rules apply to benefits and contributions made through a cafeteria plan. Section 105 rules apply to self-insured plans, including HRAs. Both sets of rules are designed to prohibit discrimination in benefits and contributions that disproportionately favor key or highly compensated employees (HCEs).

Under these rules, variances by class are allowed, provided the distinctions are based upon employment classifications consistent with the employer's usual business practice (and not made solely for the benefit offerings). Examples of permitted classifications include, but are not limited to, those based on occupation, geographic location, business lines, job titles or hourly work expectations.

Therefore, the first step is to determine whether the class distinction is based upon a bona fide employment grouping. The idea is not to handpick individuals but to apply criteria used for other business purposes as well. For example, an executive class based on job title would normally be allowed. A distinction for a business unit located in another state would also generally be permitted.

If the distinctions are determined to be based on legitimate employment-based reasons, then the next step is to assess whether the variances disproportionately benefit the HCEs. Under §125, an HCE is defined as an officer, more-than-5% shareholder, employee who earned at least $130,000 in 2021 or if in the first year of employment, $135,000 in 2022. (These salary thresholds are indexed annually.) Under the Section 105 rules, an HCE includes one of the highest five paid officers, a more than 10% shareholder or owner and those amongst the highest-paid 25% of all employees. Where two or more employers are under common ownership, individuals of all employers must be included in determining the highly compensated group and in performing certain nondiscrimination tests.

At a high level, the nondiscrimination tests consider eligibility, benefits and contributions and, in certain cases, utilization (i.e., who is actually benefiting). If an employer offers richer benefits or pays more of the contributions for the HCEs versus the non-HCEs, this could raise potential nondiscrimination concerns. Therefore, particularly after a change in contribution or benefit structures or a business reorganization, the employer should consider having midyear testing performed to ensure the changes will not cause test failures. Test failures may result in adverse tax consequences for the HCEs. If the tests are not performed until the year-end, then it is normally too late for an employer to make any necessary adjustments to correct such failures.

Additionally, whenever there are changes to contributions and benefits, the plan documents and employee communications should be reviewed and updated to clearly outline the eligibility requirements, benefit offerings and contribution structures, so there is no confusion as to the applicability.

For more information on the nondiscrimination rules applicable to group health plan benefits and contributions, please reach out to your broker or consultant for a copy of our white paper on this topic.

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