

**SECTION 125 CAFETERIA PLANS
NONDISCRIMINATION TESTING GUIDE AND FAQs
2020**



Why Do We Have To Test Our Section 125 Plan?

Because Code Section 125 cafeteria plans (and the component benefits within the 125 plan) enjoy favorable tax treatment, the Code's nondiscrimination rules exist to prevent plans from being designed in such way that it discriminates in favor of individuals who are either highly compensated employees (HCE) or are otherwise key employees (KEY) in the organization.

The nondiscrimination tests can be complicated but boil down to three basic themes:

1. ***Eligibility***. If too many non-HCEs are excluded from participation in the plan, then it will be discriminatory.
2. ***Availability of Benefit***. The plan will not pass the tests if the HCEs/KEYs can access more or better benefits than the non-HCEs/KEYs. This is sometimes called a "Contributions and Benefits Test."
3. ***Utilization***. A plan will not pass the nondiscrimination tests if the HCEs/KEYs actually ***elect*** more benefits under the plan. This is sometimes called a "Concentration Test."

The first two areas (*eligibility and availability of benefits*) are managed by proper plan design. Once you have established eligibility and the availability of benefits in a nondiscriminatory manner (e.g. all benefits are equally available to all employees and any exclusions fall within allowed parameters) then you should be able to pass those tests automatically each year. But the *utilization* tests based on actual benefits elected must be conducted annually to ensure compliance.

What Are the Specific Tests to Conduct?

There are nine different tests that can be applicable to benefits provided under a Section 125 plan. As noted above, some tests are related to ***eligibility and availability*** of benefits, and other tests are based on ***actual benefits elected (utilization)***.

The Section 125 Cafeteria Plan

1. Eligibility Test
2. Contributions and Benefits Test
3. Key Employee Concentration Test (***utilization***)

Health FSAs

4. Eligibility Test
5. Benefits Test

Dependent Care FSA (DCAP)

6. Eligibility Test
7. Contributions and Benefits Test
8. More-Than-5% Owners Concentration Test (***utilization***)
9. 55% Average Benefits Test (***utilization***)

The Utilization Tests – Which Tests Apply?

Again, all nine tests must be satisfied for a plan to be in compliance. And as stated previously, the tests for eligibility and availability of benefits can be satisfied with proper plan design.

Here we focus on the utilization tests as the results could change annually because they are based on elections made by participants, not plan design. The three tests for actual benefits elected are:

1. **The Key Employee 25% Concentration Test applies to all pretax benefits provide under the plan.** No more than 25% of the aggregate of all non-taxable benefits may be provided to key employees. This would include anything paid pretax (by an employee) or provided on a nontaxable basis (by the employer), including:
 - Group health, term life or disability coverage premiums
 - Health and Dependent Care FSA
 - Contributions to an HSA
2. **The Dependent Care 55% Average Benefits Test applies only to the Dependent Care FSA.** This test is passed if the average benefit provided to employees who are non-HCEs is at least 55% of the average benefit provided to HCEs.
3. **The 5% owners test** also applies only to Dependent Care FSA. Not more than 25% of the amounts for dependent care assistance during the year may be provided for shareholders or owners (or their spouses or dependents) who own more than 5% of the stock, the capital, or profits interest in the employer (on any day of the year).

The Utilization Tests - Who is HCE or Key for Testing Purposes?

For the utilization tests only, the following definitions apply:

1. The Key Employee 25% Concentration Test

Key employees for this test are:

- Officers whose compensation exceeded the specified dollar threshold in the *preceding* Plan Year (\$185,000 for 2019)
- More-than-5% owners in the preceding Plan Year (at any compensation level)
- More-than-1% owners with compensation over \$150,000 (not indexed).

Related party rules apply, meaning if an employee is a parent, spouse or lineal descendent of an owner or officer described above, they are also considered key, regardless of their income level and even if they are not personally owners or officers.

2. Dependent Care FSA 55% Average Benefits Test

High compensated employees for this test are:

- Employees whose *previous year's* compensation was greater than \$130,000
- A more than 5% shareholder in the company in the current or preceding year
- If the employer elects, employees with compensation over \$130,000 are only considered HCE if they are also in the top paid group (top 20% of all employees). If the employer counts only the top 20% as HCE for other benefit plan testing (such as the 401(k) plan), they must use the same election for the Dependent Care discrimination testing.

Employees that can be excluded from the 55% test: *(allowed only if the employer excludes these employees in the written plan document)*

- Under 21 years of age
- Less than one “year of service” (a year of service is a 12-month period beginning on date of hire or the first day of the plan year in which they earn at least 1,000 hours of service)
- Covered by a collective bargaining unit/union
- Previous year’s salary that is less than \$25,000

3. The 5% owners test

Owners for this test are:

Shareholders or owners owning more than 5% of the stock or the capital or profits interest in the employer on any day of the year. This would include more-than-5% owners who terminated employment during the year.

Related party rules apply, meaning if an employee is a parent, spouse or lineal descendent of an owner described above, they are also considered an owner.

Are Any Employers Excluded From Nondiscrimination Testing?

No exceptions! Even government entities, churches, and tax-exempt employers are subject to the nondiscrimination rules. However, the aforementioned employers do not have “owners”, and officers of government entities are excluded from the definition of “key employee”.

Thus, every employer is required to be in compliance with the regulations. The only way to determine if the plan is compliant is to run the test to the best of your ability

Treating Multiple Employers as a Single Employer

For testing purposes, the Code treats two or more employers as a single employer if there is sufficient common ownership or a combination of joint ownership and common activity. These rules are described in [Code §§414\(b\), \(c\), and \(m\)](#), which are directly incorporated into the cafeteria plan rules.

The concept of aggregating multiple employers because of common ownership applies to corporations, partnerships, sole proprietorships, and all other forms of business entities. A group of commonly owned businesses is referred to as a “controlled group.”

If your organization is part of a “controlled group” (broadly defined as having 80% or more common ownership among companies), then the pretax benefits under your Section 125 Plan must be aggregated with the pre-tax benefits of the other companies in the controlled group and tested together. Testing the benefits for just one company within the controlled group would produce inaccurate results. If a company is related to another company (whether through stock ownership, a partnership, or otherwise), the plan sponsor must determine which employees to include in its nondiscrimination testing. Even if plan participation may not need to be extended to all individuals, failure to consider them could lead to inaccurate test results

The common ownership rules can be complex. Consult with your legal counsel or tax consultant if you are unsure if this applies to your organization. NEO cannot determine this status for you.

When Must Discrimination Testing Be Performed?

The 2007 proposed cafeteria plan regulations address when discrimination testing must be performed, indicating that the cafeteria plan tests must be performed as of the last day of the plan year, “taking into account all non-excludable employees (or former employees) who were employees on any day during the plan year.” Because the group of employees included in the testing can change during the year, the final results cannot be known until the end of the year. However, corrections for Section 125 plans cannot be made after the end of the plan year (like they can for 401(k) plans), so it is advisable to test at the beginning of the year so you have an idea where you stand.

- *Test at the Beginning of the Plan Year.* Early testing based on elections in place at the beginning of the Plan year is valuable because anticipated problems can be resolved with election or plan design changes. The IRS has informally stated that reductions in prohibited employee elections should be permissible to ensure compliance with the applicable tests.
- *Several Months Before the End of the Plan Year.* At this point, the employer can take into account actual data for the year, including new hires, midyear election changes, terminations of employment, etc. If any testing problems appear at this point, the employer will still have time to make corrections before the end of the plan year. Note that employees whose employment terminates during the plan year may have to be included in testing.
- *After the Close of the Plan Year.* The employer will have its final year-end data to use for testing purposes. Final plan testing with year-end numbers should be documented and retained so that the employer can show, upon audit, that the plan passes the appropriate tests. Again, corrections for Section 125 plans cannot be made after the end of the plan year so if any failures are discovered at this time, the only way to fix it would be to recapture the taxes that should have been paid on the benefits (see **What Happens If a Plan Is Discriminatory?**). Don't get caught here! Test early!

What Happens If a Plan Is Discriminatory?

In general, the HCEs and Keys, as applicable, will lose the [Code §125](#) safe harbor from constructive receipt. This means the benefits that fail the nondiscrimination tests may be included in gross income, when they would have been nontaxable if the cafeteria plan benefits had passed the nondiscrimination tests. This can create some unpleasant surprises for prohibited group members, especially if the discrimination problem is not discovered before the end of the plan year, because corrections cannot be made to reduce the adverse impact once the plan year has ended.

Note that the entire plan does not fail for all participants just because it is discriminatory. Employees who are not in the prohibited group (non-HCE or non-Key) can still exclude the benefits from income.

NONDISCRIMINATION TESTING CHART

Type of Plan	Eligibility Test	Benefits Test	Utilization Test (<i>actual benefits elected</i>)	Consequences of Failure
Self-Funded Medical (e.g. Health FSA, HRA)	<ul style="list-style-type: none"> • 70% of all employees, OR • 80% of eligible employees if 70% of all employees are eligible, OR • Non-discriminatory classification 	Benefits to HCEs must be provided on same basis to other participants.	None	HCE must include excess reimbursement in taxable income
Insured, Non-Grandfathered Health Plans	<ul style="list-style-type: none"> • 70% of all employees, OR • 80% of eligible employees if 70% of all employees are eligible, OR • Non-discriminatory classification 	Benefits to HCEs must be provided on same basis to non-HCE participants.	None	<p>Effective date delayed until agencies release guidance.</p> <p>For each day that the plan is discriminatory, subject to excise taxes or civil penalties of \$100 per day <i>per individual discriminated against.</i></p>
Section 125 Cafeteria Plan	Non-discriminatory classification	Benefits or contributions cannot favor HCEs in availability or actual elections; an alternative test applies for cafeteria plans that provide health benefits.	No more than 25% of total nontaxable benefits may be elected by Key Employees.	HCEs or Key Employees must include in taxable income the highest aggregate value of taxable benefits that <i>could have been chosen for the year, regardless of actual elections.</i>
Dependent Care Assistance	Non-discriminatory classification	Benefits or contributions cannot favor HCEs. Average Non-HCEs benefits must be more than 55% of average benefit for HCEs.	No more than 25% Employer's cost for 5% owners (or their spouses or dependents)	HCEs must include all dependent care benefits as taxable income.
Educational Assistance	Non-discriminatory classification (Tax Reform rules)	None	No more than 5% of employer's cost for 5% owners (or their spouses or dependents)	All employees must include benefits as taxable income