

THIS IS A *TEST*



Nondiscrimination Testing for Cafeteria Plans & Health FSAs

 Compliance
Dashboard®

WHY IS NONDISCRIMINATION TESTING REQUIRED?

Nondiscrimination testing is designed to prevent plans from discriminating in favor of highly compensated individuals (HCIs, i.e. executives) vs. rank-and-file employees.

WHAT PLANS HAVE TO UNDERGO TESTING?

Plans that provide tax-favored (i.e. pre-tax) benefits to their beneficiaries must conduct Nondiscrimination Testing. This includes both **Cafeteria Plans, which are subject to Code §125 testing and Health FSAs, which are subject to Code §125 AND Code §105 Testing.**

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CAFETERIA PLANS

DEFINITIONS ACCORDING TO CODE §125

HIGHLY COMPENSATED INDIVIDUAL (HCI):

- Officer
- 5% Shareholder
- Compensation of previous plan year meets definition of HCI for purposes of a 401(k) plan and, if elected by employer, is in top-paid group (of top 20%) of employees when ranked on basis of compensation paid during that year **OR**
- Spouse or dependent of person described above

KEY EMPLOYEE

- Officer of employer w/ annual compensation greater than the dollar amount specified in the definition of “Key Employee” under the rules for 401(k) plans
- 5% owner of the employer OR
- 1% owner of the employer w/ annual compensation from the employer of more than \$150,000

COMMON OWNERSHIP

Individuals may be included in the testing group due to their relationship with the plan sponsor, or common ownership of other companies through stock ownership, a partnership, etc.

3 REQUIRED TESTS UNDER CODE §125

1. Eligibility Test

Are enough rank-and-file employees eligible to benefit from the plan?

2. Contributions & Benefits Test

Are contributions and benefits available on a nondiscriminatory basis? Do HCIs select a disproportionate amount of nontaxable benefits compared to non-HCIs?

3. Key Employee Concentration Test

Do key employees receive too large a share of total benefits under the plan?

SPECIFICS OF CODE §125 TESTING FOR CAFETERIA PLANS

1

ELIGIBILITY TEST

- **Employment Requirement:** The same new hire period must apply to all employees and can't be longer than 3 years
- **Entry Requirement:** Employees must be eligible immediately following the waiting period.
- **Nondiscrimination Requirement:** The plan benefits employees who qualify under a **reasonable classification** established by the employer, and the **classification of employees is nondiscriminatory.**
 - **“Reasonable classification”:** Based on “objective business criteria,” such as salaried, hourly, full-time, part-time, type of job, geographic location, etc.
 - **Classification of Employees:** The group of employees in the classification benefiting under the plan satisfy either a “safe harbor percentage test” or an “unsafe harbor percentage test.”

2

CONTRIBUTIONS & BENEFITS TEST

- **Availability Standard:** Similarly situated employees must be given the same opportunity to elect benefits.
- **Utilization Standard:** Tax-free benefits available to HCIs must compare favorably with the tax-free benefits of non-HCIs.
- **Nondiscrimination Standard:** The plan must ensure it does not discriminate in practice.

3

KEY EMPLOYEE CONCENTRATION TEST

- Do key employees receive too large a share of total benefits under the plan?
- Key employee benefits can't be more than 25% better than all employees' benefits under the plan.

COMMON REASONS WHY A CAFETERIA PLAN MAY FAIL CODE §125 TESTING

- It is not available to all employees.
- It does not provide the same entry dates for all employees.
- It provides different benefits to different groups of employees.

CONSEQUENCES OF FAILURE

- All HCIs and Keys will be taxed on the amount of their pre-tax contributions.
 - All amounts subject to tax must be reported on the HCIs' Form W-2 for purposes of income tax, FICA, and FUTA.

REVIEWING A CAFETERIA PLAN

A Cafeteria Plan document should be written to give the plan administrator the authority to change any employee's salary reductions during the year. Then, as periodic testing is performed throughout the year, if the plan fails nondiscrimination tests, the plan administrator can adjust an HCI's contributions so the test won't fail come the end of the year.

HEALTH FSAs

DEFINITIONS ACCORDING TO CODE §105

Highly Compensated Individual (HCI):

- One of 5 highest paid officers
- > 5% Shareholder **OR**
- Among the highest paid 25% of all employees

2 REQUIRED TESTS UNDER CODE §105

1. Eligibility Test

Are a reasonable number of non-HCIs eligible to benefit from the plan?

2. Benefits Test

Are all benefits provided for HCIs and dependents also available to all other participants & dependents on the same basis?

Code §105(h) rules generally don't apply to a Health FSA if it treats all employees the same in terms of:

- Eligibility
- Waiting Periods
- Age
- Years of Service
- Compensation
- Maximum Reimbursements
- Types of Expenses Reimbursed

SPECIFICS OF CODE §105 TESTING FOR HEALTH FSAs

1

ELIGIBILITY TEST

- **70% Test:** The plan must benefit 70% or more of all employees.
- **70%/80% Test:** The plan must benefit 80% or more of all employees eligible to benefit under the plan if 70% or more of all employees are eligible to benefit under the plan.
- **Classification Test:** The plan must benefit those employees that qualify under a classification of employees set up by the employer which is found by the IRS not to be discriminatory in favor of HCIs.

Note: A plan will pass the Eligibility Test if it passes any ONE of the three tests listed.

2

BENEFITS TEST

Employment Requirement:

- Benefits provided for HCIs must be provided to all other participants (type, amount reimbursed).
- Amount of reimbursement may not be in proportion to compensation, age, or years of service.
- Required employee contributions must be the same for all benefit levels.
- Different waiting periods may not be imposed.

Discrimination in Operation:

- Determination is made on the basis of the facts & circumstances of each case.
- A plan is not considered discriminatory merely because HCIs in the plan utilize a broad range of plan benefits to a greater extent than other plan participants.
- If a plan or benefit is amended or terminated and the duration of the plan or benefit coincides with the period during which an HCI utilizes the benefit, the plan would be discriminatory.

5 TESTS TOTAL FOR FSAs

Remember! Because FSAs are also considered to be Cafeteria Plans, they are subject to both §125 and §105 Nondiscrimination Testing. This means a FSA requires all 5 tests covered in this document.

Code §125 Testing:

- Eligibility Test
- Contributions & Benefits Test
- Key Employee Concentration Test



Code §105 Testing:

- Eligibility Test
- Benefits Test



**5
tests
total**

CONSEQUENCES OF FAILURE

Eligibility Test failure: Each HCI is taxed on the amount of benefits paid to the HCI under the FSA multiplied by the ratio:

FSA \$ paid to HCI



**(All benefits paid to all HCIs /
Benefits paid to all participants)**



**Tax
Amount**

Benefits Test failure: HCIs are taxed on total benefits received under the FSA.

- All amounts subject to tax must be reported on the HCIs' Form W-2 for purposes of income tax but NOT for FICA or FUTA.