Cafeteria Plan Testing

A cafeteria plan (Section 125 plan) is subject to certain nondiscrimination rules under Internal Revenue Code (IRC) Section 125. Those rules prohibit a cafeteria plan from discriminating in favor of highly compensated individuals (HCIs) as to plan eligibility and benefits. Specifically, under Section 125, a cafeteria plan must satisfy three separate nondiscrimination tests. Namely, a cafeteria plan must not discriminate in favor of:

- HCIs as to eligibility to participate (eligibility test);
- HCIs as to contributions and benefits (contributions and benefits test); and
- Key employees as to concentration of benefits (key employee concentration test).

For purposes of the above three tests, an HCI is defined as:

- A more-than-5-percent shareholder;
- Any officer; and
- An individual with annual compensation greater than $120,000 for 2015 (was $115,000 for 2014).

Eligibility Test

With respect to the eligibility test, a plan must not discriminate in favor of HCIs as to eligibility to participate. This test is designed to ensure that a reasonable number of non-HCIs are eligible to participate in the cafeteria plan. If too many non-HCIs are ineligible to participate, the cafeteria plan will fail the eligibility test. Essentially, the test asks if enough non-HCIs been invited to participate in the plan.

Importantly, certain employees may be excluded for purposes of performing the eligibility testing. These include employees covered under a collectively-bargained agreement, nonresident aliens with no U.S.-source income and employees participating in the cafeteria plan under a COBRA continuation provision. (Note that these types of excludable employees are different from the types of excludable employees under the Section 105(h) nondiscrimination testing.)

There are basically three components needed to pass the eligibility test. First, no employee may be required to complete more than three years of employment to participate, and the same employment requirement must apply to all employees. Second, entry into the cafeteria plan must not be delayed (once any length-of-service requirements have been met). Third, if the plan varies benefit offerings in any way, the plan must meet a nondiscriminatory classification test.

Under the nondiscriminatory classification test, a plan may vary eligibility based on reasonable classifications established by the employer, so long as the classification is based on a bona fide business purposes (i.e., geographic location, salaried versus hourly, occupation type, date of hire, length of service) and so long as the classification does not result in favoring HCIs. In other words, if an employer varies benefits based on a bona fide business purpose, the plan must still not favor HCIs as to eligibility. There are certain safe harbor percentage ratios that are laid out in a table in the regulations, and the testing basically compares the ratio of non-HCIs to HCIs in the favored classification to that safe harbor percentage ratio table. Thus, actual testing would have to be performed for an exact determination.
Contributions and Benefits Test

With respect to the contributions and benefits test, the test is designed to make sure that contributions and benefits are available on a nondiscriminatory basis and that HCIs do not select more nontaxable benefits than do non-HCIs. The testing group for this test must include only employees who are actually eligible to select the benefits under the plan and to make salary reductions to pay for those benefits.

There are basically two components (or standards) of this test: the availability standard and the utilization standard. Under the availability standard, the test asks whether employer contributions and actual plan benefits are available on a nondiscriminatory basis. Under the utilization standard, the test asks whether the actual elections of qualified benefits through a cafeteria plan are “disproportionately” made by HCIs. Lastly, the test looks at nondiscrimination both on its face and in operation.

Key Employee Concentration Test

With respect to the key employee concentration test, the test is designed to ensure that “key employees” don’t receive more than 25 percent of the total benefits under the plan. If the key employees are taking more than 25 percent of the total benefits, then the cafeteria plan will fail the key employee concentration test. Key employees include officers with annual compensation greater than a specified dollar threshold ($170,000), more-than-5 percent shareholders and more-than-1 percent shareholders with annual compensation over $150,000.

Generally speaking, all “statutory nontaxable benefits provided” under the plan must be taken into account when running the key employee concentration test. If an employer has a cafeteria plan under which participants who elect health insurance must pay the entire premium with salary reductions, then 100 percent of the health insurance benefits are considered to be “nontaxable benefits provided under the plan”. But it is less clear in the situation where employer contributions under a cafeteria plan pay for part of the coverage and employee salary reductions pay for the rest. So, depending on how the cafeteria plan is structured, this will be less clear.

Safe Harbor for POPs

The regulations contain a safe harbor from the Section 125 nondiscrimination requirements for premium-only plans (POPs). Under the safe harbor, a cafeteria plan that offers as its sole benefit an election between cash and payment of the employee share of the premium for employer-provided accident and health insurance is deemed to satisfy the Section 125 nondiscrimination requirements if it “satisfies the safe harbor percentage test for eligibility” under the regulations. In other words, if the plan satisfies the eligibility test above, then the plan need not also conduct or pass the contributions and benefits test or the key employee concentration test.

Consequences of a Discriminatory Plan

If a cafeteria plan fails any of the nondiscrimination tests, then the HCIs and “key” employees, as applicable, will lose the favorable tax treatment that the cafeteria plan otherwise provides. In other words, the tax-free treatment of benefits provided under the plan will be lost, and HCIs and key employees will have imputed income equal to the taxable benefit amount that they could have elected to receive for the plan year, even if they elected all qualified benefits. So HCIs and keys that make salary reductions will be taxed on the amount of those salary reductions. The employer should treat the amount as taxable income for purposes of Form W-2 wage reporting and for purposes of income tax, FICA and FUTA withholding.
A discriminatory plan, however, will not affect the favorable tax treatment conferred upon the non-HCIs under the plan. In addition, the cafeteria plan will continue to be a valid Section 125 plan even if it is discriminatory.

**Employer Action Required**

Employers should consider the nondiscrimination rules when designing or amending a cafeteria plan, particularly with respect to eligibility for and contributions to the plan. Eligibility and contributions, among other things, should be consistent for all employees and should not favor HCIs.

Employers that sponsor cafeteria plans should engage a vendor that can perform the appropriate nondiscrimination tests, and those tests should be performed during and at the end of the plan year, just to ensure that the plan is operating in a nondiscriminatory manner. Importantly, while corrections to the plan may be made throughout the year, no corrections may be made to the plan after the end of the plan year. Thus, the tests should really be monitored during the year so that any adjustments can be made prior to year-end.

**Penalties for Noncompliance**

There are no specific civil penalties associated with a nondiscrimination testing failure. However, there will be adverse tax consequences for a discriminatory plan, particularly for the HCIs, as explained above.

**Section 105(h)**

As background, Section 105(h) nondiscrimination applied in the past to self-insured plans only. Under the Patient Protection and Affordable Care Act (PPACA), Section 105(h) applies to fully insured, non-grandfathered plans as well.

*Note: Regardless of GF status, if the plan allows employees to pay premiums on a pretax basis through salary reductions, then the plan would still be subject to the Section 125 nondiscrimination rules.*

Generally, Section 105(h) prohibits plans from discriminating in favor of highly compensated individuals (HCIs) as to plan eligibility and benefits. An HCI is defined as a top-five paid officer, a more-than-10 percent shareholder and the top 25 percent of all employees, with respect to compensation. The top 25 percent category is important, since it means that every plan, regardless of the compensation structure and amounts, will have employees who are considered HCIs.

Under Section 105(h), there are two tests that the plan must satisfy: the Eligibility Test and the Benefits Test.

*Note: all employees of a controlled group (i.e., those businesses or companies that are under common control) will be included in determining the HCI group and in performing the nondiscrimination tests.*

Also, generally speaking, the plan may exclude the following employees for testing purposes (although if any of these are actually participating in the plan, they may not be excluded):

- Employees with fewer than three years of service
- Employees who have not attained age 25
- Part-time employees (generally defined as those who work fewer than 25 hours per week)
• Seasonal employees (generally defined as those who work less than seven months per year)
• Employees covered by a collective bargaining agreement
• Non-resident aliens with no U.S. source of income

Under the Eligibility Test, a plan may not discriminate in favor of HCIs as to eligibility to participate. A plan may actually satisfy any one of three tests to satisfy the eligibility test. The three tests are:

• The plan must actually benefit 70 percent or more of all employees (i.e., 70 percent or more of all employees must be enrolled in the plan).
• Seventy percent or more of all employees must be eligible to participate in the plan, and of those eligible to participate, at least 80 percent must actually benefit under the plan.
• The plan must be set up to benefit a classification of employees that is found by the Secretary of the Treasury not to be discriminatory in favor of HCIs.

The third test is a bit more complicated. Basically, the classification of employees must be based upon a bona fide employment classification consistent with the employer’s usual business practice. Examples of such bona fide classifications include full-time versus part-time status, current versus former employee status, different geographic location, occupation type, date of hire and length of service.

The classification of employees must also be considered nondiscriminatory based on a certain safe harbor percentage rate determined in IRS regulations. Since this test involves making a subjective determination based on the facts and circumstances of each particular case, outside counsel should be consulted by a plan seeking to satisfy the third test.

With respect to the Benefits Test, generally speaking both HCIs and non-HCIs must be provided with the same benefits. The Benefits Test tests whether the plan is discriminatory on its face and in operation. Generally, to pass the Benefits Test as it relates to discrimination on the plan’s face, employee contribution levels must not favor HCIs; maximum benefit and employer contribution levels may not vary based on age, compensation or years of service; types and amounts of reimbursable medical expenses must not favor HCIs; and waiting periods that favor HCIs may not be imposed.

Penalties for noncompliance with Section 105(h), are as follows;

For self-insured plans, a discriminatory plan design results in adverse tax consequences to the HCIs, who are taxed on their “excess reimbursements.”

For non-grandfathered fully insured plans, the penalty is assessed against the plan, and is based on each individual discriminated against (in the form of $100 per day per individual discriminated against). No such excess reimbursement is taxed to the HCIs of a fully insured plan.