

Checkpoint Contents

Pension & Benefits Library

Pension & Benefits Editorial Materials

EBIA Benefits Compliance Library

Cafeteria Plans

II. Cafeteria Plans: The Short Course

[II.P. How Can You Prevent Discrimination Problems?](#)

P. How Can You Prevent Discrimination Problems?

In order to provide tax savings, cafeteria plans (and their component benefit plans) must not discriminate in favor of highly compensated employees (HCEs) and key employees (Keys). To make sure this does not happen, Congress came up with some requirements that plans must meet. If a plan does not meet these requirements (i.e., if a plan is discriminatory), then some top employees will have adverse tax consequences. For example, HCEs may have to pay taxes on the amount of their salary reductions. This can create some very unpleasant surprises for HCEs/Keys, especially if a discrimination problem is not discovered before the end of the plan year, because corrections cannot be made to reduce the adverse impact after the end of the plan year.

Use of HCEs and Keys. We use these terms on a generic basis, for ease of understanding—they are shorthand references only. Consult the Code for precise definitions of who constitutes HCEs and Keys, which vary for each nondiscrimination test.

The nondiscrimination tests are complicated, but they can be boiled down to two basic themes:

- *Eligibility.* Unless enough non-highly compensated employees (non-HCEs) can get into the plan, the plan will fail as being discriminatory. Think of the tax savings as being like a party and ask yourself, "Have enough non-HCEs been invited to the party?"
- *Benefit Availability/Utilization.* A plan will be discriminatory if the HCEs/Keys can get more benefits than the non-HCEs/non-Keys. Think of the benefits as being appetizers at a party and ask, "Who is

being offered appetizers?" (availability test) or "Who is actually taking the appetizers?" (utilization test).

Although Mr. DoGood's plan is not complex-it provides for pre-tax payment of health insurance premiums, a health FSA, and a DCAP-it will have to pass nine different discrimination tests. But Widgets can easily pass some of the tests just by using the right plan design. If the company had only a POP, Mr. DoGood could even handle the testing himself. But because health FSAs and DCAPs need more careful monitoring, most employers with such programs hire a TPA to do the testing. Here is a brief overview of the tests for each plan-cafeteria plan, health FSA, and DCAP.

Safe Harbor for Simple Cafeteria Plans. Health care reform allows eligible small employers to establish "simple cafeteria plans" that are treated as meeting the nondiscrimination rules for cafeteria plans and certain component benefits (e.g., health FSAs and DCAPs), so long as specified contribution, eligibility, and participation requirements are met. In general, only employers with an average of 100 or fewer employees during either of the preceding two years may establish a simple cafeteria plan. Special rules address application of the rule to new employers and permit growing employers to continue benefiting from the relief until they employ an average of 200 or more employees. For more information, see Section XXXIII.

1. Cafeteria Plans-Three Nondiscrimination Tests

The Widgets cafeteria plan must pass an eligibility test, a contributions and benefits test, and a key employee concentration test. Under proposed regulations, these tests must be performed as of the last day of the plan year. But as a practical matter, the company should run these tests three times a year: before the beginning of the plan year, several months before the end of the year, and after the close of the year. This allows the company to take corrective action during the plan year if it appears that one or more tests will not be passed (e.g., by reducing contributions by HCEs/Keys).

Determining who is the employer and who is the employee is important for all of these tests. Some individuals must be counted because of their relationship with the plan sponsor. For example, a sponsor generally must consider not only its own employees but also those employed by related companies and employee-leasing entities. Thus, if Mr. DoGood owns 100% of Widgets and 100% of another company, then employees of both companies will need to be considered. Parent-subsidary and brother-sister

business relationships and affiliated service groups are "red flags" (i.e., these groupings raise nondiscrimination issues that need to be looked at closely by anyone running the tests).

a. Eligibility Test

This is the "Who is being invited to the party?" test. The cafeteria plan must not discriminate in favor of HCEs as to eligibility to participate. In general, HCEs for this purpose are officers; more-than-5% shareholders; individuals who are highly compensated; or the spouses or dependents of individuals in the first three categories. Proposed regulations provide additional guidance regarding these categories. For example, officers are individuals who were officers during the preceding plan year (or the current plan year in the case of a new hire). More-than-5% shareholders are individuals who own more than 5% of the employer's stock during the current or preceding plan year. When determining who is "highly compensated," a modified version of the 401(k) definition is used—an individual is highly compensated if his or her compensation during the preceding plan year (or the current plan year in the case of a new hire) exceeded the applicable dollar limit for that year (\$120,000 for 2017 and 2018; \$125,000 for 2019).

The Widgets plan will pass the eligibility test if it satisfies three requirements: (1) it benefits a nondiscriminatory classification of employees; (2) the same employment requirement applies to all employees, with no more than three years of employment needed to participate; and (3) entry is not delayed beyond the first day of the plan year after the employment requirement is met.

In order for a classification to be nondiscriminatory, it must be reasonable—i.e., based on objective business criteria, such as job categories, nature of compensation (e.g., salaried or hourly), and geographic location. Also, the group of employees in the classification benefiting under the plan must not discriminate in favor of HCEs. In general, a plan will pass this part of the test if the percentage of non-HCEs eligible under the plan is at least 50% of the percentage of eligible HCEs. If the percentage of eligible non-HCEs is less than 50% of the percentage of eligible HCEs, then the plan may still pass under certain conditions. Whoever does these tests needs to recognize some legal subtleties with respect to who can and cannot be counted—certain types of workers *must* be included and excluded. Proposed regulations also suggest that unequal availability of benefits or employer flex credits for HCEs and non-HCEs (or unequal salary reductions to get the same benefits) may also cause an eligibility test failure.

Some plan designs raise red flags in this area. These include separate cafeteria plans for different groups (e.g., having one plan for hourly employees and another plan for salaried employees), plans excluding part-timers, plans covering employees in one division but not in another, plans with different entry dates for

different employee groups, and plans that do not provide the same benefits to all participants.

b. Contributions and Benefits Test

This is the test that asks, "Who is being offered the appetizers?" (regarding the availability of benefits) and "Who is actually taking the appetizers?" (regarding the utilization of benefits). The test has three parts: availability, utilization, and nondiscrimination in operation.

In general, the availability test is satisfied if (1) all similarly situated participants get the same employer contributions (e.g., it is okay to have a greater contribution for those who take family coverage than for those who take employee-only coverage); and (2) a plan gives similarly situated participants the same opportunity to elect the same benefits.

A plan generally will fail the utilization test if nontaxable benefits (or employer contributions for such benefits) are disproportionately elected by HCEs. This test compares the actual elections by HCEs and non-HCEs; under recently proposed regulations, the aggregate benefits and contributions for each group are measured as a percentage of the group's aggregate compensation. The utilization test would be failed, for example, if a nontaxable benefit is offered to all participants but only HCEs elect it.

A cafeteria plan must also not discriminate in favor of HCEs in actual operation. An example of discriminatory operation could be a plan's duration (or offered benefit) that coincides with the period during which HCEs utilize the plan (or benefit).

Red flags are raised in this area by employers that vary benefits or contribution rates (e.g., by seniority).

c. Key Employee Concentration Test

If the qualified benefits provided to Keys exceed 25% of the total of all such benefits provided for all employees under the plan, the plan will fail the key employee concentration test. Keys differ from HCEs, although there is some overlap. A Key is someone who, during the preceding plan year, was an officer with annual compensation in excess of the dollar limit for that year (\$175,000 for 2017 and 2018; \$180,000 for 2019); a more-than-5% owner of the employer; or a more-than-1% owner of the employer with annual compensation greater than \$150,000 (not indexed). Watch out for cafeteria plans of small Subchapter C corporations in which shareholder-employees participate-the key employee concentration test is often failed by such plans even when the other tests are passed.

For more information about the nondiscrimination rules applicable to cafeteria plans, see Sections XXVIII and XXIX.

2. Health FSAs-Two Nondiscrimination Tests

Assume that Mr. DoGood's cafeteria plan passed all of the cafeteria plan nondiscrimination tests. Now he has to test the health FSA under a second group of tests, which applies to self-insured medical reimbursement plans. (Under health care reform, these tests will also apply to certain insured plans after the federal government issues regulations or other guidance about how the tests apply to these plans.) These tests differ in some respects from the tests for the cafeteria plan. Under a common (but aggressive) interpretation of the rules, a health FSA that is funded with salary reduction contributions will usually satisfy the applicable nondiscrimination requirements if all "nonexcludable employees" (employees who must be included in the plan) are eligible, and if all are able to elect the same amount of coverage.

An individual is an HCE for these purposes if he or she is (a) one of the five highest-paid officers; (b) a more-than-10% shareholder; or (c) among the highest-paid 25% of all employees (other than excludable employees who are not participants).

a. Eligibility Test

Health FSAs may not discriminate in favor of HCEs as to eligibility to participate-i.e., an employer must invite more than just the "top dogs" to the party! Certain employees may be excluded-e.g., those who have not completed three years of service. Permitted exclusions must be applied uniformly, and not just for testing.

To satisfy eligibility criteria, a plan must benefit one of the following: (1) 70% or more of all nonexcludable employees; (2) 80% or more of all employees who are eligible to benefit, if 70% or more of all nonexcludable employees are eligible to participate under the plan; or (3) employees qualifying under a classification that does not discriminate in favor of HCEs (the nondiscriminatory classification test).

Exactly what "to benefit" means in a health FSA is not clear. Does it mean that someone is merely *eligible* to elect health FSA coverage, or does it mean that the person has *actually elected* such coverage? Many

employers take the approach that being eligible to elect health FSA coverage is enough. This interpretation makes it easier to pass the test (e.g., if more than 70% of all employees are eligible, but only 25% of employees elect health FSA coverage, the test would be passed). However, the more cautious approach is that in order to benefit, an employee must have elected health FSA coverage or have been provided free health FSA coverage by plan design. If Widgets is cautious and is concerned that it may not pass the eligibility test (e.g., because mainly HCEs have elected health FSA coverage), it could provide \$100 in annual health FSA coverage to each employee via an employer seed contribution to the plan. With such a seed contribution, all employees are clearly benefiting under the plan.

b. Benefits Test

Under the benefits test, the benefits provided to HCEs under the plan must be provided to all other participants. Required contributions should be identical for each benefit level. The maximum benefit level that can be elected cannot be based on percent of compensation, age, or years of service. The type of benefits reimbursable must be identical for all participants. The health FSA must not have different waiting periods.

For more information about the nondiscrimination rules applicable to health FSAs, see Sections XXVIII and XXXI.

3. DCAPs-Four Nondiscrimination Tests

Mr. DoGood has his test results for the cafeteria plan and the health FSA-there is only one plan left. The DCAP has to pass four nondiscrimination tests. For a DCAP, an employee is an HCE if he or she is a more-than-5% owner during the current or preceding year, or if his or her compensation during the preceding year exceeded the dollar limit for that year (\$120,000 for 2017 and 2018; \$125,000 for 2019).

a. Eligibility Test

A DCAP must benefit employees who qualify under a classification that does not discriminate in favor of HCEs or their dependents. This ensures that a minimum number of non-HCEs are eligible to participate in the plan. The reasonable classification test for DCAPs is like the one for cafeteria plans, with some

exceptions (e.g., HCEs are defined differently).

b. Contributions and Benefits Test

Contributions and benefits that are available to eligible employees under the DCAP must not favor HCEs or their dependents. One way to satisfy this test is to make the maximum DCAP benefits and contributions the same for HCEs and non-HCEs.

"Bad" DCAP Distinctions. What if Widgets' DCAP were available to all employees, but only HCEs could elect the full \$5,000 benefit? Answer: It would fail the contributions and benefits test.

c. More-Than-5% Owners Concentration Test

No more than 25% of the amount paid for dependent care assistance during the year may be provided to more-than-5% shareholders or owners (or their spouses or dependents).

d. 55% Average Benefits Test

Under this utilization test, the average DCAP benefits provided to non-HCEs must be at least 55% of the average benefits provided to the HCEs. This test is considered to be one of the most important DCAP nondiscrimination tests. If the HCEs use DCAP benefits more than non-HCEs do, the plan will likely fail the test. This happens often, because HCEs (who usually have high income levels) are more likely to use DCAPs than are the non-HCEs. (Non-HCEs may believe that because of their lower income levels, they will benefit more from the DCTC (see subsection M) than from the DCAP-that is sometimes (but not always) true.) Some employees can be excluded in running the 55% Average Benefits Test. Also, employers with more than one line of business may improve their chances of passing the test by treating DCAPs sponsored by more than one line of business as separate plans.

For more information about the nondiscrimination rules applicable to DCAPs, see Sections XXVIII and XXXII.

4. Effect of Failing the Nondiscrimination Tests

If the cafeteria plan does not pass all of its nondiscrimination tests, then HCEs/Keys (depending on which test(s) are failed) will have taxable income equal to the combination of the taxable benefits with the greatest aggregate value that they could have elected for the plan year. That is, HCEs/Keys who made salary reductions will be taxed on the amount of those salary reductions. If a plan has a cash-out option (or an option to apply employer contributions to taxable benefits), then the HCEs/Keys who elect nontaxable benefits will be taxed on the cash-out amount (or other taxable benefits) that they could have elected instead. If the health FSA does not pass its tests, certain reimbursements paid to HCEs will be taxable. Likewise, if the DCAP fails any of its tests, the benefits provided to HCEs will not qualify for exclusion from income.

In any event, non-HCEs will not be harmed—they will be able to keep their tax savings even in a discriminatory plan.

Employers must monitor compliance with testing criteria during the plan year. This is because, unlike under the rules for qualified plans, employers cannot fix nondiscrimination problems after year-end.

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