Cafeteria Plans: Section 125 Nondiscrimination Rules

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Quick Facts:

- A Section 125 plan, or a cafeteria plan, allows employees to pay for certain benefits on a pre-tax basis.
- To receive a federal tax advantage, cafeteria plans must comply with Internal Revenue Code (Code) Section 125 regulations, including nondiscrimination rules.
- Additional nondiscrimination requirements apply to self-insured health plans, dependent care assistance programs (DCAPs) and certain other benefits paid for under a cafeteria plan.
- Plan sponsors should conduct nondiscrimination tests no later than the last day of the year.

This article explains the Internal Revenue Code Section 125 nondiscrimination rules applicable to cafeteria plans. This is the second in a continuing series of articles on cafeteria plan topics. The first article focused on the interaction between health flexible spending accounts (Health FSAs) and health savings accounts (HSAs).

Background

A Section 125 plan, or a cafeteria plan, allows employees to pay for qualified benefits on a pre-tax basis. Paying for benefits on a pre-tax basis reduces employees' taxable income and therefore reduces both an employee's and employer's tax liability. Partners and more-than-2% S Corp shareholders are generally not eligible to participate in a cafeteria plan.

The most common qualified benefits that may be offered under a cafeteria plan include:

- medical, vision and dental plans;
- disability and life insurance;
- health flexible spending accounts (Health FSAs);
- dependent care assistance programs (DCAPs); and
- health savings accounts (HSAs).

Section 125 Nondiscrimination Test

To retain its tax advantages, a cafeteria plan must pass certain tests to ensure that it does not discriminate in favor of certain highly compensated or key employees. If a cafeteria plan fails to pass nondiscrimination testing, highly compensated employees or key employees lose the tax benefits of participating in the plan, so their respective salary reductions become taxable. Note that, since partners and more-than-2% S Corp shareholders are generally not eligible to participate in a cafeteria plan, such individuals are not typically included in testing.

In general, a cafeteria plan must satisfy the following three nondiscrimination tests:

1	**Eligibility Test**	This test looks at whether a sufficient number of non-highly compensated employees are eligible to participate in the cafeteria plan. If too many non-highly compensated employees are ineligible to participate, the plan will fail this discrimination test.
2	**Benefits and Contributions Test**	This test is designed to make sure that a plan's contributions and benefits are available on a nondiscriminatory basis and that highly compensated employees do not select proportionately more nontaxable benefits than non-highly compensated employees select.
3	**Key Employee Concentration Test**	This test looks at whether key employees impermissibly utilize the plan's benefits more than non-key employees. Under this test, key employees must not receive more than 25% of the aggregate nontaxable benefits provided to all employees.

What Is a Highly Compensated Employee?

Under the Code, an employee is a highly compensated employee if:

- the employee was a more-than-5% owner of the employer at any time during the current or preceding plan year, or
- for the preceding plan year (or current year for new hires), the employee had compensation in excess of a specified dollar threshold ($120,000 for 2017 and 2018).

What Is a Key Employee?

Under the Code, a key employee is any employee (or former employee, including a deceased employee) who, at any time during the prior plan year, was:

- an officer of the employer with annual compensation in that year in excess of a specified dollar threshold ($175,000 for 2017 and 2018);
- a more-than-5% owner of the employer; or
- a more-than-1% owner of the employer with annual compensation in excess of $150,000.

Exceptions for Nondiscrimination Tests

Certain exceptions and safe harbors apply to the cafeteria plan nondiscrimination tests with respect to premium only plans and simple cafeteria plans.

Premium Only Plans

A cafeteria plan that is a premium only plan ("POP") – a plan that provides for pre-tax premium contributions and no other benefits – is deemed to satisfy all of the cafeteria plan nondiscrimination requirements if it passes the eligibility test described above.

Simple Cafeteria Plans

Under the Affordable Care Act (ACA), eligible small employers became eligible to establish simple cafeteria plans starting in 2011. The ACA provides a safe harbor for eligible small employers in recognition that they are more likely than larger employers to have a higher percentage of highly compensated employees and will therefore fail nondiscrimination testing. The safe harbor covers the non-discrimination requirements applicable to certain benefits offered under a cafeteria plan, including pre-tax employee contributions, self-insured health plans, dependent care assistance programs, and group life insurance.

A small employer is defined as one with an average of 100 or fewer employees on business days during either of the two preceding years. If the employer was not in existence during the prior year, the determination is based on the average number of employees who are reasonably expected to be employed on business days during the current year.

Once the plan is established, the company will be deemed to meet the requirement even if it employs an average of more than 100 people in subsequent years, in order to encourage hiring. However, if the average employee count exceeds 200 or more, the company will longer qualify for a simple cafeteria Plan in the following year.

Simple cafeteria plans are treated as meeting the nondiscrimination rules for cafeteria plans and certain component benefits (e.g., Code section 105(h) self-funded health plan nondiscrimination, Code section 129 nondiscrimination for DCAPs), so long as specified contribution, eligibility, and participation requirements are met.

Each employee who is not a highly compensated or key employee must receive an employer contribution of at least:

- two percent of the employee's compensation for the plan year, or
- the lesser of six percent of the employee's compensation for the plan year or a 100% match of the employee's own salary reduction amount.

The rate of match for highly compensated and key employees cannot exceed the rate of match for employees who are neither highly compensated nor key employees.

Certain employees may be excluded in order from the eligible employee count, such as those:

- with fewer than 1000 hours of service during the preceding plan year;
- under age 21;
- with less than one year of service with the employer;
- covered under a collective bargaining agreement; or
- that are nonresident aliens working outside the U.S.

All eligible employees must be able to elect any qualified benefit available under the plan, subject to any terms and conditions that apply to all participants.

Cafeteria Plans and HSAs

If an employer makes HSA contributions outside of a cafeteria plan, the employer must make comparable contributions to the HSAs of all comparable participating employees. As a general rule, contributions are comparable if they are the same dollar amount or the same percentage of the HDHP deductible. If an employer fails to comply with the comparability requirement during a calendar year, it will be liable for an excise tax equal to 35% of the aggregate amount contributed by the employer to the HSAs of its employees during that calendar year.

Employers that vary their HSA contributions to different groups of employees often run afoul of the comparability rule. However, the comparability rule does not apply to HSA contributions made through a cafeteria plan. Consequently, most employers include HSAs in their cafeteria plans. Even though the employer's contributions are subject to the cafeteria plan nondiscrimination rules discussed above, those are generally easier to pass than the more onerous comparability rule.

HSAs and the Section 125 Irrevocability Rule

As a general rule, cafeteria plan elections are irrevocable during a plan year, meaning participants cannot change their elections unless they experience an event that permits an election change (e.g., birth, marriage, loss of coverage).

However, HSAs are not subject to the cafeteria plan irrevocable election rules. HSA elections under a cafeteria plan may start, stop, increase or decrease at any time during a plan year, as long as the election change is effective prospectively. An employer may place additional restrictions on HSA contribution elections under its cafeteria plan, but the same restrictions must apply to all employees. Also, an employer must allow HSA election changes at least monthly and upon loss of HSA eligibility.

Additional Nondiscrimination Rules for Other Common Qualified Benefits

In addition to the Section 125 nondiscrimination rules for cafeteria plans, separate nondiscrimination requirements and tests apply to certain qualified benefits that can be paid for under a cafeteria benefit plan such as self-insured health plans and DCAPs, two of the most popular.

Code section 105(h) nondiscrimination rules apply to self-insured medical, dental, vision benefits as well as health FSAs and health reimbursement arrangements (HRAs). These complex rules will be addressed in a future cafeteria plan article.

The Section 105(h) nondiscrimination rules do not apply to fully insured group health plans. However, the Affordable Care Act (ACA), includes similar nondiscrimination rules that have been indefinitely delayed. Consequently, sanctions for failure to comply with the rules do not apply at this time. These rules, if enacted, would apply to non-grandfathered fully insured plans.

Code section 129 subjects DCAP benefits to nondiscrimination tests to ensure that they are not provided disproportionately to members of a prohibited group, which includes highly compensated employees and certain owners.

When to Conduct Section 125 Tests

Under proposed regulations, Code Section 125 nondiscrimination tests should be conducted as of the last day of the plan year, taking into account all non-excludable employees who were employed on any day during the plan year. The best practice is to perform one test in the early or middle part of the

plan year in order to provide an opportunity to make corrections before the end of the plan year so that the plan passes the tests and preserves the tax treatment for the highly compensated and key employees. A plan sponsor then would conduct a final test as of the last day of the plan year.

Employee salary reductions cannot be recharacterized as after-tax contributions after the end of the plan year. If it is determined after the close of the plan year that a test is failed, the affected key or highly compensated employee should be taxed in accordance with the Section 125 rules.

Conclusion

Cafeteria plans are subject to numerous compliance rules in order to permit tax-free contributions. In addition to written plan document requirements, irrevocability and forfeiture rules, cafeteria plans that discriminate in favor of highly compensated and key employees will lose the tax benefits for those highly compensated and key employees.

FSA administrators often perform nondiscrimination testing for their clients. Plan sponsors should confirm or identify testing vendors to regularly test their cafeteria plan (including HSA, if any) and other qualified benefits offered under the plan.