

Introduction to Nondiscrimination Testing



Cafeteria plans are popular because they allow employees to receive health insurance coverage from their employers without having to pay taxes on it. Intending cafeteria plans to benefit the rank-and-file employee, Congress created rules to ensure that their tax-favored status would not be used to benefit only or primarily the highest-paid or owners of a company. These rules are referred to as nondiscrimination testing.

Cafeteria plans are not the only type of benefit plan that receives tax-favored status and must perform nondiscrimination testing. Self-insured plans, insured plans, Health FSAs, and DCAPs must also undergo testing. Testing for each of these will vary slightly, but although the details are different, overall concepts are similar.

Nondiscrimination testing is designed to ensure that the benefits are 1) generally available to a company's employees and are 2) being utilized by a majority of rank-and-file employees. To measure this, testing rules distinguish between rank-and-file and highly compensated employees and create threshold percentages for rank-and-file participation. Also, "nondiscrimination testing" usually means that the plan must pass two or three different tests that each address either availability of benefits or utilization of benefits.

This introductory primer will first highlight some of the concepts that apply to all types of nondiscrimination testing, then detail testing requirements for each particular plan type (e.g., cafeteria plans, self-insured plans, etc.).

Nondiscrimination Testing Generally

When to test

Although not mandated by any statute, nondiscrimination testing generally should be performed three times a year: 1) prior to the beginning of the plan year; 2) several months before the end of the plan year; and 3) after the close of the plan year. This ensures that any elements in the plan that cause it to fail can be corrected before the end of the plan year.

Control groups

Control groups refer to when two or more companies are so closely related that they should be treated as one employer. For example, if XYZ Company owns 80% of ABC Company, these two companies will be treated as one employer for testing purposes. Why is this important? As discussed above, the testing is concerned with employees being eligible to participate and actually participating in the plan. Suppose that in order to pass the testing, 70% of your employees have to be eligible to participate in the plan. You have 100 employees and all 100 participate. However, if you are joined as a "control group" with another company that has 100 employees and none of them are eligible to participate in the plan, then you would no longer meet the 70% threshold.

As a result, what "to own" means becomes very important. Constructive ownership rules apply, primarily in relation to stocks. For example, let's say you own 1 share of stock out of 1000, but have an option to buy the other 999. Under the rules of constructive ownership, you would be deemed to own 1000 shares even though you don't actually own them.

What is being tested

It is important to realize that the testing is applied on a plan-by-plan basis; for example, if you have 100 employees and three separate plans, 70% of all 100 employees must be eligible to participate in each of the three plans. All non-excludable employees are considered in deciding whether a particular plan passes. So, if you offer one plan for your 10 managers in a 100-employee company and another plan for the 90 other employees, then the plan for your managers will fail unless 60 other employees are eligible to participate in it ($60 + 10 = 70$).

To benefit

The rules are concerned with whether employees are "benefiting" from the plan. "Benefit," however, is not clearly defined. There are two approaches available. The more conservative approach, which Beneliance follows, defines that in order to benefit, an

employee must have elected coverage or have been provided with free coverage by plan design. (The more aggressive approach, on the other hand, says that in order to benefit, an employee only needs to be eligible to elect coverage.)

Which employees

Not all workers are considered “employees” for nondiscrimination testing. For example, cafeteria plan nondiscrimination testing requires that part-time employees be counted. Testing for self-insured plans, however, permits part-time or seasonal employees to be excluded. Some plan types may allow the exclusion of certain employees for certain parts of the test but not others. Consequently, when discussing the particular tests, reference will be made to “non-excludable” employees. Excluding certain workers is obviously attractive to employers because it usually increases their chances of reaching the threshold percentage for passing.

Highly compensated employees (HCEs)

These are the employees whom Congress was worried about receiving the lion’s share of the benefits; they are sometimes referred to as “the prohibited group.” Like excludable employees, the definition of “highly compensated employee” (HCE) will vary depending on whether we’re looking at a cafeteria plan or self-insured plan; usually however HCE includes the highest-paid 20-25% of employees.

This also raises the question of exactly what “compensation” is. The rules allow any reasonable definition of compensation so long as it is used consistently. The time bracket for compensation must also be determined. It usually is the prior year, but the rules provide some flexibility.

Penalties

What happens if your plan fails the test? Usually that means that the benefits received by the HCEs will no longer enjoy their tax-favored status. The only exception is for fully insured plans, which receive a different penalty under the Patient Protection and Affordable Care Act (i.e., health care reform). If a plan fails the test at the beginning or in the middle of the plan year, the plan can be corrected so as to avoid adverse tax consequences. A plan administrator should have the authority to cut off any employee’s salary reductions in order to comply with the nondiscrimination rules.

Safe Harbors

Certain plans can be exempted from certain tests (or from testing altogether) if they meet particular requirements. For example, if a POP cafeteria plan passes the eligibility test, it does not have to pass the two remaining tests.

Red flags and how to pass

If your cafeteria plan contains the following elements, then you could be in danger of failing nondiscrimination testing (similar red flags exist for self-insured plans, etc.):

- Separate cafeteria plans for different employee groups, such as one plan that covers hourly employees and a different plan that covers salaried employees.
- Exclusion of part-time, seasonal, or temporary employees. (Inapplicable for self-insured plans).
- In a controlled group, employees in one division or company are covered, but those in another division or company are not.
- Employment requirements, waiting periods, or entry dates vary for different groups of employees (e.g., a single cafeteria plan sponsored by a controlled group contains different entry requirements for employees of various entities in the controlled group).
- Entry into the plan is delayed beyond the first day of the first plan year beginning after the date the employment requirement is met. This will cause a plan to fail automatically.
- The plan bases employer contributions or benefits on years of service or percentage of compensation.
- Contributions and rates within a single cafeteria plan vary for different groups of employees.

Although perhaps not a palatable business option on its face, the simplest way to pass nondiscrimination testing is to make all provided benefits available on the same basis to all your non-excludable employees and to make the provided benefits attractive enough (i.e. affordable) that a majority of your employees actually utilize the offered benefits. Nevertheless, some variation is allowed, the limits of which are discussed in the following section.

Nondiscrimination Testing by Plan Type or Benefit

We will now review the tests for each plan type and what is required for each test, beginning with cafeteria plans.

1. Cafeteria plans must perform three tests: 1) the eligibility test; 2) the contributions and benefits test; and 3) the key employee concentration test.
 - a. The eligibility test ensures that a reasonable number of non-HCEs are eligible to participate in the cafeteria plan. In order to pass, the plan must meet three requirements:
 - i. No employee is required to complete more than three years of employment to participate.
 - ii. Entry into the cafeteria plan is not delayed
 - iii. The plan meets a nondiscriminatory classification test, meaning that an employer can allow the plan to treat certain employees differently so long as the classification is a reasonable one and isn't discriminatory.¹ Reasonable classifications include:
 1. Specified job categories
 2. Nature of compensation (i.e. hourly vs. salaried)
 3. Geographic location
 4. Similar bona fide business criteria
 - iv. For the nondiscriminatory classification test the following type of employees may be excluded:
 1. Collectively bargained employees
 2. Nonresident aliens with no U.S. source income from the employer
 3. Employees participating in the cafeteria plan under a COBRA continuation provision
 - b. The contributions and benefits test asks three questions:
 - i. Are employer contributions available on a nondiscriminatory basis?
 1. Similarly situated participants must be given a uniform election with respect to employer contributions. "Similarly situated"² means participants with self-only coverage or those with family coverage.
 - ii. Are benefits available on a nondiscriminatory basis?
 1. Similarly situated participants must have a uniform opportunity to elect benefits
 - iii. Are HCEs utilizing a disproportionate amount of benefits?
 1. Who are HCEs for cafeteria plans?
 - a. Officers
 - b. More-than-5% shareholders
 - c. The highly compensated (+\$110,000 per annum)
 - d. Spouses and tax dependents of the above categories
 2. Performing this test involves determining two different ratios
 - a. First ratio: the sum of the value of all benefits elected by HCEs ÷ the sum of the compensation of all HCEs
 - b. Second ratio: the sum of the value of all benefits elected by non-HCEs ÷ the sum of the compensation of all non-HCEs
 3. In order to pass the second ratio must be greater than the first ratio
 4. Example: 3 HCEs elect \$1,200 in coverage (3 X \$1,200 = \$3,600). 5 non-HCEs elect \$1,200 in coverage (5 X \$1,200 = \$6,000). There are 4 HCEs total and their total compensation is (4 X \$120,000) \$480,000. There are 20 total non-HCE employees and their total compensation is (20 X \$30,000) \$600,000.
 - a. $\$3,600 \div \$480,000 = .75\%$
 - b. $\$6,000 \div \$600,000 = 1.0\%$
 - c. $1.0\% > .75\%$... therefore, the plan passes.

¹ A classification is not discriminatory for a plan year if, and only if, the group of employees included in the classification benefiting under the plan satisfies either a "safe harbor percentage test" or an "unsafe harbor percentage" test for the plan year. To meet the Safe Harbor Percentage Test, a plan's Ratio Percentage must be equal to or greater than the applicable Safe Harbor Percentage. The details of the passing either the Safe Harbor Percentage Test or the Unsafe Harbor Percentage Test is beyond the scope of this introductory primer.

² The proposed regulations further provide that, when determining whether participants are "similarly situated," reasonable differences in plan benefits may be taken into account, such as variations in plan benefits offered to employees working in different geographical locations or to employees with family coverage versus employee-only coverage. Prop. Treas. Reg. § 1.125-7(e)(2).

5. There is a safe harbor³
 - c. Key employee concentration test – this test only asks whether key employees are receiving more than 25% of all nontaxable benefits provided.
- i. Who is a key employee?
 1. Officers with +\$160,000 compensation per annum
 - a. Authority is more important than title with regard to who is an officer.
 2. More-than-1% owners with +\$150,000 compensation per annum
 3. More-than-5% owners
- ii. The determination key employee status is determined based on the preceding plan year.
- iii. This test does not need to be performed by collectively bargained and governmental plans

Nondiscrimination testing for fully insured plans is a new requirement brought about by health care reform. The primary difference between the two types is the penalty resulting from failure. (Also, there are certain types of benefits that are exempt from PPACA's mandate and so would be exempt from this requirement as well). For self-insured plans the penalty is the taxation of the HCEs' benefits. For fully insured plans, the penalty is \$100 per day for each individual to whom the failure relates.

2. Self-insured and fully insured medical plans must perform two tests: 1) the eligibility test and 2) the benefits test, but determining who HCEs are and what employees can be excluded needs to be known before performing the tests.
 - a. Who are the HCEs?
 - i. 5 highest-paid officers
 - ii. More-than-10% owners
 - iii. Highest-paid 25%
 - b. Which employees may be excluded?
 - i. Employees who have served fewer than 3 years
 - ii. Employees under age 25
 - iii. Part-time⁴ or seasonal⁵ employees
 - iv. Collectively bargained employees
 - v. Non-resident aliens who receive no U.S. source income
 - vi. Leased employees
 - c. The eligibility test provides three ways with which to pass it. Passing any one of them means you've passed the eligibility test.
 - i. Does the plan benefit 70% or more of all non-excludable employees?
 - ii. Are 70% of non-excludable employees eligible to benefit, and are 80% of that 70% actually benefiting from the plan?
 - iii. Does the plan benefit a nondiscriminatory classification of employees?⁶ This requires:
 1. A bona fide business classification for any exclusion, and
 2. A sufficient ratio of benefiting non-HCEs to benefiting HCEs.
 - d. The benefits test only asks two questions:
 - i. Is there any discrimination on the face plan? Four things should be true in order to answer "no."
 1. Required employee contributions must be identical for each benefit level.
 2. The maximum benefit level cannot vary based on age, years of service, or compensation.
 3. The same type of benefits that are available to HCEs must be available to non-HCEs.
 4. Disparate waiting periods cannot be imposed.
 - ii. Is there any discrimination in the operation of the plan?

3 There are three requirements to satisfy the safe harbor: 1) the cafeteria plan must provide health benefits; 2) either a) contributions under the cafeteria plan on behalf of each participant must equal 100% of the cost of the health benefit coverage under the plan of the majority of similarly situated HCEs or b) the contribution on behalf of each participant must equal or exceed 75% of the cost of the most expensive health benefit coverage available under the plan for similarly situated participants; and 3) if the cafeteria plan provides contributions or benefits in excess of the amounts needed to satisfy the 100% or 75% standard, then those excess contributions must bear a uniform relationship to compensation.

4 Part-time = less than 25 hours a week.

5 Seasonal = less than seven months.

6 The nondiscriminatory classification test found in Code § 410(b)(2)(A)(i) and Treas. Reg. § 1.410(b)-4

1. This is a facts and circumstances determination.
- e. Special issues for fully insured medical plans
 - i. As stated previously, certain benefits are exempted from this requirement like:
 1. Certain dental or vision plans
 2. Certain Health FSAs
 - ii. Although unclear, fully insured plans with fewer than fifty employees are technically required to apply, the tax imposed upon such plans as the penalty does not apply to plans with fewer than fifty employees. Therefore, unless rectified, it appears such plans are supposed to comply, but the government has no enforcement mechanism if they choose not to.
- f. Safe Harbor – Qualifying for a simple cafeteria plan means you don't have to perform either the eligibility or benefits tests. To qualify you must:
 - i. Employ an average of 100 or fewer employees during either of the two preceding years, and
 - ii. Contribute a uniform percentage (but not less than 2%) of the employee's compensation for the plan year or an amount that equals or exceeds the lesser of
 1. 6% of the employee's compensation for the plan year or
 2. Twice the employee's salary reduction contributions
 - iii. Which employees are excludable?
 1. Those under age 21
 2. Those with less than one year of service
 3. Those covered by a collective bargaining agreement
 4. Certain nonresident aliens working outside the U.S.

Nondiscrimination testing must be performed not only for plan types (e.g. a cafeteria plan) but also for certain benefits, like a DCAP or Health FSA. Testing for Health FSA involves the same tests for fully insured and self-insured plans so we won't review those. Also, because DCAPs and Health FSAs are usually offered within a cafeteria plan, these benefits would be subject to both cafeteria plan nondiscrimination testing and their individual testing. You will want to perform cafeteria plan nondiscrimination testing first because if you fail that test, then the salary reductions are taxable. If the salary reductions are taxable, the testing for DCAPs or Health FSAs will not need to be performed (i.e. there will be no double taxation).

3. DCAPs must perform four different tests: 1) the eligibility test; 2) the contributions and benefits test; 3) more-than-5% owners concentration test; and 4) the 55% average benefits test. Before testing, however, who the HCEs and excludable employees are must be determined.
 - a. Who are HCEs?
 - i. Employees whose compensation during the preceding plan year exceeds \$110,000.
 - ii. More-than-5% owners in the current or preceding year.
 - b. The eligibility test for DCAPs actually considers those who are merely eligible to participate, not those who are actually benefiting. In the event a plan makes an among employees for this benefit, the test requires that
 - i. The exclusion must be based on a bona fide business classification and
 - ii. A sufficient ratio percentage of non-HCEs to HCEs must be eligible. This ratio is determined in the same manner as it is for the eligibility test with cafeteria plans.
 1. Excludable employees for the eligibility test
 - a. Employees under age 21
 - b. Employees who have completed less than one year of service
 - c. Employees in collective bargaining agreement
 - c. The contributions and benefits test is a facts and circumstances test that examines whether HCEs and their dependents are receiving a better benefit or contribution than non-HCEs. For example, the test asks:
 - i. Do the HCEs and the non-HCEs get the same amount of employer contributions?
 - ii. Are the HCEs and non-HCEs entitled to the same maximum reimbursement?
 - iii. Do the HCEs get anything that's better than what the non-HCEs get?
 - iv. Any easy way to pass this test is to ensure that the maximum DCAP benefits and contributions are identical for HCEs and non-HCEs.
 - d. The more-than-5% owners concentration test simply asks:
 - i. Are more-than-5% owners receiving more than 25% of the DCAP benefits?

1. Note: those who owned more than 5% on any day of the year qualify.
- e. The 55% average benefits test asks:
 - i. Are non-HCEs utilizing at least 55% of the average benefits utilized by HCEs?
 - ii. Excludable employees
 1. Employees making less than \$25,000
 2. Employees who have served less than one year
 3. Employees under age 21
 4. Employees in a collective bargaining agreement
 - iii. Example: Acme Co. has seven employees—A, B, C, D, E, F, and G. A and B are HCEs; C, D, E, F, and G are non-HCEs. A, B, C, and D participate in the DCAP, but E, F, and G do not. A, B, C, and D have reduced their salaries by \$5,000 and are provided benefits worth \$5,000 under the plan. Acme must compare the average benefits of the HCEs with those of the non-HCEs. The average benefit provided to the HCEs is \$5,000 $[(\$5,000 + \$5,000) \div 2]$. The average benefit provided to the non-HCEs is \$2,000 $[(\$5,000 + \$5,000 + \$0 + \$0 + \$0) \div 5]$. The average benefit provided to the non-HCEs is 40% of the average benefit provided to the HCEs $(\$2,000 \div \$5,000 = 0.4)$. Consequently, the DCAP fails the 55% Average Benefits Test.

Conclusion

The preceding has been only an introduction into nondiscrimination testing for benefit plans; several questions arise which we did not address at this time. Beneliance is committed to working with you to ensure full compliance with the law. We welcome your questions and comments.