

Overview of Dependent Care Nondiscrimination Testing

The Internal Revenue Code provides an income tax exclusion for benefits received under employer-sponsored dependent care assistance programs. The exclusion comes with an important condition — in order for executives and other highly paid individuals to take advantage of the exclusion, an employer must be able to demonstrate that the benefit satisfies applicable nondiscrimination tests. This *FYI In-Depth* describes the nondiscrimination tests that apply to DCAPs to help employers understand how each test operates and what data they need to collect in order to conduct the tests.

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Background

Section 129 of the Internal Revenue Code (Code) provides an income tax exclusion for benefits received through an employer-sponsored dependent care assistance program (DCAP). The maximum annual exclusion depends on an employee's federal income tax filing status — \$5,000 for most filers, but only \$2,500 for employees whose status is "married, filing separately." DCAP benefits include not only reimbursements from a dependent care flexible spending account, but also direct payment of expenses by the employer and the fair market value of on-site dependent care facilities to the extent not paid for by the employee on an after-tax basis.

Section 129 subjects DCAP benefits to the following nondiscrimination tests to ensure that they are not provided disproportionately to members of a "prohibited group":

- **An eligibility test.** The DCAP must benefit employees who qualify under an eligibility classification that does not discriminate in favor of highly compensated employees.

Health and Welfare Nondiscrimination Testing

This is the second in a series on the nondiscrimination rules for health and welfare benefits. Our **November 8, 2017** *FYI In-Depth* provides an overview of the various requirements.

- **A contributions and benefits test.** The contributions or benefits provided under the DCAP may not discriminate in favor of employees who are highly compensated employees.
- **The “5-percent owner” test.** Not more than 25 percent of the total benefits under the DCAP can be provided to individuals who own more than 5 percent of stock, capital or profit interest in the employer.
- **The “55 percent average benefits” test.** The average benefits provided to non-highly compensated employees must be at least 55 percent of the average benefits provided to highly compensated employees

Satisfaction of the requirements must be demonstrated through testing. If a test is failed, the exclusion for DCAP benefits will not be available to highly compensated employees (or more than 5 percent owners, as applicable) and any dependent care benefits they receive during the year will be includible in their income.

Unfortunately, guidance on how to conduct the DCAP tests is limited. Code Section 129 only sets out the general framework for the tests and the IRS has not issued regulations to provide any specifics. For that reason, in some instances, assumptions must be made and analogies drawn from guidance issued for other nondiscrimination tests.

Elements of DCAP Nondiscrimination Testing

A general overview of each of the elements is set out below.

The Prohibited Group

There are two categories of prohibited groups in DCAP nondiscrimination testing – “highly compensated employees” (HCE) and “5-percent owners.” Status as an HCE for DCAP testing purposes is determined using the same definition of highly compensated employee that is used in identifying highly compensated employees for testing qualified retirement plans [e.g., 401(k) and defined benefit plans] for discrimination. Generally, under this definition, a highly compensated employee is an employee of an employer who meets either of these conditions:

- Was a 5-percent owner at any time during the plan year being tested or the preceding year
- For the preceding year, received compensation in excess of a specified threshold (i.e., for 2017 testing, this is compensation of at least \$120,000 in 2016)

For this purpose, “employer” includes not only the entity that employs the individual, but also all other entities that are members of the same controlled group of corporations as the employing entity or of trades or businesses under the same common control. “Employee” includes not only common-law employees, but also “leased employees.”

What is a “leased employee”?

A worker who is an employee of a leasing organization will be treated as a “leased employee” of the entity for which he or she is performing services (the “recipient”) if:

- The services are provided pursuant to an agreement between the recipient and the leasing organization.
- The worker has provided services to the recipient on a substantially full-time basis for at least a year.
- The services are performed under primary direction or control by the recipient.

A worker is considered to have performed services on a substantially full-time basis for at least one year if during any consecutive 12-month period, the worker either:

- (1) performed at least 1,500 hours of service for the recipient; or
- (2) performed at least 75 percent of the number of hours of service customarily provided by an employee of the recipient.

An employer with a significant number of employees who would have HCE status based on compensation may elect to limit HCEs to those employees who, in addition to meeting the compensation threshold, are also in the top 20 percent of all employees based on compensation during the preceding year. This top-paid group election will apply to the determination of HCE status for all nondiscrimination tests that use the Section 414(q) definition of HCE, including those for qualified plans, and across all members of the controlled group.

An employee is a 5-percent owner of the employer for a particular year if at any time during such year, he or she owns more than 5 percent of the value of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a 5-percent owner is any employee who owns more than 5 percent of the capital or profits interest in the employer.

Excludable Employees

Ineligible employees covered by a collective bargaining agreement where the DCAP benefits were the subject of good faith bargaining may be excluded from the eligibility and 55 percent average benefits tests. Employees under age 21 or who have not completed at least one year of service, as of the end of the plan year, also may be excluded from those tests — however it is unclear whether they must be ineligible to participate in the DCAP in order to be excluded. Employees whose compensation is less than \$25,000 can be excluded from the 55 percent average benefits test if the DCAP is “funded” through salary reduction contributions.

Eligibility Test

In order to satisfy the eligibility test, a DCAP must benefit a classification of employees that does not discriminate in favor of HCEs or their dependents. Because there is no specific guidance on how this requirement is satisfied, many practitioners apply the nondiscriminatory classification test under Code Section 410(b), used for qualified plans. Under this test, the classification of employees eligible to participate must be reasonable and based on objective business considerations. In addition, the classification must satisfy a mathematical test that compares the percentage of non-HCEs eligible to participate to the percentage of HCEs eligible to participate.

The eligibility test generally is run on a controlled group basis. This means that nonexcludable employees from all related employers are taken into account when running the tests. While it isn't entirely clear, it appears that the special Code Section 410(b) provision on acquisitions and dispositions applicable to qualified plans also applies to the DCAP eligibility test. Under that provision, a plan will be deemed to satisfy the eligibility test through the last day of the first plan year following an acquisition or disposition if it satisfied the eligibility test immediately prior to the transaction and there are no significant changes to the plan or coverage (except for the transaction).

Which DCAPs are at risk for failing the eligibility test?

DCAPs that exclude certain categories of employees from participation (e.g., part-time, hourly) or that are only available to employees of one member of a controlled group may fail the eligibility test.

Benefits and Contributions Test

The purpose of this test is to confirm that DCAP benefits are not available to HCEs or their dependents on more favorable terms than to other employees. This is generally a facts-and-circumstances test that considers whether members of the prohibited group receive different or greater benefits — or pay less for the same benefits — than others. There is no quantitative test for determining whether this requirement is satisfied.

The majority of DCAPs are flexible spending arrangements funded solely through salary reduction and are provided on the same terms to all eligible employees (or limits are imposed only on the amounts that HCEs can contribute to pass the 55 percent average benefits test). For this reason, most DCAPs will automatically satisfy the benefits and contributions test. However, if one member of a controlled group makes separate employer contributions to the DCAPs (e.g., “seed” money or matching contributions) of its employees and others do not, the plan could potentially fail this test. Similarly, an employer that provides on-site daycare to employees at below-market rates at some locations, (such as corporate headquarters) but not others, might be at risk. Although there is no clear guidance, it appears that different plan or benefits structures may be tested separately under this test if they can satisfy the eligibility test on their own.

5-Percent Owner Test

The 5-percent owner test is a utilization test. The purpose of this test is to confirm that principal shareholders and owners of the employer are not disproportionately receiving DCAP benefits. To satisfy this test, not more than 25 percent of the amounts paid or incurred by the employer for DCAP benefits during the year may be provided to 5-percent owners of the employer.

55 Percent Average Benefits Test

The 55 percent average benefits test is also a utilization test. To satisfy this test, the average dependent care benefit received by non-HCEs cannot be not less than 55 percent of the average dependent care benefit received by HCEs. The 55 percent average benefits test is the most easily failed of the DCAP non-discrimination tests.

The average benefits test is performed by dividing the average benefit received by non-HCEs by the average benefit received by HCEs. The average benefit for non-HCEs is determined by dividing the total amount of DCAP benefits received by non-excludable non-HCEs by the total number of non-excludable non-HCEs of all entities under common control. The same process is used to determine the average benefit received by HCEs. If the result is at least 55 percent, the DCAP passes the test; if less than 55 percent, it fails. Although there is no clear guidance, the conservative approach is to take into account all non-excludable employees, including those who are not eligible to participate in the DCAP.

Unlike the eligibility test, there is no special provision for acquisitions and dispositions — the average benefit test must be satisfied for the plan year of the transaction. The 55 percent average benefit test can be run on a separate line of business basis, but only if certain conditions are met. One condition is that the employer submit an election to be treated as a qualified separate line of business for retirement plan purposes as well as for purposes of the 55 percent average benefit test.

What steps can be taken to avoid failure?

Because HCEs typically participate in the DCAP at a much higher rate than non-HCEs, it is not unusual for a plan to fail the 55 percent average benefits test. To reduce the likelihood of failure, an employer may consider capping HCE DCAP elections at an amount below the \$5,000 maximum. Some employers cap HCE elections during open enrollment, before the plan year starts, to help pass the test. Others wait to cap HCEs until tests are conducted during the plan year. There are advantages and disadvantages to each approach. If an employer expects to fail the tests, or has capped HCEs, tests should be conducted as early in the year as practical.

If the plan is at risk of failing the eligibility test, the group eligible for the plan would need to be expanded. Use of the excludable employee categories can also help test results.

When to Run the Tests

Section 129 does not specify when the nondiscrimination tests should be run. Ideally, they would be run before, during, and immediately after the close of the plan year. However, most employers do not do this. Those that do not should consider, even before the beginning of the plan year, whether their plan design will likely pass the eligibility and benefits and contributions tests based on their demographics and that of other members of their controlled group.

The discrimination tests based on utilization (the 5-percent owner test and the 55 percent average benefits test) should be run before the end of the plan year so that appropriate action can be taken before year's end if the plan fails these tests. Unlike 401(k) plans, it is not possible to make a corrective distribution from a dependent care flexible spending account after the close of the plan year.

Tax Consequences if Nondiscrimination Test Failed

Generally, only members of the prohibited group are adversely affected if a plan fails one of the DCAP nondiscrimination test — they will lose the benefit of the applicable tax exclusion and have the value of the benefit included in their income. Employees who are not in the prohibited group will still qualify for all of the tax advantages applicable to the benefit.

In Closing

Employers need to be aware of all of the DCAP nondiscrimination tests and take action to ensure:

- All employers in the controlled group are included in testing.
- All of the required eligibility and benefits tests are satisfied.
- Testing is completed before the end of the plan year to allow time for any needed corrections or adjustments in HCE contributions.

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