

Overview of Cafeteria Plan Nondiscrimination Testing

Section 125 of the Internal Revenue Code provides an exception to the “constructive receipt” rule — without Section 125, wages that employees forgo to pay for non-taxable benefits through a cafeteria plan would be included in income. The exception comes with an important condition — in order for executives and other highly-paid individuals to take advantage of the exception, an employer must be able to demonstrate that the cafeteria plan satisfies applicable nondiscrimination tests. This *FYI In-Depth* describes the nondiscrimination tests that apply to cafeteria plans 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

Generally, individuals are cash-basis taxpayers, meaning that they recognize income in the year in which they receive a payment and not when their right to the payment accrues. However, to prevent taxpayers from manipulating when they recognize income, the IRS created the “constructive receipt” rule. That rule provides that a taxpayer who has the unrestricted right to receive taxable income in one year must recognize income in that year, even if the taxpayer gives up the right to receive it. Section 125 provides an exception to the constructive receipt rules when an individual is given the choice between receiving taxable income (i.e., cash) and non-taxable benefits through a cafeteria plan — as long as the employee elects to forego the cash before the right to receive it is earned (and chooses instead to apply the funds to non-taxable qualified benefits), the employee will not recognize the forgone cash as taxable income. Without a cafeteria plan, an employee would be taxed on the cash he/she could have received even if the amounts were then applied to qualified benefits.

Cafeteria plans are subject to the following nondiscrimination tests to ensure a plan does not disproportionately benefit members of a “prohibited group”:

Health & welfare nondiscrimination testing series

This is the third in our *FYI In-Depth* series on the nondiscrimination rules for health and welfare benefits.

The issue from **November 8, 2017** provides an overview of the various requirements, and the one from **January 2, 2018** discusses dependent care assistance plan requirements.

- An eligibility test. The cafeteria plan must benefit employees who qualify under an eligibility classification that does not discriminate in favor of highly compensated individuals.
- A benefits and contributions test. The contributions or benefits provided through the cafeteria plan may not discriminate in favor of highly compensated participants.
- A “key employee” concentration test. No more than 25% of the aggregate statutory non-taxable benefits provided to all employees through the cafeteria plan can be provided to key employees.

If any test is failed, the constructive receipt exception will not apply to highly compensated participants or key employees, as applicable, and they will have the maximum amount of cash and taxable benefits that they could have elected through the cafeteria plan included in their income. This is the case even if they elected only non-taxable benefits. There are no adverse tax consequences to employees not in the prohibited group.

Elements of Section 125 Nondiscrimination Testing

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

The Prohibited Group

There are two prohibited groups in Section 125 nondiscrimination testing — “highly compensated individuals” (HCI) and “key employees.” The definition of “highly compensated individual” is similar, but not identical, to the definition of “highly compensated employee” (HCE) set out in Code Section 414(q) used for qualified retirement plan [e.g., 401(k) and defined benefit plan] nondiscrimination testing. A highly compensated individual is defined as:

- A more than 5-percent owner (determined without attribution of ownership by family members, partnerships, etc.) at any time during the plan year being tested or in the preceding plan year
- An officer during the preceding plan year (or during the current plan year if in his or her first year of employment)
- An employee with compensation in excess of a specified threshold in the preceding plan year (e.g., for 2018 testing, compensation of at least \$120,000 in 2017) and for an employee in his or her first year of employment, has compensation above the threshold applicable to the current plan year (\$120,000 in 2018)
- The spouse or dependent of one of the individuals described above

Comparison of Section 125 HCI and Section 414(q) HCE definitions	
Section 125	Section 414(q)
Individual in first year of employment can be HCI if current year compensation exceeds threshold	Current year compensation not taken into account in HCE determination, based only on prior plan year compensation
>5% owner status based only on ownership interest of individual	>5% owner status takes into account ownership interests of family members and other entities
Officer in current or preceding year is an HCI	Officer status not basis for being HCE

For testing purposes, “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 trades or businesses that are under the same common control. “Employee” includes not only common-law employees, but also “leased” employees.

An employer with a large number of employees who would be HCIs based on compensation may elect to limit HCIs to those employees who, in addition to meeting the compensation threshold, are also in the top 20% of all employees based on compensation during the preceding year (or on compensation during the current year if in the first year of employment). This top-paid group election will apply to the determination of HCI status for all nondiscrimination tests that use the Section 414(q) definition of highly compensated employees, including those for qualified plans, and across all members of the controlled group.

An employee is a key employee for 2018 if he or she is:

- An officer with 2017 compensation of at least \$175,000 (limited to 50 officers)
- A more than 1% owner with 2017 compensation of at least \$150,000
- A more than 5% owner, regardless of compensation

A key employee covered by a collective bargaining agreement is treated as a key employee.

Excludable Employees

The following employees are excluded from the eligibility test:

- Those covered by a collective bargaining agreement if there is evidence that cafeteria plan benefits were the subject of good-faith bargaining
- Those who are nonresident aliens and receive no earned income from the employer that constitutes income from sources within the United States
- Those participating in the cafeteria plan under COBRA

In addition, if the plan provides that only employees with at least three years of service can participate, employees with less than three years of service may be excluded.

Who is the employer for Section 125 testing purposes?

All members of a controlled group are treated as a single employer for eligibility testing purposes. This means that in testing a cafeteria plan offered by one employer in the group, employees from all related employers are taken into account, which increases the possibility that the test will be failed. Employers need to be able to collect relevant demographic data regarding these other 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:

- 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.
- 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% of the number of hours of service customarily provided by an employee of the recipient.

Eligibility Test

The Section 125 discrimination rules generally incorporate the nondiscriminatory classification test under Code Section 410(b) that applies to qualified retirement plans; however, this test is modified by substituting “highly compensated individuals” and “highly compensated participants” for “highly compensated employees”. A plan will satisfy the eligibility nondiscrimination test if it benefits a group of employees who qualify under a reasonable classification (based on objective business criteria) established by the employer and the group of employees included in the classification satisfies the safe harbor percentage test or the unsafe harbor percentage component of the facts and circumstances test set out in regulations under Section 410(b). These are mathematical tests that compare the percentage of non-HCIs eligible to participate to the percentage of HCIs eligible to participate.

Examples in the proposed regulations suggest that each benefit option and each payment level is treated as if it were a separate plan for purposes of running the eligibility test. In one example, although a cafeteria plan offered the same health coverage to all participants, it failed the eligibility test because only highly compensated participants received flex credits to offset part of the employee’s share of the cost and thus paid less through salary reduction for the coverage. In another example, a cafeteria plan failed the eligibility test when only non-highly compensated participants could elect the high deductible health plan option while only highly compensated participants could elect the low deductible health plan option. This was the case even though the highly compensated participants had to pay more for their coverage than non-highly compensated participants.

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 conducting 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 Section 125 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).

Benefits and Contributions Test

Section 125 provides that a cafeteria plan will not discriminate with respect to benefits and contributions if either qualified benefits and total benefits, or employer contributions allocable to statutory nontaxable benefits and employer contributions allocable to total benefits, do not discriminate in favor of highly compensated participants. To satisfy these requirements, each similarly situated participant must be given a uniform opportunity to elect qualified benefits and employer contributions (benefit availability).

In addition, highly compensated participants must not disproportionately elect qualified benefits or utilize employer contributions for qualified benefits while other participants elect permissible taxable benefits or to receive employer contributions as permissible taxable benefits (benefit election).

What is meant by “similarly situated”?

In determining which participants are similarly situated, employers may take into account reasonable differences in plan benefits offered to employees working in different geographical locations or to employees with family coverage versus employee-only coverage.

The benefit election test is an objective utilization test. Qualified benefits are disproportionately elected by highly compensated individuals if the aggregate qualified benefits they elect, calculated as a percentage of their compensation, exceed the aggregate qualified benefits elected by non-highly compensated participants, calculated as a percentage of their compensation. Whether employer contributions are disproportionately utilized by highly

compensated individuals is determined in a similar manner, substituting “aggregate employer contributions” for “aggregate qualified benefits.”

Safe Harbors

There are two safe harbors applicable to the contributions and benefits test.

Health benefit safe harbor. A cafeteria plan providing medical benefits will not be treated as discriminatory with respect to contributions and benefits if:

- Contributions on behalf of each participant either include an amount that equals 100% of the cost of the health coverage under the plan of the majority of similarly situated highly compensated participants, or equal or exceed 75% of the cost of the participant having the highest cost benefit coverage under the plan, and
- Contributions or benefits in excess of those described above bear a uniform relationship to compensation.

This safe harbor is limited to major medical coverage and does not apply to dental coverage or health flexible spending arrangements.

Premium-only plan safe harbor. A cafeteria plan that offers an election between cash and payment of the employee’s share of the employer-provided health insurance premiums as its sole benefit will satisfy the contribution and benefits test as long as it passes the reasonable classification and safe harbor percentage tests under Section 410(b).

What are “statutory nontaxable benefits”?

Statutory nontaxable benefits are qualified benefits offered through a cafeteria plan that are excluded from gross income (e.g., health and dependent care benefits). They also include employee group-term life insurance coverage that is includable in income solely because the coverage exceeds \$50,000.

Key Employee Concentration Test

The key employee concentration test is a utilization test. The purpose of this test is to confirm that key employees are not disproportionately receiving nontaxable benefits through the cafeteria plan. To satisfy this test, not more than 25 percent of the statutory nontaxable benefits provided through the cafeteria plan to all employees during the plan year may be provided to key employees.

Permissive Disaggregation and Aggregation

The Section 125 proposed regulations permit the disaggregation or aggregation of cafeteria plans in running the nondiscrimination tests if certain conditions are met.

Permissive disaggregation. Cafeteria plans that allow employees with less than three years of service to participate in the plan are permitted to disaggregate the plan into two separate plans for nondiscrimination testing purposes — e.g., one plan for employees with less than three years of service and one for employees with three or more years of service. If a plan is disaggregated into two separate plans, the two plans must be tested separately for both the eligibility test and the benefits and contributions test.

Permissive aggregation. An employer that sponsors more than one cafeteria plan may aggregate two or more plans for nondiscrimination testing purposes. The combined plan must satisfy both the eligibility and the benefits and contributions test as if it were a single plan. This means that the combined plan must give each similarly

situated participant the same opportunity to elect qualified benefits and the actual elections by highly compensated participants may not be disproportionate.

When to Run the Tests

The Section 125 proposed regulations state that the nondiscrimination tests must be performed as of the last day of the plan year taking into account all nonexcludable employees or former employees who were employed on any day of the plan year. But ideally, the tests 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.

In Closing

Employers need to be aware of all of the Section 125 nondiscrimination tests and take action to ensure that:

- All employers in the controlled group are included in testing
- The nondiscrimination tests are satisfied
- Testing is completed before the end of the plan year to allow time for any needed corrections

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Produced by the Knowledge Resource Center of Conduent Human Resource Services

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