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# CAFETERIA PLAN NONDISCRIMINATION TESTING

## PLANS CANNOT DISCRIMINATE IN FAVOR OF CERTAIN HIGHLY COMPENSATED AND KEY EMPLOYEES

Cafeteria plans, medical plans (including health FSAs), DCAPs, and other benefit programs enjoy favorable tax treatment under the Code in order to encourage employers to provide benefits to their rank-and-file employees. Although an employer's executives may receive some tax benefits as a byproduct, it is not the primary focus of the program. The Code's nondiscrimination rules are designed to prevent plans from discriminating in favor of individuals who are either highly compensated or otherwise key to the business.

To make sure that cafeteria plans and their component plans do not discriminate in favor of HCEs and Keys, Congress came up with specific nondiscrimination tests. These tests comprise of three basic themes, all of which involve protecting employees who are not highly compensated or key to the business (i.e., non-HCEs/non-Keys):

- **Eligibility.** If enough non-HCEs cannot get into a plan, then it will be discriminatory. One way to visualize this "eligibility test" is to think of the plan as a party where the guests get to save on taxes and to ask yourself, "Have enough non-HCEs been invited to the party?"
- **Benefits.** If the HCEs/Keys are able to get more benefits than the non-HCEs, then it will be discriminatory. Think of the different benefits as being appetizers and ask, "Who's being offered appetizers at the party?" This is sometimes called a "contributions and benefits test."
- **Utilization.** If the HCEs/Keys actually take more benefits under the plan, then it will be discriminatory. In other words, ask yourself, "Who's actually taking the appetizers?" This is sometimes called a "utilization test" or "concentration test." It is often the most difficult to pass, especially for smaller employers.

### RED FLAGS: DISCRIMINATION PROBLEMS TO WATCH OUT FOR

**Below are "red flags" that may result in a failure to pass one or more nondiscrimination tests.**

- 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 is an "automatic fail."
- The plan bases employer contributions or benefits on years of service or percentage of compensation.
- An employer varies benefit contributions and rates for different groups of employees.
- A large percentage of employees that are officers of the company, earn more than $120,000 annually or are more than 5% shareholders. These are considered Highly Compensated Employees.
- A large percentage of employees that are officers who earn more than $170,000 annually, are more than 5% owners, or more than 1% who earn more than $150,000 annually. These are considered Key Employees.
- Allowing sole proprietors, partners, more than 2% Subchapter S corporation shareholders, and other self-employed individuals to participate in a cafeteria plan or its component plans.

## WHAT HAPPENS IF A PLAN IS DISCRIMINATORY?

The bad news in ending up with a discriminatory plan is that the benefits for HCE/Keys will become taxable. This can create some unpleasant surprises for these individuals, especially if the discrimination problem is not discovered before the end of the plan year, because corrections cannot be made to reduce the adverse impact once the plan year has ended. Once the plan year has closed, it's too late to take any corrective action other than to add the benefit amount as taxable income for the HCEs and Keys for that tax year. Performing a preliminary test in the first or second quarter of each Plan Year is highly recommended. Sterling offers a preliminary test to all Flexible Spending Account and Health Reimbursement Account customers.