Cafeteria plans, self-insured health plans, and dependent care assistance programs (DCAPs) are subject to nondiscrimination requirements under the Internal Revenue Code.

The requirements are generally intended to prevent these plans from discriminating in favor of certain highly paid and key employees. If a plan fails to comply with these requirements, there may be adverse tax consequences for these highly paid and key employees. For example, if a cafeteria plan is discriminatory, these employees may have to pay taxes on their cafeteria plan salary reductions.

**Nondiscrimination Tests for Cafeteria Plans, Self-Insured Health Plans, and DCAPs**

**Self-Insured Health Plan Tests**
- (includes self-insured medical, dental, and vision plans, as well as health FSAs and HRAs)*
  - 1. Eligibility
  - 2. Benefits

**DCAP Tests**
- 1. Eligibility
- 2. Contributions and Benefits
- 3. > 5% Owners Concentration
- 4. 55% Average Benefits

**Cafeteria Plan Tests**
- 1. Eligibility
- 2. Contributions and Benefits
- 3. Key Employee Concentration

- **Benefits for applicable plan excludable from gross income**
  - Pass
  - Fail

- **Part or all of benefits for applicable plan includible in gross income of prohibited group**
  - Pass
  - Fail

- **Contributions under cafeteria plan for nontaxable benefits are excludable by all employees**
  - Pass
  - Fail

- **Prohibited group must include in income all taxable benefits that could have been selected (including all cash and salary reductions)**
  - Pass
  - Fail

* These nondiscrimination rules will also apply to certain insured group health plans after the government issues regulations or other guidance on how the rules apply to insured plans.

**On the Horizon:**

Nondiscrimination Requirements for Insured Health Plans

The Affordable Care Act also establishes nondiscrimination requirements for insured (funded through insurance) health plans.

However, compliance is not required until after the government has issued regulations or other guidance on the new requirements.

Failure to comply with the requirements (which are expected to be similar to the requirements for self-insured health plans described on page 4), may result in excise taxes, civil money penalties, or a civil action to compel the employer to provide nondiscriminatory benefits.

Although the nondiscrimination requirements for these plans differ and are complex, they boil down to three common themes: eligibility, availability, and utilization. Imagine that you are planning a party, with the plan benefits being the appetizers. The nondiscrimination requirements essentially ask, “Have enough non-highly paid employees been invited to the party?” (eligibility), “Are enough non-highly paid employees being offered the appetizers?” (availability), and “Are enough non-highly paid employees actually taking the appetizers?” (utilization). The prohibited group (those in whose favor discrimination is prohibited) is defined differently for purposes of the various nondiscrimination tests that apply to each plan, so the individuals who are actually considered highly paid or key may vary from one plan or test to the next (see the discussion below).

Employers should monitor compliance with testing criteria during the plan year. This allows adjustments to be made before year-end if needed to bring the plan into compliance. (Unlike under the rules for qualified retirement plans, employers cannot fix discrimination problems after year-end.) Furthermore, the group of employees included in the testing can change during the year, so the final results cannot be known until the end of the year. While employers can easily meet some of the requirements by using the right plan design, compliance with other requirements needs careful monitoring, so many employers prefer not to conduct nondiscrimination testing themselves.

Here is an overview of the rules that are currently in place for cafeteria plans, self-insured health plans, and DCAPs.

1. Cafeteria Plans—Three Nondiscrimination Tests

A cafeteria plan must pass an eligibility test, a contributions and benefits test, and a key employee concentration test. Under proposed IRS regulations, these tests must be performed as of the last day of the plan year. But as a practical matter, these tests should be run at least three times a year: before the beginning of the plan year, several months before the end of the year, and after the close of the year. This allows the employer to take corrective action during the plan year if it appears that one or more tests will not be passed (e.g., by reducing contributions of highly paid or key employees).

a. Eligibility Test

This is the “Who is being invited to the party?” test. The cafeteria plan must not discriminate in favor of highly compensated individuals (HCIs) as to eligibility to participate.

HCIs Under the Cafeteria Plan Rules.

In general, HCIs for this purpose are officers, more-than-5% shareholders, highly compensated employees, or the spouses or dependents of individuals in the first three categories.

Proposed regulations provide additional guidance regarding these categories. For example, officers are individuals who were officers during the preceding plan year (or the current plan year in the case of a new hire). More-than-5% shareholders are individuals who own more than 5% of the employer’s stock during the current or preceding plan year. When determining who is “highly compensated,” a modified version of the 401(k) definition is used—an individual is highly compensated if his or her compensation during the preceding year (or the current plan year in the case of a new hire) exceeded the applicable dollar limit for that year ($115,000 for 2012, 2013, and 2014).
A cafeteria plan will pass the eligibility test if it satisfies three requirements: (1) it benefits a nondiscriminatory classification of employees; (2) the same employment requirement applies to all employees, with no more than three years of employment needed to participate; and (3) entry is not delayed beyond the first day of the plan year after the employment requirement is met.

In order for a classification to be nondiscriminatory, it must be reasonable—i.e., based on objective business criteria, such as job categories, nature of compensation (e.g., salaried or hourly), or geographic location. Also, the group of employees in the classification benefiting under the plan must not discriminate in favor of HCIs. If the percentage of eligible non-HCIs is less than 50% of the percentage of eligible HCIs, then the plan may still pass under certain conditions. Whoever does the testing must recognize some legal subtleties with respect to who can and cannot be counted—e.g., certain types of workers may have to be included. Proposed regulations also suggest that unequal availability of benefits or employer flex credits for HCIs and non-HCIs (or unequal salary reductions to get the same benefits) may also cause an eligibility test failure.

Some plan designs raise red flags in this area. Examples include separate cafeteria plans for different groups (e.g., having one plan for hourly employees and another plan for salaried employees), plans excluding part-time employees, plans covering employees in one division but not in another, and plans with different entry dates for different employee groups.

b. Contributions and Benefits Test

This is the test that asks, “Who is being offered the appetizers?” (availability of benefits) and “Who is actually taking the appetizers?” (utilization of benefits). The test has three parts: availability, utilization, and nondiscrimination in operation.

1. Availability. In general, the availability test is satisfied if (a) all similarly situated participants get the same employer contributions (e.g., it is okay to have a greater contribution for those who take family coverage than for those who take employee-only coverage); and (b) a plan gives similarly situated participants the same opportunity to elect the same benefits.

2. Utilization. A plan generally will fail the utilization test if nontaxable benefits (or employer contributions for such benefits) are disproportionately elected by HCIs. This test compares the actual elections by HCIs and non-HCIs; under proposed regulations, the aggregate benefits and contributions for each group are measured as a percentage of the group’s aggregate compensation.

3. Nondiscrimination in operation. A cafeteria plan must also not discriminate in favor of HCIs in actual operation. An example of discriminatory operation could be a plan’s duration (or offered benefit) that coincides with the period during which HCEs utilize the plan (or benefit).

Red flags are raised in this area by employers that vary benefits or contribution rates (e.g., by seniority).

c. Key Employee Concentration Test

In order for a cafeteria plan to pass the key employee concentration test, the qualified benefits provided to key employees (Keys) cannot exceed 25% of the total of all such benefits provided for all employees under the plan.

Key Employees Under the Cafeteria Plan Rules.

Keys differ from HCIs, although there is some overlap. A Key is someone who, during the preceding plan year, was an officer with annual compensation in excess of the dollar limit for that year ($170,000 for 2014; $165,000 for 2012 and 2013); a more-than-5% owner of the employer; or a more-than-1% owner of the employer with annual compensation greater than $150,000 (not indexed).
The key employee concentration test is often failed by cafeteria plans of small Subchapter C corporations in which shareholder-employees participate, even when the other tests are passed.

### 2. Self-Insured Health Plans—Two Nondiscrimination Tests

A second group of tests applies to self-insured health plans. The self-insured health plan tests apply to self-insured medical, dental, and vision plans, as well as health flexible spending arrangements (health FSAs) and health reimbursement arrangements (HRAs). Under health care reform, similar tests will also apply to certain insured plans after the federal government issues regulations or other guidance about how the tests apply to these plans.

#### a. Eligibility Test

Self-insured health plans, health FSAs, and HRAs may not discriminate in favor of HCIs as to eligibility to participate. To satisfy eligibility criteria, a plan must benefit one of the following:

(1) 70% or more of all nonexcludable employees; (2) 80% or more of all employees who are eligible to benefit, if 70% or more of all nonexcludable employees are eligible to participate under the plan; or (3) employees qualifying under a classification that does not discriminate in favor of HCIs (the nondiscriminatory classification test).

#### HCIs Under the Self-Insured Health Plan Rules.

An individual is an HCI for purposes of these tests if he or she is (a) one of the five highest-paid officers; (b) a more-than-10% shareholder; or (c) among the highest-paid 25% of all employees (other than excludable employees who are not participants).

#### b. Benefits Test

Under the benefits test, the benefits provided to HCIs under the self-insured health plan, health FSA, or HRA must be provided to all other participants. Required contributions should be identical for each benefit level. The maximum benefit level that can be elected cannot be based on percent of compensation, age, or years of service. The type of benefits reimbursable must be identical for all participants. The plan must not have different waiting periods.

### 3. DCAPs—Four Nondiscrimination Tests

A DCAP has to pass four nondiscrimination tests that consider eligibility, availability, and utilization.

#### a. Eligibility Test

A DCAP must benefit employees who qualify under a classification that does not discriminate in favor of HCEs or their dependents. This ensures that a minimum number of non-HCEs are eligible to participate in the plan. The reasonable classification test for DCAPs is like the one for cafeteria plans, with some exceptions (e.g., HCEs are defined differently).

#### HCEs Under the DCAP Rules.

For a DCAP, an employee is an HCE if he or she is a more-than-5% owner during the current or preceding year or if his or her compensation during the preceding year exceeded the dollar limit for that year ($115,000 for 2012, 2013, and 2014).
b. Contributions and Benefits Test

Contributions and benefits that are available to eligible employees under the DCAP must not favor HCEs or their dependents. One way to satisfy this test is to make the maximum DCAP benefits and contributions the same for HCEs and non-HCEs.

c. More-Than-5% Owners Concentration Test

No more than 25% of the amount paid for dependent care assistance during the year may be provided to more-than-5% shareholders or owners, or their spouses or dependents.

d. 55% Average Benefits Test

Under this utilization test, the average DCAP benefits provided to non-HCEs must be at least 55% of the average benefits provided to the HCEs. If the HCEs use DCAP benefits more than non-HCEs do—which often happens—the plan will likely fail the test. (Non-HCEs may believe that because of their lower income levels, they will benefit more from the dependent tax credit under Code § 21 than from the DCAP, which is sometimes but not always true.) Some employees can be excluded in running the 55% Average Benefits Test. Also, employers with more than one line of business may improve their chances of passing the test by treating DCAPs sponsored by more than one line of business as separate plans.

4. Effect of Failing the Nondiscrimination Tests

If a cafeteria plan does not pass all of its nondiscrimination tests, then HCIs or Keys (depending on which tests are failed) will have taxable income equal to the combination of the taxable benefits with the greatest aggregate value that they could have elected for the plan year. That is, the HCIs or Keys who made salary reductions will be taxed on the amount of those salary reductions. If a plan has a cash-out option (or an option to apply employer contributions to taxable benefits), then the HCIs or Keys who elect nontaxable benefits will be taxed on the cash-out amount (or other taxable benefits) that they could have elected instead. If a self-insured health plan does not pass its tests, certain reimbursements paid to HCIs will be taxable. Likewise, if a DCAP fails any of its tests, the benefits provided to HCEs will not qualify for exclusion from income. However, non-highly paid employees will be able to keep their tax savings, even in a discriminatory plan.

“"If a cafeteria plan does not pass all of its nondiscrimination tests, then HCIs or Keys (depending on which tests are failed) will have taxable income equal to the combination of the taxable benefits with the greatest aggregate value that they could have elected for the plan year.”"

5. Other Issues for Employers

Some of the nondiscrimination tests require that the plan’s sponsoring employer consider not only its own employees, but also individuals employed by certain related entities or leased employees. If the plan sponsor is related to another company or organization (whether through stock ownership, a partnership, or otherwise) or utilizes leased employees, the plan sponsor must determine which employees to include in its nondiscrimination testing. While plan participation may not need to be extended to all individuals, failure to consider them could lead to inaccurate test results. Depending on the test, it may also be possible to exclude some employees from the testing group on a uniform basis (e.g., because of their age or limited service).
Non-federal governments, churches, and other tax-exempt employers generally are not exempt from the nondiscrimination requirements, although there are some practical issues and a few special rules for these employers.

Health care reform allows eligible small employers to establish “simple cafeteria plans” that are treated as meeting the nondiscrimination rules for cafeteria plans and certain component benefits (e.g., health FSAs and DCAPs), so long as specified contribution, eligibility, and participation requirements are also met. In general, only employers with an average of 100 or fewer employees during either of the preceding two years may establish a simple cafeteria plan. (There are special rules for new and growing employers.) Simple cafeteria plans may be of interest to eligible employers that might otherwise have difficulty passing one or more of the nondiscrimination tests, if they are willing and able to make the required contributions and to meet the additional requirements that apply to these plans. There is also a safe harbor for “premium-only” cafeteria plans sponsored by employers of any size—plans that offer only an election between cash and payment of the employee share of employer-provided accident and health insurance premiums are deemed to satisfy the cafeteria plan nondiscrimination requirements if they pass the eligibility test.

**Nondiscrimination Guidance and Training**

We’re happy to provide comprehensive tools and learning opportunities to help you navigate the complex maze of nondiscrimination rules for cafeteria plans, health plans, and DCAPs.

**EBIA’s Cafeteria Plans**

One of the nation’s leading resources for cafeteria plan sponsors and administrators, EBIA’s *Cafeteria Plans* discusses just about every cafeteria plan design and administration issue. It provides in-depth coverage of legal requirements for cafeteria plans, health FSAs, and DCAPs, and features practical, real-world examples, tips, tables, checklists, and sample documents to keep you in compliance and on top of new developments.

**EBIA’s Consumer-Driven Health Care**

Everything you need to understand and implement HSAs, HRAs, and other consumer-driven arrangements, EBIA’s *Consumer-Driven Health Care* provides employers and advisors with top-notch legal analysis, practical tips, sample documents, and useful examples they need to understand what consumer-driven health care is and to be able to compare, choose, and implement these tax-favored arrangements.

**EBIA’s Self-Insured Health Plans**

Answering your questions about what it means to self-insure a health plan and what challenges to expect when changing from an insured plan to a self-insured plan, EBIA’s *Self-Insured Health Plans* walks through each step of establishing and maintaining a self-insured health plan. It takes you from plan design, drafting, and funding, through plan administration and compliance, with the aid of sample documents, checklists, and practical examples.

**Nondiscrimination Testing (NDX)**

Powered by Claims-X-Change and now available on Checkpoint, this dynamic new tool delivers an accurate, more cost-effective and automated way for plan administrators and advisors to help employers stay compliant with nondiscrimination requirements for cafeteria plans, self-insured health plans (including health FSAs and HRAs), and DCAPs.
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