



Nondiscrimination Testing for Health and Welfare Plans

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1 Hour

What is Nondiscrimination Testing?

- Cafeteria plans, medical plans, etc. enjoy favorable tax treatment
 - Encourage employers to provide benefits to rank-and-file employees
- Pre-tax treatment dependent on plans being nondiscriminatory
 - In favor of highly compensated and “key” employees (prohibited group)
- Code Sections
 - Section 125 – Cafeteria Plan
 - Section 105(h) – Self-Insured Medical, Health FSA, HRA
 - Section 129 – Dependent Care
 - Section 79 – Group Term Life

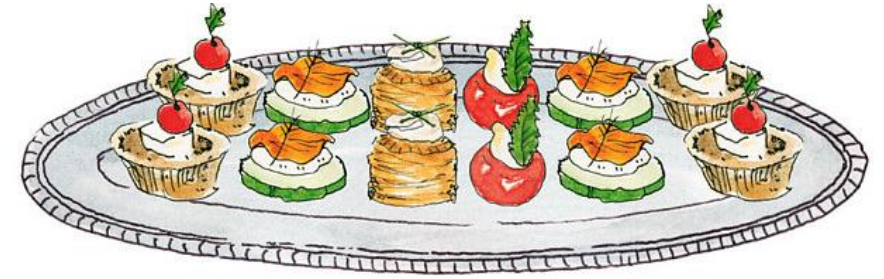
Recommended Timelines

- Pre-testing
 - after open enrollment
 - prior to plan year start
- Mid-year testing
 - 3-6 months prior to plan year end
- Final testing
 - after the end of plan year



Nondiscrimination Testing Explained

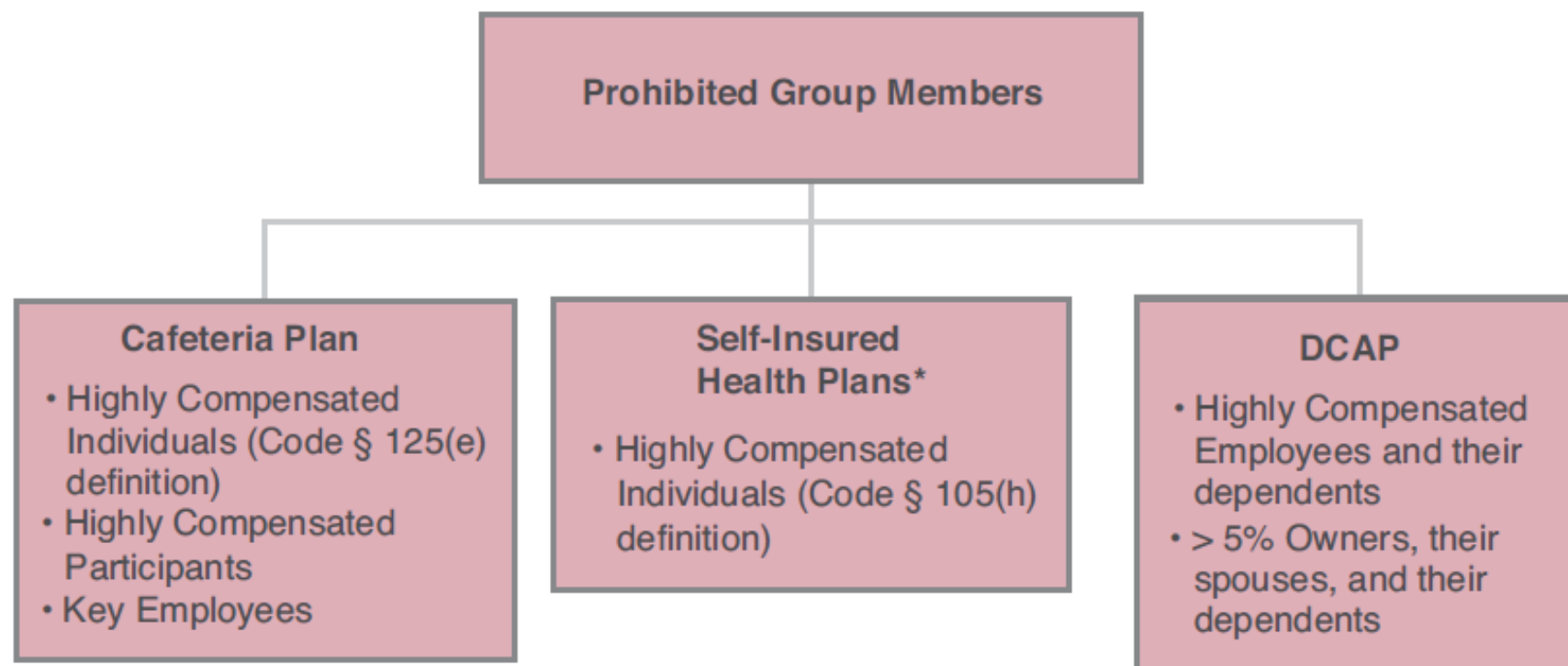
- Imagine that you are planning a party, with the benefits under your company's plan being the appetizers
- The nondiscrimination tests essentially ask,
 - "Have enough non-highly paid employees been invited to the party?" (eligibility)
 - "Are enough non-highly paid employees being offered the appetizers?" (availability)
 - "Are enough non-highly paid employees actually eating the appetizers?" (utilization)



Test Types

- Eligibility Test
 - Nondiscriminatory Classification (Safe Harbor) Test
- Benefits Test
- Utilization Test
- Key Employee Concentration Test
- 55% Average Benefits Test
- More-Than-5% Owners Test

Who are Members of Prohibited Groups?



* Includes self-insured medical, dental, and vision plans, as well as health FSAs and HRAs.

Aggregated Employer Group

- Terminology
 - Controlled Group of Corporations
 - Trades or Businesses Under Common Control
 - Affiliated Service Group
 - Aggregated ALE Group
- Separate tax ID numbers (EIN, or FEIN)
 - For nondiscrimination testing purposes
 - Separate EIN is not same as separate employers
 - 1094/1095 reporting
 - Separate EIN requires separate reporting



Common Causes of Failure

- Eligibility failures
 - Too many participating HCLs
 - Too few participating non-HCLs
- Utilization failures (Cafeteria Plan)
 - HCLs utilize benefits disproportionately
- Key Employee Concentration Test (Cafeteria Plan)
 - >25% of aggregate benefits go to key employees
 - Very common for small employers
- 55% Average Benefits (DCAP)
 - <55% of DCAP benefits go to non-HCEs

Ineligible Participants

- Certain employees are ineligible to participate in Cafeteria Plans and HRAs
- Based on company type
 - Corporation – all can participate
 - Subchapter S Corp – more than 2% shareholders can't participate
 - LLC/LLP – shareholders can't participate
- Allowing ineligible participants can disqualify an entire plan
 - All participants (HCIs and non-HCIs) would lose favorable tax status

Tips for Avoiding Discrimination

- Seek uniformity
 - Benefits offered
 - Waiting periods
 - Contribution structure
- Monitor throughout the plan year
 - Pre-testing
 - Mid-year testing
- Make adjustments before end of plan year
 - Cutbacks to avoid discrimination are permissible

How to Correct Discriminatory Plans

- Identify the cause
 - Plan design
 - Calculation-based
- Reduce pre-tax contributions
 - Identify amount of reduction necessary
 - Impute income
 - Benefits treated as taxable income for employees
- *Note:* For adjustments must be made before end of plan year

Consequences of Failure

- Section 125 (Cafeteria Plan)
 - Prohibited group members taxed on all “available” benefits
- Section 105(h) (Self-Insured Medical, Health FSA, HRA)
 - Prohibited group members taxed on “excess reimbursements”
- Section 129 (Dependent Care)
 - Prohibited group members taxed on actual benefits
- Section 79 (Group Term Life)
 - Prohibited group members taxed on first \$50k of coverage
- *Note:* Only prohibited group members lose tax-favorable status

Questions



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