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Getting a Handle on Health & Welfare Plan Nondiscrimination Testing

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Health and welfare plan nondiscrimination testing

- What are the requirements?
- Which plans are tested?
- What happens if we fail?
- How can we avoid a problem?

Wrap Plan vs. Cafeteria Plans vs. Component Plans

- Cafeteria Plan
 - Satisfies Internal Revenue Code Requirements for Pre-Tax Benefits
 - Requires Non-Discrimination as a Condition to Pre-Tax Benefits
- Wrap Plan
 - Satisfies ERISA content requirements
 - Allows a single 5500 for multiple Component Benefit plans
 - No non-discrimination testing for a “wrap” plan
- Component Plans
 - The underlying options in a wrap plan such as medical, life and disability
 - May or may not have separate nondiscrimination testing requirements

Common Structures for Cafeteria Plans



- Premium Only Plan
 - Funded by salary reduction payments
 - Used to pay for pre-tax premiums for qualified benefits
- Health Savings Accounts (HSAs)
 - Employee pre-tax contributions to HSAs must be run through cafeteria plan
 - Avoids HSA comparability nondiscrimination testing because HSAs tested under cafeteria plan
- Flexible Spending Accounts (FSAs) –
 - Funded by salary reduction payments
 - Used to reimburse employees for expenses incurred for certain qualified benefits
 - Offered for dependent care assistance, adoption assistance and medical care reimbursements
 - Benefits subject to annual “use it or lose it” rule
 - Health FSA uniform coverage rule

Common Benefits that May Be Offered Under a Cafeteria Plan



- Qualified Benefits
 - Group health and accident benefits (some exceptions)
 - Group term life insurance (employee's life only)
 - Adoption assistance
 - Dependent care assistance (DCAP)
 - Health savings account (HSA)
 - Flexible spending arrangement (FSA)
 - Cash option

Nondiscrimination Testing Overview



Cafeteria Plans

- Eligibility Test
- Contributions and Benefits (C&B) Test
- Key Employee Concentration Test

Self-Insured Group Health (Medical, Dental, and Vision)

- Eligibility Test
- Benefits Test

Health FSAs

- Eligibility Test
- Benefits Test

Nondiscrimination Testing Overview

DCAPs

- Eligibility Test
- Contributions and Benefits Test
- More-Than-5% Owners Concentration Test
- 55% Average Benefits Test

Group Term Life Insurance

- Eligibility Test
- Benefits Test

Others

How to Minimize Nondiscrimination Testing

- Keep it simple - Utilize Premium-Only Plan. POP deemed nondiscriminatory if:
 - Cafeteria plan offers an election solely between cash and payment of the premium for employer-provided accident and health insurance (no HSAs – FSAs permitted)
 - Plan is deemed to satisfy the eligibility test if the ratio of non-HCIs participating in the plan to HCIs participating in the plan is 50% or more
 - If the eligibility test is satisfied, no additional testing is required – but eligibility test may include a benefits component under proposed regs

How to Minimize Nondiscrimination Testing



- Utilize a Simple Cafeteria Plan - Deemed Nondiscriminatory if:
 - Employer Size: Applicable to employers that employed an average of 100 or fewer employees on business days during either of the 2 preceding years.
 - Eligibility: In general, all employees with at least 1,000 hours of service during the preceding plan year must be eligible to participate.
 - Required employer contributions: Employees who are not Key Employees or HCIs must receive employer contributions of at least: (a) 2% of the employee's compensation for the plan year, or (b) the lesser of 6% of the employee's compensation for the plan year or twice the employee's salary reductions

Key Questions for Nondiscrimination Testing for Cafeteria Plans

- Who is the employer? (controlled group rules apply – no exemptions for government or church plans)
- What plans does the employer offer and which are subject to separate nondiscrimination requirements?
- How many plans are there for testing purposes? Can the plans be aggregated or disaggregated?
- Which employees must be included in testing? Are there any applicable exclusions?
- Who are the members of the prohibited group for testing purposes? (HCE/HCI/Key Employee)
- Are there any exceptions, safe harbors, or other special rules that may apply when conducting nondiscrimination tests?
- When (and how often) must the testing be performed?
- Are there any “red flags” in the plan's design?
- What will happen to prohibited group members if a test is failed?
- Can corrections be made?

Core Concepts for Nondiscrimination Testing for Cafeteria Plans

- Nondiscrimination testing is required for all employers for both a cafeteria plan and its component benefit plans
- Controlled Group Testing (as determined under Code § § 414(b), (c) and (m))
- Disaggregation options limited
- 9 different nondiscrimination tests are possible depending on the structure of the arrangement and the component benefits available
- All applicable tests must be satisfied for a cafeteria plan to be in compliance with the nondiscrimination rules

Core Concepts for Nondiscrimination Testing for Cafeteria Plans

- Employers must ensure that the cafeteria plan and all component benefits do not unduly favor the Highly Compensated Individuals (HCIs), Highly Compensated Employees (HCEs) and/or Key Employees with respect to either eligibility to participate or benefits offered and selected
 - Annual nondiscrimination testing required
 - HCI, HCE and Key Employee defined differently for different component benefits offered under a cafeteria plan
 - Using the wrong definition of HCI, HCE and Key Employee for any particular test could result in incorrect results

Common Plan Designs that are Red Flags for Discrimination

- Separate plans for different employee groups – other than union/non-union
- Exclusion of seasonal or temporary employees
- Benefits differ by division or location or EIN
- Different waiting periods for different groups of employees
- Fully paid or highly subsidized premiums for management
- Employer contributions or benefits increase based on years of service or percentage of compensation.



Cafeteria Plan Testing Details



Definition of HCI for Cafeteria Plan Nondiscrimination Test

- Cafeteria Plan HCI (Code §125):
 - An Officer (during the preceding year or current year if in the first year of employment)
 - A more-than-5% Shareholder (during preceding or current year)
 - determined without attribution of ownership
 - An employee who made at least \$135k in 2022 (uses a “look back” to the preceding year – amount indexed yearly)
 - Also – need to determine if the employer made a “Top Paid Group” election for their qualified retirement plan (Code §414(q))
 - The spouse or dependent of any individual meeting the above criteria

Definition of Key Employee for Cafeteria Plan Nondiscrimination Test

- Cafeteria Plan Key Employee (Code §125):
 - An officer making over \$200k in 2022 (amount indexed yearly) (looks at prior plan year)
 - A more-than-5% owner in the prior plan year
 - A more-than-1% owner making over \$150k in the prior plan year (this amount is not indexed)

When Must Cafeteria Plan Nondiscrimination Tests be Performed?

- Nondiscrimination testing must be performed as of the last day of the plan year for cafeteria plans and component benefits
- Earlier testing is advisable to detect potential problems that may be resolved before the end of the plan year
 - Change participant elections to correct a potential failure during the plan year
 - Plan design changes may be possible to prevent potential failures
 - Any failure discovered after the end of the plan year cannot be corrected and applicable HCIs or Key Employees would be taxed

Nondiscrimination Tests for Cafeteria Plans

- Eligibility Test – ensures that enough non-highly compensated individuals (non-HCIs) are eligible to benefit or elect to participate in the plan
- Contributions and Benefits Test – ensures that the benefits do not discriminate in favor of HCIs and that HCIs do not select more nontaxable benefits than non-HCIs
- Key Employee Concentration Test – ensures that benefits provided to Key Employees do not exceed 25% of the benefits provided to all employees

The Eligibility Test for Cafeteria Plans

- 3-part test to ensure that enough non-HCIs are eligible to participate in a cafeteria plan
 - Employment requirement
 - Entry requirement
 - Nondiscriminatory classification requirement
- Testing group includes all employees (including leased employees) of the employer and any other business in the same controlled group
- May exclude employees covered by a collective bargaining agreement, nonresident aliens with no U.S. source income, employees participating under COBRA continuation coverage
- 90-day limit on health plan waiting period may affect eligibility provisions for cafeteria plans because most employers will want all employees eligible for health coverage to be eligible for cafeteria plan so that they can pay for health care on a pretax basis

The Eligibility Test for Cafeteria Plans

- Employment Requirement

- No employee may be required to complete more than three years of employment
- Employment requirements must be the same for all employees

- Entry Requirement

- Any employee who has satisfied the employment requirement and is otherwise eligible must enter the plan not later than the first day of the plan year after the employment requirement is satisfied

- Nondiscriminatory Classification Test

- Eligibility must be based on a reasonable classification which is based on an objective business criteria (e.g., salaried, hourly, full-time, part-time, type of job, geographic location)
- Classification is nondiscriminatory – Safe Harbor Percentage Test
 - If ratio percentage of non-HCIs to non-HCIs who benefit is greater than 50%, plan automatically passes
 - If ratio percentage is less than 50% - test may be satisfied if percentage exceeds applicable percentage on Code §410(b) Nondiscriminatory Classification Table
 - Factual determination component

- Nondiscriminatory Classification Test (cont.)
 - Testing group includes part-time employees even if they are not eligible to participate in the plan
 - Employees who have not met the waiting period may be excluded if the plan restricts participation to employees who have completed 3 years of employment
 - An employee “benefits” under the nondiscriminatory classification test if the employee is eligible to make an election under the plan

- Plan features and other steps that may help reduce likelihood of failure
 - Maintain one cafeteria plan for all employees
 - Hire less seasonal or part-time employees
 - Broadening eligibility requirements to cover all employees
 - Maintain the same waiting periods and entry dates and for all employees
 - Provide equal availability of employer contributions and benefits

The Contributions and Benefits Test for Cafeteria Plans



- 3-part test to ensure that contributions and benefits are available on a nondiscriminatory basis and that HCPs do not select more qualified benefits than non-HCPs
 - Availability
 - Utilization
 - Nondiscriminatory in operation
- Testing group includes all employees who are actually eligible to select benefits under the plan and make salary reductions to pay for those benefits (including those who gained and lost eligibility during the year)
- Safe Harbor for plans that provide health benefits do not need to satisfy contributions and benefits test
 - 75/100% contributions test
 - Excess contributions test

The Contributions and Benefits Test for Cafeteria Plans



- Availability Standard: Satisfied if (1) employer contributions are available on a nondiscriminatory basis or (2) benefits (qualified and nonqualified) are available on a nondiscriminatory basis
 - Similarly situated participants must have the same opportunity to receive employer contributions to pay for qualified and nonqualified benefits and to elect benefits
 - Cost for benefits for non-HCPs and HCPs must be the same
 - Qualified and nonqualified benefits, including cash compensation, must be available on the same basis to HCPs and non-HCPs

The Contributions and Benefits Test for Cafeteria Plans



- Utilization Standard: Satisfied if the actual election of qualified benefits through a cafeteria plan is not disproportionate by HCPs as determined by calculation and comparison of 2 ratios
 - Ratio 1 = aggregate qualified benefits elected (or employer contributions utilized) by the HCPs divided by the aggregate compensation of the HCP group
 - Ratio 2 = aggregate qualified benefits elected (or employer contributions utilized) by the non-HCPs divided by the aggregate compensation of the non-HCP group
- Ratio 1 must be less than or equal to Ratio 2 for the cafeteria plan to satisfy the utilization standard

The Contributions and Benefits Test for Cafeteria Plans

- Nondiscrimination in Operation:
 - Satisfied if the plan does not discriminate in favor of HCPs in operation
 - This requirement will generally be satisfied if the availability and utilization standards are satisfied
 - An example of nondiscriminatory operation would be if a benefit is offered for a length of time that only HCPs utilize the benefit

The Contributions and Benefits Test for Cafeteria Plans

- Plan features and other steps that may help reduce likelihood of failure
 - Offer the same benefits to all employees
 - Educate non-HCEs regarding the importance of pre-tax elections and participation in the cafeteria plan
 - Avoid 100% employer-paid premium plans
 - HCPs pay a portion of insurance premiums after-tax
 - Run preliminary and interim tests so that elections of HCPs may be adjusted in the event of likely failure
 - Attempt to have the plan satisfy the safe harbor

The 25% Key Employee Concentration Test for Cafeteria Plans

- Ensures that Key Employees do not receive more than 25% of the aggregate benefits offered through a cafeteria plan
- Determines the total value of qualified benefits provided under the plan and tests whether Key Employees receive more than 25%
- Testing group includes employees who have elected at least one nontaxable benefit (including those who have gained or lost eligibility during the plan year)
- Employees who are not participants are excluded from the testing group
- This test is not required for cafeteria plans maintained by governmental entities and certain collectively bargained plans

The 25% Key Employee Concentration Test for Cafeteria Plans

- Small employers with owner-employees may find it difficult to pass the 25% Key Employee Concentration Test
- Plan design features and steps that may avoid the likelihood of failure
 - Educate non-Key Employees about the value of pre-tax elections under the plan
 - Do not use benefit plans to compensate higher paid workers – cash is king!
 - Run preliminary and interim tests so that elections of Key Employees may be adjusted in the event of likely failure
 - Prohibited group of employees pay insurance premiums after-tax
 - Avoid 100% employer-paid premium plans
 - Consider a plan design that can take advantage of a safe harbor (POP and Simple Cafeteria Plan)

Component Plan Nondiscrimination Tests – Group Health

Self-Insured Reimbursement Plans (Code §105(h)) – Test prior to plan year

- Eligibility Test – 410(b) Based
 - **70% Test:** the plan must benefit 70% or more of all employees;
 - **70% / 80% Test:** the plan must benefit 80% or more of all the employees who are eligible to benefit under the plan if 70% or more of all employees are eligible to benefit under the plan; or
 - **Classification Test:** the plan must benefit such employees as qualify under a classification of employees set up by the employer which is found by the Internal Revenue Service not to be discriminatory in favor of highly compensated individuals.
- Benefits Test – generally will fail if one HCE receives a better benefit than any NHCI
 - Highly Compensated Determination**
 - One of the 5 highest paid officers,
 - A shareholder who owns more than 10 percent in value of the stock of the employer, or
 - Among the highest paid 25 percent of all employees (other than excludable employees who are not participants)

Component Plan Nondiscrimination Tests - DCAP

DCAP Tests (Code §129):

- **Eligibility Test** - must benefit employees who qualify under an eligibility classification that does not discriminate in favor of HCEs (*same as for 401(k) purposes*). No guidance – default to 410(b)
- **Contributions and Benefits Test** - 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. No quantitative test provided.
- **5% Owners Concentration 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% Average Benefits Test** - the average DCAP benefit received by non-HCEs must be at least 55 percent of the average DCAP benefit received by HCEs - most easily failed of the DCAP non-discrimination tests.

Component Plan Nondiscrimination Tests

- Group Term Life Insurance Tests (Code §79)
 - Eligibility Test – may use Code §125 Plan test to satisfy, or
 - 70% test — The plan must benefit at least 70% of all non-excludable employees.
 - The 85% test — At least 85% of all non-excludable employees eligible to participate are non-key employees.
 - Nondiscriminatory classification test — Under this test, the plan must benefit a classification of employees that does not discriminate in favor of key employees.
 - Benefits Test - facts-and-circumstances test that considers whether key employees receive different or better benefits — or pay less for the same benefits — than others. A plan will not fail the benefits test merely because the amount of life insurance for employees under the plan bears a uniform relationship to compensation.

Component Plan Nondiscrimination Tests



Health Care FSA (Code §105): In addition to 125 tests

- Eligibility Test – same as 105(h) for group health plans
- Benefits – *facts and circumstances*
 - The required employee contribution must be identical for each benefit level;
 - The maximum benefit level that can be elected cannot vary based on percent of compensation, age or years of service;
 - The same type of benefits (i.e., medical expenses) provided to HCIs must be provided to all other participants; and
 - Disparate waiting periods may not be imposed

Consequences of Failure of Cafeteria Plan Nondiscrimination Tests

- Consequences for Employees
 - HCIs and/or Key Employees participating in a discriminatory cafeteria plan will have imputed income equal to the taxable benefit amount that the employee could have elected to receive for the plan year even if the employee elected to receive all nontaxable (qualified) benefits.
 - HCPs and Key Employees will be taxed on the amount of salary reductions plus any cash-out amounts or other taxable benefits received under the plan
 - Amounts are treated as taxable income for purposes of wage reporting on form W-2 and for purposes of income tax, FICA and FUTA withholding
 - Employer should consider the impact of failure of the cafeteria plan on any component plan nondiscrimination tests
 - Non-HCPs and non-Key Employees are not affected by a plan's failure to pass the nondiscrimination tests

Consequences of Failure of Cafeteria Plan Nondiscrimination Tests



- Consequences for Employers
 - The plan does not cease to be a qualified plan (tax-favored status) due to failing nondiscrimination testing
 - If it is determined plan failed testing after plan year end, employer may be subject to additional taxes (underpaid state/federal tax, payroll taxes, etc.)
 - May have to reissue W-2s - HCIs, HCEs, and Key Employees may have to file amended tax returns
 - Employer may be subject to interest and penalties on top of additional taxes

Plan Design and Monitoring to Avoid Discrimination

- Plan document should permit the plan administrator to revoke or reduce salary reduction elections made by HCIs and Key Employees if necessary to pass the nondiscrimination tests and preserve favorable tax treatment for all HCIs and Key Employees
- Plan administrator should closely monitor the benefits provided to HCIs and Key Employees as compared to other employees during the plan year so that any corrective action can be taken before the end of the plan year



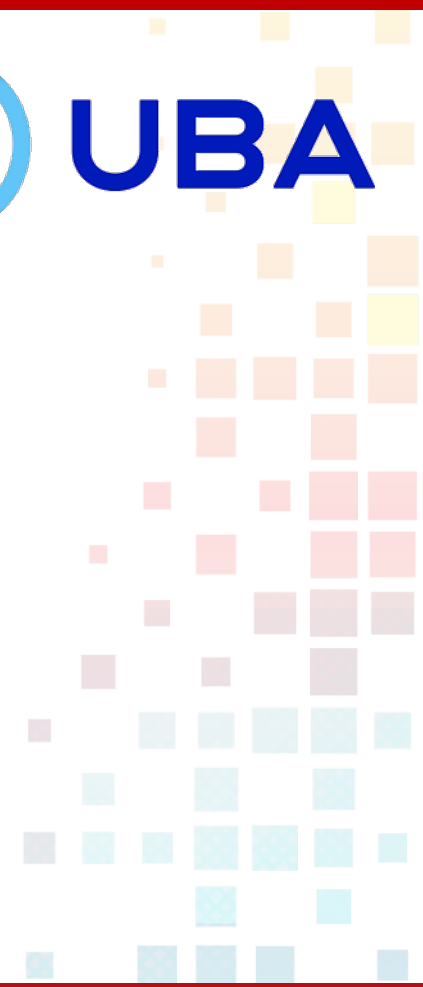
Final Questions



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Thank You

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