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COMPLIANCE CONNECTION

CP Release 1

Compliance Reminder For Cafeteria Plans Non-Discrimination Testing

As benefits administration becomes more and more complicated, compliance is on everyone's to-do list. In the compliance world of never-ending change, the following is a refresher course for employers compliance requirements for Internal Revenue Code Section 125 cafeteria plans and nondiscrimination testing.

What are the Nondiscrimination Tests?

The overall "25% Concentration test" compares all the pre-tax benefits elected by key employees with all the pre-tax benefits elected by non-key employees. Not more than 25% of the total benefits elected by all employees may be attributed to key employees.

Here's an example. All elections to the cafeteria plan add up to $35,000. Of those total elections, Key employee elections equal $5,000. Key employee elections are about 14% of the total elections to the plan ($5,000/$35,000). In this example, the cafeteria plan passes the 25% Concentration test.

The "55% Average Benefits test" involves just the dependent care portion of the cafeteria plan. The average dollar amount of benefits elected by non-highly compensated employees must be at least 55% of the average dollar amount of benefits elected by highly compensated employees.

In this example, let's assume that highly compensated employees' elections are $10,000 to the dependent care portion of the plan and there are five highly compensated employees in the company. Non-highly compensated employees elect $19,500 to the dependent care portion of the plan and there are 13 non-highly compensated employees. The highly compensated average dollar amount is $2,000 ($10,000/5). The non-highly compensated average dollar amount is $1,500 ($19,500/13). The average dollar amount of benefits elected by non-highly compensated employees is 75% of the average dollar amount of benefits elected by highly compensated employees ($1,500/$2,000). In this example, the dependent portion of the cafeteria plan passes the 55% Average Benefits test.

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The "25% Owner test" compares the dependent care benefits elected by more-than-5% owners of a company with dependent care benefits elected by non-owners. Not more than 25% of the total dependent care benefits elected by everyone in the dependent care benefit may be attributed to more than- 5% owners.

An example of this test would consist of a $5,000 election to the dependent care portion of the plan by a more-than-5% owner and elections in the amount of $19,500 made by all non-owners. The more than 5% owner's election is 20% of the total benefits elected to the dependent care portion of the plan ($5,000 + $19,500 = $24,500) ($5,000/$24,500). In this example, the dependent care portion of the plan passes the 25% Owner test because only 20% of the dependent care benefits were elected by the more-than-5% owner.

Eligibility, benefits available and contribution and benefits tests. These tests ensure that employers offer all benefits to an adequate number of employees and benefits do not discriminate in favor of highly compensated or key employees.

In the event the cafeteria plan does not meet all the nondiscrimination requirements, employers may need to change benefit elections and payroll amounts to bring the plan into compliance. And, it is important to test prior to the end of the cafeteria plan year. If testing is completed after the end of the plan year, it's too late to take corrective action. Instead of reducing key or highly compensated elections in order to pass the nondiscrimination test(s), the affected employees would be taxed on their total election amount.

*Information in this document is general in nature and not intended to replace legal advice in any particular manner.

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