WHAT IS IT?

In order to qualify for tax-favored status, a Section 125 plan must not discriminate in favor of highly compensated employees (HCEs) and key employees with respect to eligibility, contributions, and benefits. In order to document compliance an annual test must be performed and the results documented for each Section 125 plan. The results are subject to audit by the IRS.

The definition for HCEs and key employees varies by plan and type of test performed. However, they can generally be defined as follows:

- Highly compensated:
  - Officers.
  - More than 5% shareholders.
  - An employee with gross annual compensation over $110,000.
  - A spouse or dependent of any of the above defined employees.

- Key employee: employee who at any time during the plan year or any of the four preceding plan year is:
  - An officer with gross annual compensation over $160,000,
  - An owner of at least 5% of the company, or
  - An owner of at least 1% of the company with gross annual compensation over $150,000.

WHY OFFER IT?

To retain their tax-favored status, Section 125 plans are required to pass nondiscrimination tests mandated in IRS Code Sections 125, 105(h) and 129.

WHAT TYPES AND SIZE OF EMPLOYERS OFFER IT?

Any employer offering a Section 125 plan (Full-Flex Cafeteria Plan, Health Care Spending Account, Dependent Care Spending Account, or Premium Only Plan) must demonstrate that these plans do not discriminate in favor of certain employees. For testing employers must take into account all employees including those employed by related corporations if there is sufficient common ownership or a combination of joint ownership and common activity. This aggregation of multiple employers due to common ownership is known as a “controlled group”.

WHAT ARE THE CRITICAL UNDERWRITING OR PARTICIPATION REQUIREMENTS?

Although discrimination tests are slightly different depending on the plan being tested, general descriptions are as follows:

- **Eligibility Test:** The IRS requires fair and reasonable employee eligibility requirements whereby the plan may not exclude non-HCEs from participating in favor of HCEs or key employees. Passing the Eligibility Test usually requires the plan to benefit:
  - 70% or more of all non-excludable employees, regardless of whether they are HCE or non-HCE; and
  - 80% or more of these employees who are eligible to benefit; and

- Employees qualifying under a classification that does not discriminate in favor of highly compensated employees.

- **Contributions and Benefits Test (also called the Utilization Test):** In addition to the Eligibility test, the plan may not discriminate in favor of HCEs in regards to contributions and benefits. Each eligible participant must have an equal opportunity to select the non-taxable benefit. Waiting periods, required employee contributions and maximum benefit levels should be uniform for all participants and their dependents. The following tests are required in order to pass the Utilization Test:
  - **Key Employee Concentration Test:** Requires no more than 25% of the aggregate of nontaxable benefits provided to all employees under all the plans may be provided to key employees.
  - **Dependent Care Spending Account Test:** Includes the 55% Average Benefit Test, which is often considered the most crucial test, as it is the one most often failed by employers.
  - **Owner's Test:** This test demonstrates no more than 25% of the non-taxable dependent care flexible spending account benefits are provided to owners of at least 5% of the company.

How much does it cost?

Employers often outsource administration of the Section 125 plan, including execution of the nondiscrimination testing. Although often included in the standard fees, some administrators may charge an additional $300 to $500 to perform the tests.

Informational link(s)

- US Code: IRS Section 125 (Cornell Law School)

ArlenGroup Fact Sheets

- Dependent Care Assistance Program
- Health Care Flexible Spending Account
- Full Flex Cafeteria Plans

Pros and cons

Pros

- Compliance with IRS regulations results in favorable tax treatment of employer provided benefits.
- Pre-testing, or testing in the early stages of a plan year, allows for correction if failure occurs.

Cons

- "Discriminatory benefits" are included in the gross income of HCEs and key employees when the plan fails to comply with IRS regulations.
- Lack of uniformity may occur between the nondiscrimination rules of the different benefits.

NOTES

- IRS regulations do not specify when the nondiscrimination testing must be performed each year.
- Corrections to reduce the adverse impact of a failure cannot be made after the end of the plan year.
- Nondiscrimination guidelines also apply to 401(k) plans, group term life insurance plans, self-insured medical reimbursement plans, voluntary employees' beneficiary associations (VEBA) and adoption assistance plans.