Nondiscrimination Testing

**General Information**

The tax laws contain rules that prohibit discrimination in a cafeteria plan in favor of highly compensated (HCE) or key employees. Cafeteria plans, self-insured medical reimbursement plans (including Health FSAs), DCAPs, and other benefit programs enjoy favorable tax treatment under the Internal Revenue Code and discrimination testing is required to encourage employers to make benefits available to their rank and file employees, not just to the employer's highly compensated employees. The benefits must be made proportionally available to and must be proportionally utilized by both classes of employees. AFA provides worksheets for our employer groups for two of these tests. We do not require a copy of the tests to be sent to AFA, however, you must retain copies in case of an audit to show that the plan is not discriminatory. The information needed to run the tests can be provided by your Human Resources Department, CPA, or legal advisor.

The §125 Tax Code requires employers to run the tests on the last day of the plan year. However, we still advise employers to run discrimination testing as soon as the enrollment is complete; several months before the end of the plan year; and, on the last day of the plan year. Generally, all plans prohibit discrimination in favor of highly compensated employees (HCEs) and key employees (Keys). If a discrimination problem is discovered prior to the end of the plan year or during the plan year, adjustments can be made in the prohibited group's (HCEs and Keys) elections to allow the plan to pass the testing. Note that a plan does not cease to be qualified for all participants just because it is discriminatory. Non-HCE's and non-Keys can still exclude the benefits from income. Benefits that fail the test may be included in the prohibited group's gross income and they will have to pay for those benefits on an after-tax basis. If the problem is discovered after the end of the plan year, elections cannot be adjusted to bring the plan into compliance. However, benefits that fail the test will be reported as gross income by the employer and are taxable.

**Cafeteria Plan Testing**

The three questions to ask to determine non-discrimination for the Cafeteria Plan are:

- Can enough non-HCEs/Keys get into the plan?
- Are the HCEs/Keys able to get more benefits than the non-HCEs?
- Do the HCEs/Keys take more benefits under the plan? The plan cannot provide more than 25% of the total plan benefits to Keys.

**The Key Employees Concentration Test** insures the Key Employees do not receive more than 25% of the total benefits under the plan. A Key is any employee (or former employee, including a deceased employee) who, during the plan year, was:

- an officer with annual compensation greater than $175,000 for 2017;
- a more than 5% owner of the employer; and,
- a more than 1% owner of the employer with annual compensation over $150,000 (not indexed).

Only plan participants who have elected nontaxable benefits need to be included in the test. The test determines the total value of nontaxable benefits provided under the cafeteria plan (whether funded by true employer contributions or made by salary reduction elections) and determine whether Keys receive more than 25%. If the employer is anything other than a C-Corp, **DO NOT** include the benefit election of owners, partners, etc. Their elections should be made on an After-Tax basis.

2017 SECTION 125 DISCRIMINATION WORKSHEET
(25% “Key Employee” Calculation Test)
1. **Total number employees of the employer:**
   (Include employees of corporations, partnerships, etc., under common control; they are treated as employed by a single employer.)

2. **Number of employees excluded from plan because of:**
   (Choose one category for each excluded employee as defined by the Plan.)

   * Hours of service
   * Age
   * Collective Bargaining Group
   * Other

   TOTAL: _________

3. **Total number of employees eligible to participate:**
   (Subtract #2 from #1)

4. **Number of "key employees"- count each key employee only once.**
   A key employee is defined as an employee who, during the current year is:
   a. An officer earning more than $175,000, or
   b. A 5% owner, or
   c. A 1% owner earning more than $150,000 (not indexed) (or a spouse, child, parent or grandchild of an owner listed in b or c. Stock ownership includes constructively owned stock, or stock owned by a spouse, child, parent or grandchild of an owner.)

   TOTAL: _________

5. **Total amount of benefits elected under the plan**
   (include employer contributions towards premiums)

6. **Total amount of benefits elected by "key employees":**
   (include employer contributions towards premiums)

7. **Divide item 6 by item 5:**

If item 7 is greater than 25%, the benefits of key employees must be reduced to a level of 25% or less. If benefit elections are not reduced so that the plan is not discriminatory, the key employees will be taxed as if they had received all taxable benefits under the plan.

________________________________________  _________________________________
Date                                    Name of Group

_______________________________________
Signature of Employer

25% - rev 11/11