

Nondiscrimination Testing

General Information

Benefit programs like cafeteria plans, self-insured medical reimbursement plans (including Healthcare Flexible Spending Accounts), and Dependent Care Assistance Programs enjoy favorable tax treatment under the Internal Revenue Code. The benefits must be made proportionally available to and proportionally utilized by both classes of employees. Generally, all plans prohibit discrimination in favor of highly compensated employees (HCEs) or key employees (Keys).

The tax laws contain rules that prohibit discrimination in a cafeteria plan. Nondiscrimination testing is required to encourage employers to make benefits available to their rank-and-file employees, not just to the employer's HCEs and Keys. American Fidelity provides worksheets for our employer groups for two of these tests. We do not require a copy of the tests to be sent to us. However, you must retain copies in case of an audit to show that the plan is not discriminatory. Your Human Resources department, CPA, or legal advisor can provide the information needed to run the tests.

The §125 Tax Code requires employers to run the tests on the last day of the plan year. However, we advise employers to run discrimination testing three times:

1. As soon as the enrollment is complete
2. Several months before the end of the plan year
3. On the last day of the plan year

If a discrimination problem is discovered before the plan year ends, 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-HCEs 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 plan year's end, 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.

Section 125 Plan Testing

The three questions to ask to determine non-discrimination for the Section 125 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

This test ensures Keys 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 a/an:

- Officer with annual compensation greater than \$230,000 for 2025
- More than 5% owner of the employer
- More than 1% owner of the employer with annual compensation greater than \$150,000 (not indexed)

Only plan participants who have elected nontaxable benefits must be included in the test. The test determines the total value of nontaxable benefits provided under the Section 125 Plan (whether funded by true employer contributions or made by salary reduction elections) and determines 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.

2025 SECTION 125 DISCRIMINATION WORKSHEET (25% Key Employee Calculation Test)

1. **Total number employees of the employer:** _____(1)
(Include employees of corporations, partnerships, etc., under common control; they are treated as employed by a single employer.)

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

*	Hours of service	_____
*	Age	_____
*	Collective bargaining group	_____
*	Other	_____

TOTAL: _____(2)

3. **Total number of employees eligible to participate:** _____(3)
(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 \$230,000, 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: _____(4)

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

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

7. **Divide row 6 by row 5:** _____(7)

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

Date

Name of Group

Signature of Employer