

Employee **Benefits** Corporation

Nondiscrimination Testing Overview



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Home Menu

- Our Products
 - The BESTflex Plan
 - The BESTflex Plan Premiums Only
 - The EBC HRA
 - COBRASecure
 - SimplyHSA
 - CommutEase
 - The Benefits Card
 - Compliance Services
 - Self-Administration
 - Billing Services
 - Request A Quote
- Support
 - Start Here: Employers and HR Professionals
 - Start Here: Employees and Participants
 - Start Here: Brokers and Consultants
 - BESTflex Plan Help
 - EBC HRA Help
 - COBRASecure Help
 - SimplyHSA Help
 - CommutEase Help
 - Benefits Card Help
 - Compliance Services Help
 - My Account Administrator
 - My Account Assistant
 - My Mobile Account Assistant
 - FSA Score FAQs
 - Billing Services Help and Q&A
- Resources
 - Welcome
 - Contact Us
 - Careers
 - Compliance Buzz
 - Webinars
 - News Center
 - Keeping Up With Health Care Reform
 - Required ACA Reporting
 - My Money-My Health
 - Videos

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**IRS Requirements
Common Data Errors
Reasons and How to Fix Failures
Outside Factors**



IRS Requirements

IRS Requirements

- **Mandated testing for each plan year**
- **Test and results may be requested in financial audit**
- **Failure of a test results in taxation**
- **Number of tests determined by plan type**
 - 2 tests per self-funded health plan (e.g. Health Care FSA, HRA)
 - 4 tests per Dependent Care FSA
 - 3 tests per Cafeteria Plan

IRS Requirements

- **Number of tests determined by plan type**
 - Section 105 - Self-funded Health Plan (e.g. Health Care FSA)
 - **Eligibility Test***
 - **Benefits Test**
 - Section 129 - Dependent Care FSA
 - **Eligibility Test**
 - **Contributions and Benefits Test**
 - **55% Average Test***
 - **25% Owner Concentration test**

IRS Requirements

- **Number of tests determined by plan type**
 - Section 125 - Cafeteria Plan
 - Eligibility Test
 - Contributions and Benefits Test*
 - 25% Concentration Test (key employee test)*
- Each set of tests has own Highly-Compensated definition
- If 105 or 129 tests fail, 125 test is impacted
- 125 test must be done at end of plan year

*Most common tests that fail

Common Data Errors

Common Data Errors

- **Missing or incorrectly identifying Cafeteria Plan components**
 - 100% employer-paid are not included
 - 100% employee-paid are included if pre-tax
 - Full cost of benefit included if any portion pre-tax
- **Officer not correctly identified**
 - All organizations have an officer under testing definition
 - Most organization have more financial officers than testing officers

Common Data Errors

- **Incorrect compensation**
 - Should be gross wages, not gross taxable wages
 - Compensation period looks back a year (ongoing employees)
 - **Calendar plans use prior plan year**
 - **Off-calendar plans can use prior plan year or calendar year ending during plan year**
 - Example: July 1, 2016 to June 30, 2017 plan may use either
 - » July 1, 2015 to June 30, 2016 gross compensation or
 - » January 1, 2016 to December 31, 2016 gross compensation

Common Data Errors

- **Extra employees or missing employees**
 - Employees employed during plan year
 - **Employees who terminated during plan year**
 - **Employees hired during plan year**
 - Employees of related employers
 - Non-benefit eligible employees
- **Incorrectly identifying eligible employees**
 - Must be eligible for the benefit being tested
 - Especially difficult for Cafeteria Plan testing

Reasons and How to Fix Failures

Reasons and How to Fix Failures

- **Section 105 - Self-funded health plans**
 - Highly Compensated includes
 - Over 10% owners
 - Top 25% of employees by pay
 - Officers

Reasons and How to Fix Failures

- **Section 105 - Self-funded health plans (e.g. Health Care FSA)**
 - Excludable employees
 - Ineligible employees who have not completed 3 years of service as of the first date of the plan year
 - Ineligible employees who were under the age of 25 as of the first date of the plan year
 - Ineligible employees who are part-time or seasonal employees
 - Ineligible employees who are not eligible due to collectively bargained agreements
 - Ineligible employees who receive no U.S. source earned income

Reasons and How to Fix Failures

- **Section 105 - Self-funded health plans (e.g. Health Care FSA)**
 - Eligibility Test*
 - **Fails if more Highly Compensated participants than non-Highly Compensated participants**
 - **Avoid failure by**
 - Increasing number of non-Highly Compensated participants
 - Decreasing number of Highly Compensated participants
 - Limiting eligibility
 - Auto-enrolling all eligible employees by offering 100% employer-paid options (e.g. employer contributions to Health Care FSA)

Reasons and How to Fix Failures

- **Section 105 - Self-funded health plans (e.g. Health Care FSA)**
 - Benefits Test
 - **Fails if Highly Compensated employees are offered**
 - Shorter waiting period than non-Highly Compensated employees
 - Larger benefit pay-out than non-Highly Compensated employees
 - **Avoid failure by offering non-Highly Compensated employees**
 - Plan at the same time as Highly Compensated employees
 - Same benefits as Highly Compensated employees

Reasons and How to Fix Failures

- **Section 129 - Dependent Care FSA**
 - Highly Compensated includes
 - **Over 5% owners**
 - **Employees whose compensation exceeds threshold**
 - Prior year threshold and compensation applies unless new hires
 - Limit to top 20% of employees by pay if more than 20% of employees' compensation exceeds threshold

Reasons and How to Fix Failures

- **Section 129 - Dependent Care FSA**
 - Excludable employees
 - **Employees who are ineligible due to eligibility criteria stating an age requirement of age 21**
 - **Employees who are ineligible due to eligibility criteria stating a waiting period of one year**
 - **Ineligible employees who are not eligible due to collectively bargained agreements**

Reasons and How to Fix Failures

- **Section 129 - Dependent Care FSA**

- Eligibility Test

- **Fails if percentage of eligible non-HCEs is less than 20% of the percentage of eligible HCEs**

- Example: Client fails with percentage of 11.12%

- » 2 eligible HCEs, 4 total HCEs (50%)

- » 50 eligible non-HCEs, 900 non-HCEs (5.56%)

- **Avoid failure by**

- Hiring less seasonal or part-time employees

- Expanding eligibility for benefit

Reasons and How to Fix Failures

- **Section 129 - Dependent Care FSA**

- Contributions and Benefits Test

- **Fails if HCEs are offered**

- Options that are not available to non-HCEs

- » **Onsite daycare**

- » **Bussing programs**

- Larger benefit pay-out than non-HCEs

- **Avoid failure by**

- Same benefits as Highly Compensated employees

Reasons and How to Fix Failures

- **Section 129 - Dependent Care FSA**

- 55% Average Test*

- **Fails if average non-HCE election is 55% or less of average HCE election (excluding non-HCEs earning less than \$25,000)**

- Example: Client fails with percentage of 3.71%

- » 20 HCEs elect \$5,000 (\$250 average)

- » 1000 non-HCEs elect \$9,000 (\$9.28 average)

- » 30 non-HCEs earning less than \$25,000

Reasons and How to Fix Failures

- **Section 129 - Dependent Care FSA**

- 55% Average Test*

- **Avoid failure by**

- Prohibiting HCEs from electing

- Limit HCEs elections

- » **Constant monitoring required**

- Mid-year election changes

- New hire elections

- » **Cannot increase mid-year if results are better than anticipated**

Reasons and How to Fix Failures

- **Section 129 - Dependent Care FSA**
 - 25% Owner Concentration Test
 - **Fails if more than 5% owner's and their spouse's and dependent's elections comprise more than 25% of the elections for the plan**
 - Example: Client fails with percentage of 28.57%
 - » 10% Owner elects \$5,000
 - » Owner's dependent child elects \$5,000
 - » Non-owners elect \$25,000

Reasons and How to Fix Failures

- **Section 129 - Dependent Care FSA**
 - 25% Owner Concentration Test
 - **Avoid failure by**
 - Prohibiting > 5% owners, spouses and dependents from electing
 - Limit > 5% owners', spouses' and dependents' elections to 33% of non-owners' elections
 - » **Constant monitoring required**
 - Mid-year election changes
 - New hire elections
 - » **Cannot increase mid-year if results are better than anticipated**

Reasons and How to Fix Failures

- **Section 125 - Cafeteria Plan**
 - Highly Compensated includes
 - **Officers**
 - **Employees whose compensation exceeds threshold**
 - Prior year threshold and compensation applies unless new hires
 - Limit to top 20% of employees by pay if more than 20% of employees' compensation exceeds threshold
 - **Over 5% owners**
 - **Spouse or tax dependent of any of these**

Reasons and How to Fix Failures

- **Section 125 - Cafeteria Plan**
 - Excludable employees
 - **Ineligible employees who are not eligible due to collectively bargained agreements**

Reasons and How to Fix Failures

- **Section 125 - Cafeteria Plan**

- Eligibility Test

- **Fails if percentage of eligible non-HCEs is less than 20% of the percentage of eligible HCEs**

- Example: Client fails with percentage of 11.12%

- » 2 eligible HCEs, 4 total HCEs (50%)

- » 50 eligible non-HCEs, 900 non-HCEs (5.56%)

- **Avoid failure by**

- Hiring less seasonal or part-time employees

- Expanding eligibility for benefit

Reasons and How to Fix Failures

- **Section 125 - Cafeteria Plan**

- Contributions and Benefits Test*

- **Passes automatically if company pays 75% or more of every health plan premium for every eligible employee**

- **Utilization Test**

- Fails if HCEs' benefit to compensation ratio exceeds non-HCEs'

- » **Example: Client fails with HCEs at 12.82% and non-HCEs at 9%**

- HCEs elect \$250,000 in Cafeteria Plan benefits
- HCEs earn \$1,950,000 combined
- non-HCEs elect \$9,000,000 in Cafeteria Plan benefits
- Eligible non-HCEs earn \$100,000,000 combined

Reasons and How to Fix Failures

- **Section 125 - Cafeteria Plan**
 - Contributions and Benefits Test*
 - **Utilization Test**
 - Avoid failure by
 - » Increasing Cafeteria Plan participation among non-HCEs
 - » Avoiding 100% employer-paid single insurance premiums
 - » Increasing HCE overall compensation
 - » Having HCEs pay post-tax for insurance (mostly health)
 - » Decreasing number of eligible employees

Reasons and How to Fix Failures

- **Section 125 - Cafeteria Plan**
 - Contributions and Benefits Test*
 - **Availability Test**
 - Fails if HCEs are offered options that are not available to non-HCEs
 - » **Better insurance plans**
 - » **Additional insurance plans**
 - Avoid failure by offering same insurance plans to all eligible employees

Reasons and How to Fix Failures

- **Section 125 - Cafeteria Plan**
 - 25% Concentration Test (key employee test)*
 - **Key employees include**
 - Officers who earn over threshold
 - More than 5% owners
 - More than 1% owners who earn over \$150,000
 - Spouses and dependents of any of these

Reasons and How to Fix Failures

- **Section 125 - Cafeteria Plan**
 - 25% Concentration Test (key employee test)*
 - **Fails if key employees' elections comprise more than 25% of the elections for the plan**
 - Example: Client fails with percentage of 26.32%
 - » 10% Owner elects \$25,000
 - » Owner's dependent child elects \$25,000
 - » Non-key employees' elect \$190,000

Reasons and How to Fix Failures

- **Section 125 - Cafeteria Plan**

- 25% Concentration Test (key employee test)*

- **Avoid failure by**

- Prohibiting key employees from electing
- Avoiding 100% employer-paid single insurance premiums
- Having HCEs pay post-tax for insurance (mostly health)
- Waiting to make HSA contributions until end of plan year

Outside Factors

Outside factors

- **Large changes in number of total employees**
 - Mass layoffs
 - **Lowers participation among non-HCEs**
 - **Section 105 Eligibility Test at risk (following plan year)**
 - Mass hiring
 - **New employees ineligible: Section 129 and 125 Eligibility Tests at risk (current plan year)**
 - **New employees eligible but not electing self-funded health plan: Section 105 Eligibility Test at risk (current plan year)**

Outside factors

- **Implementing a HDHP**
 - Section 105 Eligibility Test risks for Health Care FSA
 - **Higher interest in HDHP among lower-paid individuals**
 - **Alleviates most interest in Health Care FSA due to HSA interaction**
 - **Limited Health Care FSA not as appealing**
 - Section 125 Contributions & Benefits Test risks
 - **HCEs deposit more pre-tax HSA contributions than non-HCEs**
 - **Maximum HSA contribution based on family structure**

Outside factors

- **Changing plan year**
 - Interest for short plan year among non-HCEs declines
 - **Section 105 Eligibility Test at risk for Health Care FSA**
 - **Section 129 55% Average Test at risk**
 - **Section 129 25% Owner Concentration Test at risk**
- **Employees' children aging out of Dependent Care**
 - Section 129 55% Average Test at risk
 - Section 129 25% Owner Concentration Test at risk

Outside factors

- **Economy declines**
 - Employees feel need to save
 - **Section 105 Eligibility Test at risk**
 - **Section 129 55% Average Test at risk**
 - **Section 129 25% Owner Concentration Test at risk**
 - **Section 125 Contributions & Benefits Test at risk**
 - **Section 125 25% Concentration Test (key employee test) at risk**

Outside factors

- **Economy declines**

- Employees become ineligible for Dependent Care expenses
 - **Section 129 55% Average Test at risk**
 - **Section 129 25% Owner Concentration Test at risk**
- Employees' spouse's employer implements HDHP
 - **Section 105 Eligibility Test at risk for Health Care FSA**
- Premium rate increases
 - **Section 125 Contributions & Benefits Test at risk**

Outside factors

- **Economy declines**

- Spousal surcharge added or employee + spouse coverage dropped
 - **Section 125 Contributions & Benefits Test at risk**

Questions?

Any questions can be addressed by e-mail or phone at your convenience

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43