



Design Options and Nondiscrimination Testing

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Overview

Federal regulation requires annual nondiscrimination testing of an employer's Section 125 cafeteria plan, including separate testing for the health care flexible spending account (FSA). The purpose of this whitepaper is to discuss the impact on the nondiscrimination testing that certain design decisions regarding employer contributions to the health FSA and the waiting period eligibility criteria for employees to participate in the health care FSA can have. Two particular plan design options will impact testing results – employer contributions and waiting periods.

Employer Contributions

Employer contributions to the health care FSA are a good way to introduce employees to the health care FSA and increase participation in the plan. They may even help to show employees the benefits of the plan and encourage them to set aside pre-tax contributions of their own into the account.

If designed and applied correctly, employer contributions to the health care FSA can contribute to better nondiscrimination testing results due to the corresponding increase in participation. However, if done improperly, it could cause testing to fail.

Due to the implementation of the \$2,500 cap on employee pre-tax health care FSA deductions, plan administrators must separately track the employee and employer contributions to the health care FSA. Thus, the employee is limited to the maximum allowed. But, the employer's contributions is "on top" of the amount elected by the employee. Thus, and employee's total health FSA account can exceed the cap. This ensures that the plan is in compliance with the regulation.

The side effect to this is that the plan's pre-tax election maximum no longer includes employer contributions to the health care FSA.

Employer Contributions Defined

An employer contribution is an elective or non-elective dollar amount that the employee cannot receive as cash that is directed into the employee's health care FSA.¹

If any portion of a contribution can be received as cash, then the amount that could be received as cash that is directed into the employee's health care FSA is treated as being a pre-tax election made by the employee.

¹ Treas. Reg. §54.9831-1(c)(3)(v)(B); DOL Reg. §2590.732(c)(3)(v)(B); HHS Reg. §146.145(c)(3)(v)(B)

Elective Employer Contribution:

Example - Company A provides employees with \$12,000 per year that the employee can use towards health insurance premiums, dental insurance premiums, vision insurance premiums, life insurance premiums, or place into a health care FSA or dependent care FSA. If the employee does not use the full \$12,000 that year, the employee will not receive any portion as cash.

In this case, the amount the employee chooses to place into a health care FSA is considered to be an employer contribution to the health care FSA.

Non-Elective Employer Contribution:

Example - Company B provides employees \$100 – with no cash-out option – into the health care FSA.

In this case, the \$100 is considered to be an employer contribution to the health care FSA.

Cashable Employer Contribution:

Example - Company C provides employees with \$1,000 per year that the employee can use towards dental insurance premiums, vision insurance premiums, life insurance premiums, or place into a health care FSA or dependent care FSA. If the employee does not designate the full \$1,000 that year for pre-tax benefits, the employee can choose to receive up to \$500 as cash.

In this case, if the employee directs more than \$500 of the \$1,000 cashable contribution into the health care FSA, only the excess over \$500 would be considered to be an employer contribution to the health care FSA.

Differing Employer Contribution Amounts

Section 105(h) governs self-funded health plans and therefore applies to the health care FSA. The test which specifically addresses the issue of an employer making different contribution amounts for different sets of employees is the section 105(h) Benefits Test.

This test passes when all of the following requirements are met:²

1. All participants are eligible for the same benefits under the plan;
2. All benefits are offered under the same conditions to all participants (including required employee contributions for each benefit level);
3. If optional benefits are offered, all participants are able to elect each benefit option for the same additional contribution;
4. Disparate waiting periods are not being used; and
5. Benefits do not vary based on age, years of service, or compensation.

² Treas. Reg. §1.105-11(c)(3)(i)

If an employer makes different contribution amounts for different sets of employees, the second requirement would not be met because all employees who are eligible to participate in the health care FSA did not receive the same amount of employer contributions. In this case, the employees who receive a greater employer contribution will have a greater health FSA amount available for reimbursement.

Example 1: Company A provides salaried employees with \$12,000 per year and hourly employees with \$7,500 per year that the employee can use towards health insurance premiums, dental insurance premiums, vision insurance premiums, life insurance premiums, or place into a health care FSA or dependent care FSA. If the employee does not use the full \$12,000 that year, the employee will not receive any portion as cash.

This would mean hourly employees have a possible cumulative health FSA account election that is \$4,500 less than salaried employees which would result in a failure of the section 105(h) Benefits Test.

Example 2: Company B allows all employees who work at least 20 hours per week to participate in the health care FSA up to the statutory \$2,500 maximum. If an employee is a full-time employee, that employee receives \$100 of employer contributions – with no cash-out option – into the health care FSA regardless of whether that employee chose to set aside pre-tax money into that account. Part-time employees do not receive this employer contribution.

This would mean that in order to receive a cumulative election amount of \$100, full-time employees would have to contribute \$0 pre-tax while part-time employees would have to contribute \$100 pre-tax of their own money which would result in a failure of the section 105(h) Benefits Test.

Example 3: Company C provides all employees with \$1,000 per year that the employee can use towards dental insurance premiums, vision insurance premiums, life insurance premiums, or place into a health care FSA or dependent care FSA. If the employee does not use the full \$1,000 that year, the employee can choose to receive up to \$500 as cash.

*This would mean that all employees have the possibility to have the same cumulative election. This **plan would pass** the section 105(h) Benefits Test.*

Waiting Periods

Instituting a waiting period before employees can participate in the health care FSA is one way to reduce risk in offering the plan. If an employer has a history of employees terminating employment soon after being hired, if there is no waiting period or a very short waiting period,

an employee could enroll on the plan, exhaust the benefit, terminate employment and leave the employer with the heavy burden of funding the majority of the expenses.

However, if the waiting period is designed improperly, it could cause testing to fail.

The test which specifically addresses the issue of waiting periods for different sets of employees is the section 105(h) Benefits Test.

The health care FSA benefits test passes when all of the following requirements are met:³

1. All participants are eligible for the same benefits under the plan;
2. All benefits are offered under the same conditions to all participants (including required employee contributions for each benefit level);
3. If optional benefits are offered, all participants are able to elect each benefit option for the same additional contribution;
4. Disparate waiting periods are not being used; and
5. Benefits do not vary based on age, years of service, or compensation.

Differing Waiting Period

If all employees who are eligible to participate in the health care FSA are not subjected to the same waiting period, the fourth requirement would not be met – there would be disparate waiting periods within the plan. Consequently, the Benefits Test would fail – those employees with the longer waiting period have to wait longer to receive pre-tax reimbursement of their medical expenses.

Example 1: Company A allows salaried employees to enroll in the health care FSA on their date of hire and hourly employees to enroll in the health care FSA on the first of the month following their date of hire.

This would mean that the salaried employees are eligible for reimbursement earlier than the hourly employees and the plan would fail the Benefits Test.

Example 2: Company B allows all employees to enroll in the health care FSA on the first of the month following their date of hire unless they were hired on the first of the month, then eligible on hire date.

This would mean that employees who were hired on the first of the month are not subjected to the same waiting period requirements as those hired on any other day during the month and the plan would fail the Benefits Test.

³ Treas. Reg. §1.105-11(c)(3)(i)

Example 3: Company C allows all employees to enroll in the health care FSA on the first day of the plan year following their date of hire unless they were hired on the first day of the plan year, then eligible for that plan year.

This would mean that employees who were hired on the first day of the plan year are not subjected to the same waiting period requirements as those hired on any other day during the plan year and the plan would fail the Benefits Test.

Potential Simple Solutions

The easiest solution is to come to a compromise and provide the same health care FSA employer contribution and waiting period to all eligible employees. This could be done in a variety of ways.

Same Employer Contributions

Example 1: Company A could provide

- *Salaried and hourly employees both receive the same set dollar amount per year with the same conditions for what the contribution can be used for as before; or*
- *Salaried employees receive \$12,000 per year with the same conditions as before except that if the salaried employee does not use the full \$12,000 that year, the employee will have the option to receive up to \$4,500 in cash/Hourly employees receive \$7,500 per year but no cash out option with the same conditions for use as before; or*
- *Salaried employees receive \$12,000 per year with the same conditions as before except that none of the allocated money may be placed in the health care FSA and Hourly employees receive \$7,500 per year with the same conditions as before except that none of the allocated money may be placed in the health care FSA*

Example 2: Company B could provide

- *Full-time and part-time employees both receive the same set dollar amount per year with the same conditions for use as before; or*
- *Only full-time employees have the option to enroll in the health care FSA and make the part-time employees ineligible; or*
- *Full-time employees the option to receive the employer contribution as cash; or*
- *No employer contributions to full-time employees*

Same Waiting Periods

Example 1: Company A could provide

- *Salaried and hourly employees the same ability to enroll in the health care FSA after the same amount of time; or*
- *Salaried employees have the ability to enroll in the health care FSA on their date of hire but take deductions out post-tax until the first of the month following their date of hire and*

allow hourly employees to enroll in the health care FSA on the first of the month following their date of hire with all deductions taken pre-tax

Example 2: Company B could provide

- *All employees the ability to enroll in the health care FSA after the same amount of time – on the date of hire or the first of the month following date of hire; or*
- *Employees hired on the first of the month have the ability to enroll in the health care FSA on their date of hire but take deductions out post-tax until the first of the month following their date of hire and allow employees hired on other days of the month to enroll in the health care FSA on the first of the month following their date of hire*

Example 3: Company C could provide

- *All employees the ability to enroll in the health care FSA after the same amount of time – on the date of hire or the first day of the plan year following date of hire*
- *Employees hired on the first day of the plan year the ability to enroll in the health care FSA on their date of hire but take deductions out post-tax for that year and allow employees hired on other days of the plan year to enroll in the health care FSA on the first day of the plan year following their date of hire*

Potential Complex Solutions

There are some plan design options that are more complex to implement. These are discussed in the following sections.

Separating Groups of Employees

The regulation does, however, allow a plan to be restructured in order to pass the testing.⁴ If the plan was not compliant and would fail the Benefits Test, then the employer could offer two or more plans. These smaller disaggregated plans would be defined by the fact that all five of the required elements for the 105(h) testing are the same for all participants of that plan.

Example: Company B offers two Cafeteria Plans – one for full-time employees where all employees receive \$100 of employer contribution into the health care FSA and are eligible on date of hire and a second cafeteria plan for part-time employees where all part-time employees receive no employer contribution and are eligible first of the month following date of hire.

If Company B decided to separate their one plan into multiple plans in order to pass the section 105(h) Benefits Test, each of those separate cafeteria plans would need to pass all eight other nondiscrimination tests in order to keep their tax-free status.

⁴ Reg. §1.105-11(c)(4)

There are certain situations that may cause a failure of one or more of the required tests due to the disaggregation. Each test has different rules and danger zones outlined below. The details below are based on the assumption that the plan would have failed the 105(h) testing but would have passed all eight other nondiscrimination tests if it had not been separated into two plans. Governmental entities would not need to perform the section 125 Key Employee Test.⁵

Examination of Full-Time versus Part-Time Cafeteria Plan Testing

Section 105(h) Eligibility Test⁶ – As long as the majority of the employer’s full-time employees have a health care FSA and the majority of the part-time employees work less than 35 hours per week⁷, the full-time employee plan will pass the section 105(h) Eligibility Test.

As long as the employer either has no part-time employees who are also an officer, a more than 10% shareholder or a spouse or dependent of those individuals, or if they do, those individuals are not the only part-time employees participating in the health care FSA, the part-time employee plan will pass the section 105(h) Eligibility Test.

Section 129 55% Average Test⁸ – As long as no full-time employee who is a more than 5% shareholder or an individuals whose compensation classifies as a highly compensated employee participates in the dependent care FSA or there are no part-time employees with dependent care FSA elections, the full-time employee plan will pass the section 129 55% Average Test.

As long as no part-time employee is a more-than 5% shareholder or individual whose compensation classifies them as a highly compensated employee, the part-time employee plan will pass the section 129 55% Average Test.

Section 129 25% Concentration Test⁹ – As long as no more-than 5% shareholders or spouses/dependents of a more-than 5% shareholder participate in the dependent care FSA or there are no part-time employees with dependent care FSA elections, the full-time employee plan will pass the section 129 25% Concentration Test.

As long as no part-time employee is a more-than 5% shareholder or spouse/dependent of a more-than 5% shareholder, the part-time employee plan will pass the section 129 25% Concentration Test.

⁵ Code §416(i)(1)(A)

⁶ Code §105(h)(2)(A)

⁷ Code §105(h)(3)(B)

⁸ Code §129(d)(8)

⁹ Code §129(d)(4)

Section 125 Contributions and Benefits Test¹⁰ – As long as the employer pays for 75% of the health insurance premium for the most expensive health insurance coverage (including the family premium) for every full-time employee, the full-time employee plan will pass the section 125 Contributions and Benefits Test¹¹. If not, separating the part-time employees' cafeteria plan and removing their elections from the full-time employee plan may cause the non-highly compensated employee benefit percentage to decrease. This could cause the highly compensated participant benefit percentage to exceed the non-highly compensated participant benefit percentage and the full-time employee plan would then fail the section 125 Contributions and Benefits Test.

As long as the employer pays for 75% of the health insurance premium for the most expensive health insurance coverage (including the family premium) for every part-time employee¹², or if no part-time employee is an officer, individual whose compensation classifies them as a highly compensated employee, more than 5% shareholder or spouse/dependent of those individuals, the part-time employee plan will pass the section 125 Contributions and Benefits Test.

Section 125 Key Employee Test¹³ – Removing the part-time employees' cafeteria plan elections may cause the full-time employee test result for the Key Employees to exceed the 25% maximum and the full-time employee plan would then fail the section 125 Key Employee 25% Concentration Test.

As long as no part-time employee is an officer whose compensation classifies them as a key employee, more than 1% shareholder whose compensation exceeds \$150,000, more than 5% shareholder or spouse/dependent of those individuals, the part-time employee plan will pass the section 125 Key Employee Test.

Examination of Salary versus Hourly Cafeteria Plan Testing

Section 105(h) Eligibility Test¹⁴ – As long as the highest-paid 25% of the employees include around an even number of hourly and salaried employees and the majority of the salaried employees have a health care FSA, the salaried employee plan will pass the section 105(h) Eligibility Test.

As long as the employer either has no hourly employees who are also an officer, a more than 10% shareholder or a spouse or dependent of those individuals, or if they do, those individuals are not the only hourly employees participating in the health care FSA, the hourly employee plan will pass the section 105(h) Eligibility Test.

¹⁰ Code §125(b)(1)(B)

¹¹ Code §125(g)(2)

¹² Code §125(g)(2)

¹³ Code §125(b)(2)

¹⁴ Code §105(h)(2)(A)

Section 129 55% Average Test¹⁵ – As long as no more-than 5% shareholder or spouse/dependent of a more-than 5% shareholder participates in the dependent care FSA or there are no hourly employees with dependent care FSA elections, the salaried employee plan will pass the section 129 25% Concentration Test.

As long as no hourly employee is a more- than 5% shareholder or individual whose compensation classifies them as a highly compensated employee, the hourly employee plan will pass the section 129 55% Average Test.

Section 129 25% Concentration Test¹⁶ – As long as no more- than 5% shareholder or spouse/dependent of a more-than 5% shareholder participate in the dependent care FSA or there are no hourly employees with dependent care FSA elections, the salaried employee plan will pass the section 129 25% Concentration Test.

As long as no hourly employee is a more-than 5% shareholder or spouse/dependent of a more-than 5% shareholder, the hourly employee plan will pass the section 129 25% Concentration Test.

Section 125 Contributions and Benefits Test¹⁷ – As long as the employer pays for 75% of the health insurance premium for the most expensive health insurance coverage (including the family premium) for every salaried employee, the salaried employee plan will pass the section 125 Contributions and Benefits Test¹⁸. If not, separating out the hourly employees and removing the hourly employees' cafeteria plan elections from the salaried employee's cafeteria plan may cause the non-highly compensated employee benefit percentage to decrease. This could cause the highly compensated participant benefit percentage to exceed the non-highly compensated participant benefit percentage and the salaried employee plan to fail the section 125 Contributions and Benefits Test.

As long as the employer pays for 75% of the health insurance premium for the most expensive health insurance coverage (including the family premium) for every hourly employee¹⁹, or if no hourly employee is an officer, individual whose compensation classifies them as a highly compensated employee, more than 5% shareholder or spouse/dependent of those individuals, the hourly employee plan will pass the section 125 Contributions and Benefits Test.

¹⁵ Code §129(d)(8)

¹⁶ Code §129(d)(4)

¹⁷ Code §125(b)(1)(B)

¹⁸ Code §125(g)(2)

¹⁹ Code §125(g)(2)

Section 125 Key Employee Test²⁰ – Separating the plans and removing the hourly employees' cafeteria plan elections from the salaried employee's plan may cause the salaried employee plan's Key Employee test result to exceed the 25% maximum and the salaried employee plan to fail the section 125 Key Employee 25% Concentration Test.

As long as no hourly employee is an officer whose compensation classifies them as a key employee, more than 1% shareholder whose compensation exceeds \$150,000, more than 5% shareholder or spouse/dependent of those individuals, the hourly employee plan will pass the section 125 Key Employee Test.

Examination of Separate Union versus non-Union Cafeteria Plan Testing

Note: In this instance, union refers to a group of individuals who collectively bargain for their cafeteria plan benefits. This example would not work for groups of individuals who collectively bargain for wages, but do not include the cafeteria plan as part of their bargaining agreement.

Section 105(h) Eligibility Test²¹ – As long as the majority of the non-union employees have a health care FSA, the non-union employee plan will pass the section 105(h) Eligibility Test²².

As long as the highest-paid 25% of the employees include around an even number of union and non-union employees and the majority of the union employees have a health care FSA, the union employee plan will pass the section 105(h) Eligibility Test.

Section 129 55% Average Test²³ – As long as no more-than 5% shareholder or spouse/dependent of a more-than 5% shareholder participates in the dependent care FSA or there are no union employees with dependent care FSA elections, the non-union employee plan will pass the section 129 25% Concentration Test²⁴.

As long as no union employee is a more than 5% shareholder or individual whose compensation classifies them as a highly compensated employee, the union employee plan will pass the section 129 55% Average Test.

Section 129 25% Concentration Test²⁵ – As long as no more-than 5% shareholder or spouse/dependent of a more- than 5% shareholder participates in the dependent care FSA or there are no union employees with dependent care FSA elections, the non-union employee plan will pass the section 129 25% Concentration Test.

²⁰ Code §125(b)(2)

²¹ Code §105(h)(2)(A)

²² Code §105(h)(3)(B)

²³ Code §129(d)(8)

²⁴ Code §129(d)(9)(B)

²⁵ Code §129(d)(4)

As long as no union employee is a more-than 5% shareholder or spouse/dependent of a more-than 5% shareholder, the union employee plan will pass the section 129 25% Concentration Test.

Section 125 Contributions and Benefits Test²⁶ – As long as the employer pays for 75% of the health insurance premium for the most expensive health insurance coverage (including the family premium) for every non-union employee, the non-union employee plan will pass the section 125 Contributions and Benefits Test²⁷. If not, removing the union employees' cafeteria plan elections from the non-union cafeteria plan may cause the non-highly compensated non-union employee benefit percentage to decrease. This could cause the highly compensated non-union participant benefit percentage to exceed the non-highly compensated non-union participant benefit percentage and the non-union employee plan to fail the section 125 Contributions and Benefits Test.

The union employee plan will automatically pass the section 125 Contributions and Benefits Test²⁸.

Section 125 Key Employee Test²⁹ – Removing the union employees' cafeteria plan elections from the non-union cafeteria plan may cause the key employee test result to exceed the 25% maximum and the non-union employee plan to fail the section 125 Key Employee 25% Concentration Test.

As long as no union employee is an officer whose compensation classifies them as a key employee, more than 1% shareholder whose compensation exceeds \$150,000, more than 5% shareholder or spouse/dependent of those individuals, the union employee plan will pass the section 125 Key Employee Test.

Examination of Separate Administrators versus non-Administrators Cafeteria Plan Testing

Section 105(h) Eligibility Test³⁰ – As long as the highest-paid 25% of the employees include around an even number of administrative and non-administrative employees and the majority of the administrative employees have a health care FSA, the administrative employee plan will pass the section 105(h) Eligibility Test.

As long as the employer either has no non-administrative employees who are also an officer, a more than 10% shareholder or a spouse or dependent of those individuals, or if they do, those individuals are not the only non-administrative employees participating in the health care FSA

²⁶ Code §125(b)(1)(B)

²⁷ Code §125(g)(2)

²⁸ Code §125(g)(1)

²⁹ Code §125(b)(2)

³⁰ Code §105(h)(2)(A)

and the majority of the non-administrative employees have a health care FSA, the non-administrative plan will pass the section 105(h) Eligibility Test.

Section 129 55% Average Test³¹ – As long as no more-than 5% shareholder or spouse/dependent of a more-than 5% shareholder participate in the dependent care FSA or there are no non-administrative employees with dependent care FSA elections, the administrative employee plan will pass the section 129 25% Concentration Test.

As long as no non-administrative employee is a more-than 5% shareholder or individual whose compensation classifies them as a highly compensated employee, the non-administrative employee plan will pass the section 129 55% Average Test.

Section 129 25% Concentration Test³² – As long as no more-than 5% shareholder or spouse/dependent of a more-than 5% shareholder participates in the dependent care FSA or there are no non-administrative employees with dependent care FSA elections, the administrative employee plan will pass the section 129 25% Concentration Test.

As long as no non-administrative employee is a more-than 5% shareholder or spouse/dependent of a more- than 5% shareholder, the non-administrative employee plan will pass the section 129 25% Concentration Test.

Section 125 Contributions and Benefits Test³³ – As long as the employer pays for 75% of the health insurance premium for the most expensive health insurance coverage (including the family premium) for every administrative employee, the administrative employee plan will pass the section 125 Contributions and Benefits Test³⁴. If not, removing the non-administrative employees' cafeteria plan elections from the administrative staff cafeteria plan may cause the non-highly compensated administrative staff employee benefit percentage to decrease. This could cause the highly compensated administrative participant benefit percentage to exceed the non-highly compensated administrative participant benefit percentage and the administrative employee plan to fail the section 125 Contributions and Benefits Test.

As long as the employer pays for 75% of the health insurance premium for the most expensive health insurance coverage (including the family premium) for every non-administrative employee³⁵, or no non-administrative employee is an officer, individual whose compensation classifies them as a highly compensated employee, more- than 5% shareholder or

³¹ Code §129(d)(8)

³² Code §129(d)(4)

³³ Code §125(b)(1)(B)

³⁴ Code §125(g)(2)

³⁵ Code §125(g)(2)

spouse/dependent of those individuals, the non-administrative employee plan will pass the section 125 Contributions and Benefits Test.

Section 125 Key Employee Test³⁶ – Removing the non-administrative employees' cafeteria plan elections from the administrative staff's cafeteria plan may cause the test result to exceed the 25% maximum and the administrative employee plan to fail the section 125 Key Employee Concentration Test.

As long as no non-administrative employee is an officer whose compensation classifies them as a key employee, more than 1% shareholder whose compensation exceeds \$150,000, more than 5% shareholder or spouse/dependent of those individuals, the non-administrative employee plan will pass the section 125 Key Employee Test.

³⁶ Code §125(b)(2)



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