McGraw Wentworth

BENEFIT Advisor

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In This Issue

In this issue of the McGraw Wentworth Benefit Advisor, we will discuss the non-discrimination requirements for Section 125 cafeteria plans. Most organizations offer their employees Section 125 plans as a way to save tax dollars on certain health plan premiums along with health and dependent care expenses.

One of the requirements of offering a Section 125 plan is that the plan does not discriminate in favor of highly compensated or key employees. This Advisor will discuss the complicated non-discrimination requirements as well as the tests your plan can perform to demonstrate the plan is non-discriminatory.

We welcome your comments and suggestions regarding this issue of our technical bulletin. For more information on this Benefit Advisor, please contact your Account Manager or visit the McGraw Wentworth web site at www.mcgrawwentworth.com.

"Non-Discrimination Requirements for Section 125 Plans"

Various non-discrimination requirements affect employer-sponsored health and welfare plans. McGraw Wentworth is devoting several *Benefit Advisors* to discussing these requirements. Last month's *Advisor* discussed the Section 105(h) non-discrimination requirements for self-funded medical plans. This *Advisor* discusses the Section 125 non-discrimination rules for cafeteria plans. Next month, we will discuss Section 79 non-discrimination requirements for employer-sponsored life insurance plans.

Section 125 cafeteria plans allow employees to pay for certain benefits with pre-tax dollars. Employers may also choose to offer Flexible Spending Accounts which allow employees to set aside funds on a pre-tax basis that can be used for certain medical and dependent care expenses.

However, certain highly compensated employees and key employees may be forced to pay taxes on these benefits if the cafeteria plan discriminates in their favor. This *Advisor* discusses the following key areas of Section 125 non-discrimination testing:

- Defining Highly Compensated Employees
- Eligibility Test
- The Contributions and Benefits Test
- Key Employee Concentration Test
- Consequences of Having a Discriminatory Section 125 Plan
- Concluding Thoughts

A cafeteria plan must pass three tests to prove it does not discriminate. Although Section 125 requires plans to pass all three tests, it does not require these tests to be performed at regular intervals. However, if your plan is audited, you must demonstrate your plan does not favor certain employees. It is good practice to test your plan to make sure your plan meets these requirements.

Defining Highly Compensated Employees

Different non-discrimination tests examine different groups of employees. The employees being examined are called the *prohibited* group.

For the Eligibility Test, the prohibited group consists of highly compensated *individuals*. For the Contribution and Benefits Test, the prohib-

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ited group consists of highly compensated *participants*. At the end of the day, even though slightly different terms are used, the prohibited group for both tests consists of the same participants and includes:

- An officer
- A shareholder owning more than 5% of the voting power or value of all classes of company stock
- The highly compensated
- A spouse or dependent of an individual described above

These categories are not necessarily self-explanatory. Following is a more detailed definition of prohibited employees.

An Officer

Unfortunately, Section 125 does not define *officer*. However, it is believed employers can rely on the definition of officer from Section 416 of the Internal Revenue Code.

In general, an officer is an administrative executive in regular and continuous service based on the facts and circumstances of the position, including the source of the executive's authority and the extent of his or her duties. Title alone is not an indicator of an officer. For example, if an organization assigns the title of Assistant Vice President to senior sales personnel when the position has no real administrative authority, those individuals would not be considered officers under Section 125, despite their job title.

More than 5% Shareholder

Any employee who owns more than 5% of the value of the outstanding stock for the corporation is considered a more than 5% shareholder. Value means the fair market value of the stock. Employees owning just 5% of stock are not included in this group.

The Highly Compensated

Unfortunately Section 125 does not formally define *highly compensated employee*. In fact, the description seems rather circular since it includes more than 5% shareholders, officers and spouses and dependents of these individuals.

Because Section 125 is unclear, the following Section 414(q) definition is generally used for these non-discrimination tests:

- If an employee was more than a 5% owner of the company at any time during the current or preceding plan year.
- If an employee was paid more than a specified amount during the preceding plan year. This amount is the highly compensated employee limit under Section 414(g). For 2006, the threshold was $100,000.

Employers may test the 20% top-paid group instead of the Section 414(g) highly compensated employee limit. For employers with a fairly high average compensation, this approach may make more sense. Identifying the top-paid 20% is a two step process. First, the employer must determine the number of employees in the top 20% of the workforce. Then the employer must determine which employees are in the 20% because of their compensation for the look-back year.

The employer can exclude the following employees from the 20% top-paid group:

- Employees who have not completed six months of service.
- Employees who normally work less than 17.5 hours a week.
- Employees who normally work less than 6 months during any year.
- Employees who are under age 21.
- Employees who are covered by a collective bargaining agreement (this exclusion applies only if at least 90% of all employees are covered by a collective bargaining agreement and if the plan being tested covers only non-union employees).

Employers do have some flexibility. The limitations listed above are the outer limits. Employers may exclude employees with less than three months of service or employees who are under age 20. These

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Notable Thoughts

Growth begins when we begin to accept our own weakness.

Jean Vanier

modifications are allowed as long as they are consistent and uniform.

Spouse or Dependent

A spouse or dependent of any of following individuals should also be included in the Section 125 prohibited group:

- Any officer
- A more than 5% shareholder or
- A highly compensated employee

The Section 152 definition of *dependent* should be used for determining dependents to be included in the prohibited group. This definition is the same definition that employers use for dependents eligible for tax-favored health benefits.

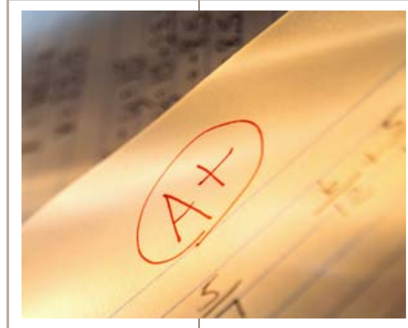
Identifying the Highly Compensated Employees

While the definitions for which employees should be placed in the highly compensated category for non-discrimination testing are fairly clear, determining which employees should be placed in the *prohibited* group is not that easy. To make that determination, take the following steps:

Step 1: Determine who the employer is and which employees should be counted. Use controlled group rules to determine which entities should be treated as one employer. List the employees that should be included in the testing.

Step 2: List the prior plan year's compensation for all the employees included in the testing. Add in salary deferred for 401(k) contributions, cafeteria plan elections, a qualified transportation plan, a SARSEP, a SIMPLE plan, 403(b) plan, or a Code 457 plan.

Step 3: Identify highly paid employees. Using the 414(g) annual limit, determine which employees have been paid more than the highly compensated dollar threshold for the year being considered.



Step 4: Determine the number of employees in the Top-Paid group. Identifying the top-paid individuals after defining the highly compensated employee group should help determine which group an employer should use for non-discrimination testing. You can disregard the excluded employees defined in the previous section.

Step 5: Sort the employees in descending order by annual compensation. In this group, you should include the employees that were excluded in Step 4 (except for collectively bargained employees). Identify which employees are in the top 20%.

Step 6: Compare the top 20% group with the highly compensated group. The employer needs to identify which group will be more favorable from a testing standpoint (usually the group with fewer participants). If the 20% group is more favorable, the employer needs to amend the plan to use that group.

Step 7: Whichever group is chosen (either the highly compensated or the top 20%) add back in the more than 5% shareholders, officers, and spouses and dependents of all included employees.

The group of employees and dependents determined in Step 7 is considered prohibited and must be tested separately for non-discrimination purposes.

Eligibility Test

Plans must meet the following three elements to pass the eligibility test:

1. *Employment Requirement*: No employee can be required to complete more than 3 years of employment to participate, and the same employment requirement must apply to all employees.
2. *Entry Requirement*: Entry into the Section 125 plan is not delayed.
3. *Non-Discrimination Test*: Plan meets a non-discriminatory classification test.

These three requirements constitute the eligibility test. **If all your employees are eligible to participate in your cafeteria plan, employees all have the same new hire waiting period and it is less than three years, your plan automatically passes the eligibility test.** The tests are fairly complicated. If your plan passes by virtue of plan design, you can move to the next section addressing the Contribution and Benefits Test.

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Employment Requirement

To pass this portion of the eligibility test, a plan cannot impose a service requirement (new hire waiting period) of longer than three years. The regulation language uses the terms *service requirement* and *employment requirement* interchangeably and unfortunately does not define either term.

This requirement also states the new hire waiting period must be the same for all employees. Employers cannot pass this requirement if they have a 120-day waiting period for one group of employees and then impose only a 60-day new hire waiting period for a different group of employees.

Cafeteria plans with different waiting periods for different classes of employees generally violate the employment requirement. If necessary, however, employers can offer separate cafeteria plans with different waiting periods.

Entry Requirement

The entry requirement defines when an individual is eligible for coverage under the plan. A plan must allow individuals that have satisfied the employment requirement to participate in the plan no later than the first day of the first plan year after they complete the service requirement.

For many plans this entry requirement will not be an issue because it is fairly standard to cover new hires as soon as they complete the waiting period or on the first of the month after they complete it.

Non-Discriminatory Classification Requirement

A plan meets the non-discriminatory classification requirement if:

- The plan benefits employees who qualify under a reasonable classification that is established by the employer.
- The classification is considered non-discriminatory.

In order for a classification to be considered reasonable, it must be based on objective business criteria. For example, distinctions could be based on salaried or hourly status, full or part-time status, or even based on geographic location. Meeting the reasonable classification requirement is subjective, which does allow room for interpretation. If the plan is going to offer different benefits or plan provisions to different employee groups, it is best to use objective business criteria.

The second requirement, that the classification be considered non-discriminatory, is much more difficult to determine. The plan can satisfy an objective "safe harbor percentage test" or a subjective "facts and circumstances" test for the plan year. Most plans resort to the facts and circumstances test only if they are unable to pass the safe harbor test first.

Safe Harbor Percentage Test

The safe harbor percentage test examines the relationship between non-highly compensated individuals and highly compensated individuals to see whether both groups benefit from the plan. To apply this test, follow these steps:

Step 1*:* Determine the **Plan's Ratio Percentage.** To determine this percentage, divide the percentage of non-highly compensated employees (non-HCEs) that benefit from the plan by the percentage of highly compensated employees (HCEs) that benefit from the plan.

The equation is as follows:

Ratio Percentage =

$$\frac{\dfrac{\text{Non-HCEs who benefit}}{\text{All non-excludible, non HCEs}}}{\dfrac{\text{HCEs who benefit}}{\text{All non-excludible HCEs}}}$$

Step 2: Determine the Non-HCE concentration percentage:

Non-HCE Concentration Percentage =

$$\frac{\text{Non-excludible non-HCEs}}{\text{Total non-excludible non-HCE and HCEs}}$$

Step 3: Using the Ratio Percentage and the non-HCE concentration percentage, employers can determine whether they meet the safe harbor requirement. The employer must use the Non-discriminatory Classification Table published by the IRS (see table on page 5).

Compare the ratio percentage calculated in Step 1 with the Safe Harbor percentage that corresponds to your ratio percentage:

1. If your plan's ratio percentage is equal to or greater than the corresponding safe harbor percentage, your plan is deemed to be non-discriminatory. If your plan's ratio is 75%, the safe harbor percent

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Non-HCE Concentration %	Safe Harbor %	UnSafe Harbor %	Non-HCE Concentration %	Safe Harbor %	UnSafe Harbor %
0-60	50.00	40.00	80	35.00	25.00
61	49.25	39.25	81	34.25	24.24
62	48.50	38.50	82	33.50	23.50
63	47.75	37.75	83	32.75	22.75
64	47.00	37.00	84	32.00	22.00
65	46.25	36.25	85	31.25	21.25
66	45.50	35.50	86	30.50	20.50
67	44.75	34.75	87	29.75	20.00
68	44.00	34.00	88	29.00	20.00
69	43.25	33.25	89	28.25	20.00
70	42.50	32.50	90	27.50	20.00
71	41.75	31.75	91	26.75	20.00
72	41.00	31.00	92	26.00	20.00
73	40.25	30.25	93	25.25	20.00
74	39.50	29.50	94	24.50	20.00
75	38.75	28.75	95	23.75	20.00
76	38.00	28.00	96	23.00	20.00
77	37.25	27.25	97	22.25	20.00
78	36.50	26.50	98	21.50	20.00
79	35.75	25.75	99	20.75	20.00

is 38.75% and your plan passes. If your plan passed the service requirement and entry requirement, your plan has passed the eligibility portion of the non-discrimination test.

2. If the plan ratio percentage is less than the safe harbor percentage, the plan does not meet the safe harbor. However, the plan can still pass the eligibility test if:
   - The plan's ratio percentage is greater than or equal to the Unsafe Harbor Percentage (listed in the table above).
   - The classification satisfies the Facts and Circumstances test discussed below.
   - The other requirements for the eligibility test are met (the service requirement and entry requirement).

Facts and Circumstances Test

The facts and circumstances test is subjective. Based on all the facts and circumstances, the classification must be found to be non-discriminatory. The IRS will consider several factors including:

- The underlying business reason for the classification.
- The percentage of employees benefiting under the plan.
- The number of employees benefiting from the plan across all salary ranges in the employer's workforce.
- The difference between the plan's ratio percentage and the safe harbor percentage. The smaller the difference, the more likely the plan will pass.

The eligibility test is very complicated and several areas are unclear. For example, the regulations do not define what it means to "benefit" under the plan. It is generally believed if employees elect salary reductions, they benefit under the plan.

If at all possible, it makes sense to design your plan so that eligibility tests are not needed. Under the safe harbor, if all your employees are eligible to participate in the cafeteria plan, all employees have the same new hire waiting period and it is less than three years, your plan automatically passes the eligibility test.

The Contributions and Benefits Test

This test ensures contributions and benefits are available on a non-discriminatory basis. It also determines whether highly compensated employees are allowed to choose

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more tax-free benefits than non-highly compensated employees can.

The guidelines for this test are not particularly clear. Several issues need to be considered:

- Safe harbor for health benefits
- Availability standard
- Utilization standard
- Non-discriminatory requirement

Safe Harbor for Health Benefits

Section 125 offers a safe harbor to cafeteria plans that include health benefits. If your plan meets the safe harbor requirements, your plan is not considered discriminatory in contributions or benefits, and you can skip to the next section of this *Advisor*, the Key Employee Concentration Test.

The requirements of the safe harbor are:

- The plan must provide health benefits. Health benefits are not defined, but it appears they include comprehensive medical coverage, such as an HMO, PPO or POS plan and not ancillary coverage such as dental, vision and health FSAs.
- The plan must meet the 100%/75% test. Under this test, the employer must pay 100% of the coverage cost for the plan most HCEs elect **OR** the employer pays an amount for each participant equal to or exceeding 75% of the cost of the most expensive health benefit plan option for similarly situated participants. *Similarly situated* refers to geographic region or coverage election (single or family).
- If plan contributions or benefits exceed the amounts needed for the 100% or 75% standard, the excess contributions must bear a uniform relationship to compensation. If the plan does not provide any excess contributions or benefits, this requirement is met.

If a plan can meet the three requirements for the safe harbor, it meets the contribution and benefits non-discrimination requirements. If not, plans must pass the availability standard, the utilization standard and the non-discriminatory requirement to pass the contribution and benefits test.

Availability Standard

Employers can meet the availability standard in either of two ways:

1. Show *employer* contributions are non-discriminatory.
2. Show benefits are non-discriminatory.

The easiest way to meet the availability standard is to show all participants get the same employer contribution or at least all similarly situated employees get the same employer contributions. Contributions can differ, for example, the employer can contribute different amounts for single coverage and family coverage.

If a plan cannot show that employer contributions are non-discriminatory, the plan can still meet this standard by showing the benefits are non-discriminatory. For this standard, an employer needs to show tax-free benefits and total benefits are non-discriminatory. If plan participants can choose among the same benefits, this standard is satisfied. Employers should consider the following issues to decide whether participants can indeed choose among the same benefits:

- Non-highly compensated individuals cannot be charged more than highly compensated individuals for the same benefits.
- Equal contributions are considered in determining whether participants are offered the same benefits.
- From a benefits perspective, this standard does allow employers to offer different levels of benefits in different regions. If the benefits are comparable, they will be considered the same. When cost varies by region, the employer funding can also vary by region, if funding is represented as a percentage of cost.

Utilization Standard

In order for a plan to be considered non-discriminatory, highly compensated employees must not disproportionately select tax-free benefits while other employees select taxable benefits. The utilization standard compares the percentage of highly compensated employees who select tax-free benefits with the percentage of other participants who do not. Unfortunately Section 125 does not for-

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mally explain how to apply this standard.

An employer can test the plan to be sure it meets this standard in one of four ways. The plan needs to satisfy only one of these options to meet the requirements:

- **Option 1:** Compare the total tax-free benefits highly compensated employees select with the total tax-free benefits non-highly compensated employees select. If the non-highly compensated employees' tax-free benefits equal or exceed the highly compensated employees' tax-free benefits, the plan passes the utilization standard.
- **Option 2:** Compare tax-free benefits with total pay for HCEs and for non-HCEs. If the percentage for the non-highly compensated equals or exceeds the percentage for the HCEs, the plan passes the utilization standard.
- **Option 3:** Compare the percentage of HCEs that take some tax-free benefits with the percentage of non-HCEs that do so. This option will probably be the most difficult to satisfy because HCEs typically select tax-free benefits more often than non-HCEs.
- **Option 4:** Compare the average HCE tax-free benefits with the average non-HCE tax-free benefits. Again, this option may be difficult to satisfy because HCEs typically select tax-free benefits more often than non-HCEs.

If your plan satisfies any one of the above options, it meets the utilization standard.

Non-Discriminatory in Operation

The plan must also not discriminate in operation. If your plan has met the other contribution and benefit standards, it is unlikely the plan will be considered discriminatory in operation.

The one area that can be an issue, however, is the maximum set for the health care flexible spending account. For example, if you have a large number of low to moderately paid employees and offer a $20,000 maximum on a health FSA, your organization could very well be considered to be discriminating in operation. It is likely only the highly compensated will elect amounts close to such a high maximum. If HCEs do elect close to the $20,000 maximum, your plan will not pass the non-discrimination in operation standard.

As a general rule of thumb, keeping your health FSA maximum under $5,000 should allow your plan to pass the non-discrimination in operation standard.

The only exception for the discrimination tests are union employees. A cafeteria plan is not discriminatory if it adheres to a collective bargaining agreement. Although Section 125 does not directly refer to this issue, it appears that union employees can be excluded from contribution and benefits tests.

Key Employee Concentration Test

The final test is the Key Employee Concentration test. This test determines whether key employees' tax-free benefits are more than 25% higher than all employees' tax-free benefits.

This test involves looking at covered key employees. The prohibited group for this test includes only key employees. Key employees are defined as:

- An officer paid more than the indexed threshold (for 2007 - $145,000 a year).
- A more than 5% owner.
- A more than 1% owner paid more than $150,000 a year.

Key employee status should be determined based on the plan year.

There are two exceptions to the key employee concentration. One is a plan that is part of a collective bargaining agreement. The other exception is the plan of a governmental entity.

On the surface, the key employee concentration test appears to be fairly simple. An employer would identify the key employees' tax-free benefits and compare them with all employees' benefits.

Key employees' tax-free benefits **cannot exceed 25%** of all employees' benefits.

Benefits under a cafeteria plan include pre-tax contributions for health plan coverage and also any funds set aside in a health care reimbursement FSA or a dependent care reimbursement FSA.

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If a cafeteria plan can pass all three non-discrimination tests (Eligibility Test, The Contributions and Benefits Test, Key Employee Concentration Test), the plan is considered non-discriminatory under Section 125.

Consequences of Having a Discriminatory Section 125 plan

If your plan favors highly compensated employees, those employees will have to pay income tax on certain plan benefits. Although your plan itself will not lose its qualified status, your highly compensated and key employees will lose their tax benefits. If they were allowed to pay premiums with pre-tax dollars, they will be taxed on the total annual amount of those premiums. If your cafeteria plan has other benefits such as medical flexible spending accounts, your highly compensated employees will have to pay tax on contributions to those accounts as well.

Concluding Thoughts

If you made it this far, you undoubtedly have a headache. The non-discrimination tests under Section 125 are very complicated. However, to protect the tax savings for your highly compensated and key employees your plan must not discriminate in their favor.

Section 125 does not require you to perform these tests annually. It merely requires that your plan does not discriminate. If your plan is set up in a way that does not favor highly compensated employees, it is unlikely these non-discrimination requirements will become an issue.

However, it is a good practice to perform these tests to make sure your plan is not discriminatory. Organizations often choose to perform these tests mid-year. If an organization discovers a situation that may cause a discrimination problem, they have an opportunity to correct the situation before it has an adverse affect on a highly compensated or key employee.

Because these tests are complicated, it may not make sense to perform them in house. Many flexible spending account administrators will perform the non-discrimination tests for you. The vendor will charge a fee for conducting the tests, but typically these fees are very reasonable.

If you have any questions regarding the Section 125 non-discrimination requirements, please contact your McGraw Wentworth Account Director. MW

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McGraw Wentworth, Inc.
3331 West Big Beaver Road, Suite 200
Troy, MI 48084
Telephone: 248-822-8000 Fax: 248-822-4131
www.mcgrawwentworth.com