



New Cafeteria Plan Regulations – 1.125-7

The seventh set of Internal Revenue Code (IRC) Section 125 Regulations illustrates the nondiscrimination rules for cafeteria plans.

In this collection of directives the Internal Revenue Service (IRS) provides help with a more clear-cut definition of a highly compensated (HC) employee and a not so helpful set of complicated calculations to prove that employee elections are not discriminatory.

1.125-7 – Cafeteria plan nondiscrimination rules

This Regulation starts with an extensive list of definitions and expands to include three distinct tests that cafeteria plans must pass in order to be considered nondiscriminatory:

- Eligibility
- Contributions and Benefits
- Overall 25% Concentration

Since an in-depth look at nondiscrimination testing would fill a book, this article will be limited to a general overview of the tests. First we'll start with a couple of definitions and then we'll plunge into the nondiscrimination tests.

Who is a Highly Compensated Employee?

By invoking IRC Section 414(q) and adding compensation levels, the IRS hits a home run for clarity with this definition. The new definition of an HC employee includes an employee:

1. Who is an officer of the company for the preceding year (or the current plan year in the case of the first year of employment).
2. With more than 5% ownership at any time during the current or preceding plan year.
3. Who, for the preceding plan year (or the current plan year in the case of the first year of employment), had compensation in excess of \$100,000 (2007) \$105,000 (2008).
4. Who is a spouse or tax dependent of an HC employee.

Who is a Key Employee?

This definition was not changed in the new Regulations; however, plan sponsors are allowed to look back to the previous year to determine if an employee is a key employee for current plan year testing. The definition, provided by IRC Section 416(i)(1), includes an employee:

1. Who is an officer during the preceding plan year with annual compensation greater than \$145,000 (2007) \$150,000 (2008).
2. Who owns more than 5% of the voting power or value of all classes of stock of the employer.
3. Who is a more than 1% owner with annual compensation greater than \$150,000.

Eligibility Test

What is the eligibility test and how is it passed? The three-part eligibility test ensures that the employer has made enough of their employees eligible to enroll in the cafeteria plan, makes sure that employees are not left out of the plan for too long, and takes a look at the underlying components of the plan.

First, determine who in the organization is considered to be a HC employee. This definition was discussed earlier.

Next, let's look at the requirements to pass the eligibility test.

1. **Eligibility.** The requirements for participation in a cafeteria plan must not discriminate in favor of HC employees. The plan must benefit a group of employees who qualify

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under a reasonable classification established by the employer, as defined in IRC Section 1.410(b)-4(b). The group of employees included in the classification must satisfy the safe harbor percentage test or the unsafe harbor percentage component of the facts and circumstances test. This test is a comparison of the ratio of HC and nonhighly compensated (NHC) employees who are allowed to participate in the plan.

For purposes of the safe and unsafe harbor percentage components of the eligibility test, employees who can be excluded from the plan and this portion of the test are:

- Employees covered under a collectively bargained agreement
- Nonresident aliens with no United States income
- Employees participating in the cafeteria plan under COBRA

What's the fastest way to guarantee compliance with this piece of the test? Make all employees eligible to participate in the plan.

- 2. Participation.** An employee who satisfies any conditions for participation must be permitted to elect to participate in the cafeteria plan no later than the first day of the plan year immediately following the date they became eligible for the plan. But in no case can the requirements for participation withhold enrollment in the plan beyond three years of employment.
- 3. Benefits.** Benefits cannot be offered to HC participants that are not offered to NHC participants. Example: If a low-deductible health plan is offered to just HC employees and a high-deductible health plan is offered to all NHC employees, the plan would fail the eligibility test. Even if the same accident and health plan is offered to all employees, but unequal premium contribution amounts are established for each group, the cafeteria plan would not pass the eligibility test.

Contributions and Benefits Test

This second nondiscrimination test ensures that a cafeteria plan does not discriminate in favor of HC employees as to employer contributions or benefits offered through the plan.

First, determine who in the organization is considered to be a HC employee. This definition was discussed earlier. Then, trek through the two components of the test.

This test ensures that "similarly situated" HC and NHC employees have a uniform opportunity to elect qualified benefits, or to receive employer contributions; and the actual elections are not made disproportionately by HC employees.

Similarly situated means that discrepancies may apply to the two different groups. For example, different levels of employer contributions may be made available to those selecting single health insurance coverage in deference to those selecting family coverage. Or benefits may be different according to geographic location.

- 1. Availability.** The same benefits or employer contributions are available to similarly situated HC and NHC employees on a nondiscriminatory basis.
- 2. Utilization.** The aggregate qualified benefits elected by HC employees, measured as a percentage of their aggregate compensation must not exceed the aggregate qualified benefits elected by NHC employees measured as a percentage of their aggregate compensation.

The availability section of the contributions and benefits test is fairly straight forward. The plan sponsor needs to provide the same benefits, with the same price tags, to all similarly situated employees, whether they are HC or NHC employees.

Or the plan can be tested on employer contributions. Employer contributions need to be the same for all HC and NHC employees who are similarly situated. If there is a cash-out option

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for employer contributions, the same rules need to apply to similarly situated HC and NHC employees. Now let's move on to the utilization segment of the test.

Let's calculate the benefit utilization. All benefits offered to HC employees are also offered to NHC employees. Here is an example of how the benefit utilization portion of the test would work. The aggregate of all benefits elected by HC employees equals \$35,000 and their aggregate compensation is \$700,000. That means the HC employees' benefit elections equal 5% of their aggregate income.

The aggregate of all benefits elected by NHC employees is \$48,000 and their total compensation is \$800,000. NHC employees' benefit elections equal 6%. This plan would pass the benefit utilization test because the resulting NHC percentage is higher than the HC percentage.

A cafeteria plan that provides for major medical coverage, along with other benefits, can pass a relatively simple safe harbor test and skip the contributions and benefits test. The employer must provide a contribution on behalf of each participant that is:

- One hundred percent of the cost of the premium of the majority of similarly situated HC employees, or
- At least 75% of the cost of the most expensive premium for all similarly situated employees.

And any excess contributions must bear a uniform relationship to compensation.

25% Concentration Test

This test states that the nontaxable benefits provided to key employees must not exceed 25% of the nontaxable benefits provided for all employees through the plan. The first step for this test would be to determine the key employees, using the definition shown earlier.

Here's an example of the 25% Concentration Test: Let's say that the key employees for the ABC Company elect a total of \$7,500 in nontaxable benefits that are offered through the cafeteria plan. All non-key employees elect \$25,000 in nontaxable benefits. Does this pass the 25% Concentration Test?

To help you out, first determine the total benefits selected by both the key and non-key participants. In this example, the answer would be \$32,500 (\$7,500 + \$25,000). Then determine if the key employees are receiving more than 25% of the total benefits going through the plan. To determine the percentage of benefits going to key employees, divide the key employees' elections by the total benefits selected (\$7,500 / \$32,500). The results would be that 23% of the non-taxable benefits are provided to key employees. This plan would pass the 25% concentration test.

The Last Word

Just to make doubly sure that the plan is not discriminatory – the IRS threw in additional guidelines for plan sponsors. First, the plan must be nondiscriminatory in actual operation. This means that the processes and procedures used by the plan administrator must not favor HC employees. And secondly, there is an anti-abuse warning. This warning plugs any holes that might be left and states that this Regulation must be interpreted in a reasonable manner consistent with the purpose of preventing discrimination in favor of HC employees.

Remember, these are the discrimination tests outlined for the cafeteria plan as a whole. The component plans, like the health flexible spending account and the dependent care portion of the plan have discrimination tests of their own to pass.

Premium Only Plans

Within this Regulation is a real jewel for sponsors of premium only plans. Premium only plans provide for the payment of the employee share of the premium for their employer-

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provided accident and health insurance plan, that does not include flexible spending, or reimbursement accounts.

If a premium only plan passes the eligibility test, it does not have to perform or pass the contributions and benefits or the overall 25% concentration test. This is welcome relief for all premium only plan sponsors, but of particular value for smaller employers.

What should a plan sponsor do?

Plan sponsors need to understand the new regulations in regard to their own cafeteria plan. This might take the form of studying the regulations or consulting with a trusted plan service provider or ERISA attorney. Some of the regulations must be incorporated into plan documents, while others are optional.

The IRS had indicated that the final regulations should be published by June 2008 in order for them to become effective on January 1, 2009. Now that we're into July, it looks like they may be finalized later in the summer or early fall. If that is the case, their effective date will be extended for plan years beginning on or after January 1, 2010.

This is the final article of this series that reported on the five new, proposed IRS Regulations issued in 2007. It's now a wait-and-see on the IRS's next move. So stay tuned for updates as they develop on the effective date for all the new cafeteria plan Regulations. ■

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