



Nondiscrimination Tests for Cafeteria Plans

A Section 125 plan, or a cafeteria plan, allows employers to provide their employees with a choice between cash and certain qualified benefits without adverse tax consequences. To receive this tax advantage, the cafeteria plan must generally pass certain tests that are designed to ensure that the plan does not discriminate in favor of highly compensated employees.

If a cafeteria plan fails to pass nondiscrimination testing, highly compensated employees lose the tax benefits of participating in the plan (that is, they must include the benefits or compensation in their income). However, even if a cafeteria plan is discriminatory, non-highly compensated employees will not lose the tax benefits of participating in the plan.

Certain exceptions and safe harbors apply to the cafeteria plan nondiscrimination tests. Because these tests are so complex, employers should work with their benefit advisors or legal counsel when performing cafeteria plan nondiscrimination testing.

Links and Resources

- [Internal Revenue Code Section 125](#)
- IRS' [proposed Section 125 regulations](#) from 2007 – Taxpayers may rely on these regulations until final regulations are issued.

Three Types of Tests

In general, a cafeteria plan must satisfy the following three nondiscrimination tests:

- The eligibility to participate test;
- The benefits and contributions test; and
- The key employee concentration test.

Additional Tests

Additional nondiscrimination tests apply to specific benefits that may be offered under a cafeteria plan, such as:

- Health FSAs;
- Dependent care FSAs; and
- Group term life insurance.

Eligibility Test

The eligibility test looks at whether a sufficient number of non-highly compensated individuals are eligible to participate in the cafeteria plan. If too many non-highly compensated individuals are ineligible to participate, the plan will fail this discrimination test.

Highly Compensated Individuals

A **highly compensated** individual generally includes any individual who is:

- An officer;
- A shareholder owning more than 5 percent of the voting power or value of all classes of stock of the employer;
- Highly compensated; or
- A spouse or dependent of a person described above.

An employee is generally considered “highly compensated” if they had compensation in excess of a specified dollar threshold for the preceding plan year (**\$135,000** if the preceding plan year is 2022, and **\$150,000** if the preceding plan year is 2023), and, if elected by the employer, was also in the “top-paid group” of employees (that is, the top 20 percent).

Testing Group

With a few exceptions, all employees must be included in the testing group. However, the following employees may be excluded:

- Employees (other than key employees) covered by a collective bargaining agreement;
- Non-resident aliens with no U.S. source income from the employer; and
- Employees participating in the cafeteria plan under COBRA continuation coverage.

Testing Requirements

Under the eligibility test, a plan does not discriminate in favor of highly compensated individuals if it meets all of the following requirements:

Employment Requirement	The same employment requirement applies to all employees and the plan does not require more than three years of employment to participate.
Entry Requirement	Entry into the plan is not delayed.
Nondiscriminatory Classification Requirement	The plan benefits a classification of employees that does not discriminate in favor of highly compensated individuals.

The Affordable Care Act (ACA) prohibits group health plans from applying any waiting period that exceeds **90 days**. This ACA provision affects cafeteria plans because employers will generally want to allow employees to pay for their health plan coverage on a pre-tax basis, starting when they first become eligible for health plan coverage. Thus, employers will typically align their health plan’s and cafeteria plan’s waiting periods, which means that a cafeteria plan will rarely have a waiting period that exceeds 90 days.

The nondiscriminatory classification component incorporates certain rules applicable to qualified retirement plans. A plan satisfies this component for a plan year if:

- The plan benefits employees who qualify under a reasonable classification established by the employer; and
- The classification is nondiscriminatory.

A reasonable classification must be based on **objective business criteria**. Reasonable classifications generally include specified job categories, nature of compensation (that is, salaried or hourly), geographic location and similar bona fide business criteria.

A classification is nondiscriminatory if it satisfies either a “safe harbor percentage test” or an “unsafe harbor percentage test” for the plan year. These percentage tests are laid out in IRS regulations and involve dividing the percentage of non-highly compensated individuals who benefit under the plan by the percentage of highly compensated individuals who benefit under the plan. The result is the plan’s ratio percentage. If the plan’s ratio percentage is 50 percent or more, the plan will satisfy the safe harbor percentage test. If it is less than 50 percent, the plan may still be nondiscriminatory, depending on the employer’s concentration of non-highly compensated individuals and whether the plan can pass the safe harbor percentage or the unsafe harbor percentage tests.

Benefits and Contributions Test

A plan may not discriminate in favor of highly compensated participants as to benefits or contributions. This test is designed to make sure that a plan’s contributions and benefits are available on a nondiscriminatory basis and that highly compensated participants do not select more nontaxable benefits than non-highly compensated participants select.

Before an employer runs the benefits and contributions test for its cafeteria plan, it should determine whether it can use the safe harbor rule described below.

Highly Compensated Participants

Highly compensated participants are highly compensated individuals (as defined above under the eligibility test) who actually participate in the plan.

Testing Group

Employees who are eligible to select benefits under the cafeteria plan, and, if applicable, to make salary reductions to pay for those benefits, are included in the testing group.

Testing Requirements

IRS regulations provide that a cafeteria plan must satisfy the benefits and contributions test with respect to both benefit **availability** and **utilization**. The regulations also require the cafeteria plan to be **nondiscriminatory in operation**. A plan will pass or fail the benefits and contributions test based upon the facts and circumstances of each case.

Availability

A cafeteria plan satisfies the availability requirement by showing that employer contributions are available on a nondiscriminatory basis or that benefits are available on a nondiscriminatory basis. This test generally requires a cafeteria plan to make available the same qualified benefits at the same price for similarly situated participants.

Utilization

The utilization requirement analyzes whether highly compensated participants elect benefits to a greater extent than non-highly compensated participants. For example, a plan would likely fail this test if benefits were so expensive that only highly compensated participants could afford to elect the benefits.

Nondiscrimination in Operation

IRS regulations provide that a cafeteria plan may not discriminate in favor of highly compensated participants in operation. For example, a cafeteria plan may be discriminatory in operation if the duration of a benefit offered through the plan is for a period during which only highly compensated participants utilize the benefit.

Safe Harbor Rule

There is a special safe harbor rule under the benefits and contributions test for cafeteria plans that provide health benefits (that is, major medical coverage). If a health plan satisfies the safe harbor, then the plan passes the benefits and contributions test. It must still, however, satisfy the eligibility test and the key employee concentration test. The following three requirements must be met to qualify for the safe harbor:

- The cafeteria plan must provide major medical coverage benefits;
- Contributions under the cafeteria plan on behalf of each participant must equal 100 percent of the cost of health benefit coverage under the plan of the majority of the similarly situated highly compensated participants or the contribution on behalf of each participant must equal or exceed 75 percent of the cost of the most expensive health benefit coverage available under the plan for similarly situated participants; and
- If the cafeteria plan provides contributions or benefits in excess of the amounts needed to satisfy the 100 percent or 75 percent standard, the excess contributions must bear a uniform relationship to compensation.

In determining which participants are similarly situated, reasonable differences in plan benefits may be taken into account (for example, variations in plan benefits offered to employees working in different geographical locations or to employees with family coverage versus employee-only coverage).

IRS regulations include the following example for this safe harbor test: All 10 of Employer E's employees are eligible to elect between permitted taxable benefits and salary reduction of \$8,000 per plan year for self-only coverage in the major medical health plan provided by Employer E. All 10 employees elect the \$8,000 salary reduction for the major medical plan. The cafeteria plan satisfies the safe harbor rule under the benefits and contributions test.

Key Employee Concentration Test

A key employee is generally an employee who is:

- An officer whose annual pay exceeds a specified dollar amount; or
- An employee who is either of the following:
 - A 5 percent (or greater) owner of the business; or
 - A 1 percent (or greater) owner whose annual pay is greater than \$150,000.

*For purposes of determining who is a key employee, the employee's annual compensation for the prior plan year is generally used. If the preceding plan year is 2022, the threshold is **\$200,000**. If the preceding plan year is 2023, the threshold is **\$215,000**.

Only cafeteria plan participants who have elected one or more nontaxable benefits under the plan are included in the testing group. The test is performed by calculating the aggregate nontaxable benefits provided to key employees and the aggregate nontaxable benefits provided to all employees (key employees and non-key employees). Key employees must not receive more than 25 percent of the aggregate nontaxable benefits provided to all employees.

Safe Harbors and Exceptions

Collectively Bargained Plans

A cafeteria plan will not be discriminatory if it is maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers.

Premium-only Plans

IRS regulations include a special safe harbor for premium-only plans. A premium-only plan is a cafeteria plan that offers (as its only benefit) an election between cash and the payment of the employee share of the premium for employer-provided health insurance.

Under this safe harbor, a premium-only plan is deemed to satisfy the cafeteria plan nondiscrimination requirements if it passes the eligibility test. In other words, the plan will automatically satisfy the contributions and benefits test and the key employee concentration test if it passes the eligibility test.

Simple Cafeteria Plans

The ACA allows employers with **100 or fewer employees** to establish “simple cafeteria plans.” These plans are treated as meeting the nondiscrimination requirements applicable to cafeteria plans as long as certain eligibility, participation and minimum contribution requirements are met. They are also treated as meeting the separate nondiscrimination tests for group term life insurance, health FSAs and dependent care FSAs.

Eligibility and Participation Requirements

The eligibility and participation requirements are met if all employees who had at least 1,000 hours of service for the preceding plan year are eligible to participate and each eligible employee may elect any benefit available under the plan (subject to any terms and conditions that are applicable to all participants). The employer may choose to exclude from the plan employees who:

- Have not attained age 21 before the close of the plan year;
- Have less than one year of service with the employer as of any day during the plan year;
- Are covered under a collective bargaining agreement; or
- Are nonresident aliens working outside the United States whose income did not come from a U.S. source.

The employer’s contribution must equal either:

- A uniform percentage (at least 2 percent) of the employee’s compensation for the plan year; or
- An amount that is at least 6 percent of the employee’s compensation for the plan year or twice the amount of the salary reduction contributions of each qualified employee, whichever is less.

If an employer decides to provide the matching contribution, it cannot provide a matching contribution to highly compensated or key employees at a rate greater than the matching contribution it provides to all other employees.

The employer must use the same method to calculate the minimum contribution for all non-highly compensated employees. In addition, an employer can make contributions to provide additional qualified benefits under the plan, as long as the above requirements are met.

Additional Nondiscrimination Tests

Additional nondiscrimination tests apply to a cafeteria plan that includes certain component benefits, such as a health FSA, a dependent care FSA or group term life insurance. For example, these tests include the:

- Internal Revenue Code (Code) Section 79(d) nondiscrimination rules for group term life insurance (eligibility and benefits test);
- Code Section 105(h) rules for self-insured medical expense reimbursement plans, including health FSAs (eligibility and benefits test); and
- Code Section 129(d) nondiscrimination rules for dependent care FSAs (eligibility, contributions and benefits, more-than-5 percent owners concentration and 55 percent average benefits test).