



SALUS GROUP

Section 125 Nondiscrimination Rules

To qualify for favorable tax treatment, a Section 125 plan (or cafeteria plan) cannot discriminate in favor of highly compensated employees. In general, a Section 125 cafeteria plan must satisfy the following three nondiscrimination tests:

1. Eligibility Test

This test examines whether a sufficient number of non-highly compensated employees are eligible to participate in the cafeteria plan. If too many non-highly compensated employees are ineligible to participate, the plan will fail this discrimination test.

2. Benefits and Contributions Test

This test is designed to make sure that a plan's contributions and benefits are available on a nondiscriminatory basis and that highly compensated employees do not select more nontaxable benefits than non-highly compensated employees select.

3. Key Employee Concentration Test

This test examines whether key employees impermissibly use the plan's benefits more than non-key employees. Under this test, key employees must not receive more than 25% of the aggregate nontaxable benefits provided to all employees.

Special Rules

Certain exceptions and safe harbors apply to these nondiscrimination tests. For example, a Section 125 plan that is a premium only plan is deemed to satisfy these nondiscrimination requirements if it passes the eligibility test. In other words, the plan will automatically satisfy the benefits and contributions test and the key employee concentration test if it passes the eligibility test. In addition, simple cafeteria plans are treated as meeting the Section 125 nondiscrimination requirements as long as certain eligibility, participation and minimum contribution requirements are met.

Provided to you by Salus Group

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Core Concepts

- Nondiscrimination testing should be performed each plan year (if performed early, employers may be able to make adjustments to ensure compliance).
- Nondiscrimination testing is complex; most employers use outside service providers to perform it.
- If a plan is discriminatory, benefits for highly compensated individuals are taxed. Non-highly compensated employees will not lose the tax benefits of participating in the plan.

Additional Tests

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

- Health flexible spending accounts (FSAs);
- Dependent care FSAs; and
- Group-term life insurance.