

QUESTION: Our company will soon be adopting a cafeteria plan so that our employees can pay their share of the premiums for health insurance coverage with pre-tax salary reductions. The plan will also include a health FSA and a DCAP. I understand that cafeteria plans, health FSAs, and DCAPs are subject to nondiscrimination tests. How many tests are there, and are there any exceptions for small businesses like ours?

ANSWER: Cafeteria plans, health FSAs, and DCAPs are subject to nondiscrimination requirements under the Code that are generally intended to prevent these plans from providing benefits that unduly favor individuals who are highly paid or key to the business. The Code uses specific definitions of the individuals in whose favor discrimination is prohibited, and these definitions vary among the nondiscrimination tests that are described below. In this answer, we use the terms “highly paid employees” and “key employees” as shorthand references. If a plan doesn’t pass the tests for a plan year (i.e., it is discriminatory), then highly paid or key employees, as applicable, may have adverse tax consequences. Non-highly paid employees and non-key employees will not be taxed, however, and the plan’s status under the Code won’t be affected. Except for the simple cafeteria plan safe harbor discussed below, small employers are not exempt from these requirements.

There are nine nondiscrimination tests that can apply to a cafeteria plan and its separate benefits, but those tests focus on only three topics: eligibility, availability, and utilization. Imagine that you are planning a party, with the benefits under your company’s plan being the appetizers. The nondiscrimination requirements essentially ask, “Have enough non-highly paid employees been invited to the party?” (eligibility), “Are enough non-highly paid employees being offered the appetizers?” (availability), and “Are enough non-highly paid or non-key employees actually taking the appetizers?” (utilization). Here is a summary of these tests and two safe harbors:

- *Cafeteria Plan Tests.* Three nondiscrimination tests apply to cafeteria plans: (1) an Eligibility Test (cafeteria plans cannot discriminate in favor of highly paid employees as to eligibility to participate); (2) a Contributions and Benefits Test (cafeteria plans cannot discriminate in favor of highly paid employees as to contributions and benefits); and (3) a Key Employee Concentration Test (nontaxable benefits provided to key employees under a cafeteria plan cannot exceed 25% of the nontaxable benefits provided to all employees under the plan).
- *Health FSA Tests.* If a health FSA is added, two more tests apply: an Eligibility Test and a Benefits Test. (These tests also apply to self-insured medical, dental, and vision plans, as well as health reimbursement arrangements (HRAs).)
- *DCAP Tests.* If a DCAP is added, there are four additional tests: (1) an Eligibility Test; (2) a Contributions and Benefits Test; (3) a More-Than-5% Owners Concentration Test; and (4) a 55% Average Benefits Test.
- *Premium-Only Safe Harbor.* There is a safe harbor for “premium-only” cafeteria plans: A plan that offers only an election between cash and payment of the

employee share of employer-provided accident and health insurance premiums is deemed to satisfy the cafeteria plan nondiscrimination requirements if it passes the Eligibility Test.

- *Simple Cafeteria Plan Safe Harbor for Small Employers.* A “simple cafeteria plan” is treated as meeting the nondiscrimination rules for cafeteria plans and certain component benefits (including health FSAs, and DCAPs), so long as specified contribution, eligibility, and participation requirements are met. In general, only employers with an average of 100 or fewer employees during either of the preceding two years may establish a simple cafeteria plan. (There are special rules for new and growing employers.) Simple cafeteria plans may be of interest to eligible employers that might otherwise have difficulty passing one or more of the nondiscrimination tests, if they are willing and able to make the required contributions and meet the additional requirements.

Health care reform also established nondiscrimination requirements for certain insured health plans, although compliance is not required until the government issues regulations or other guidance on the new requirements