XXIX. Cafeteria Plan Nondiscrimination Rules

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A. Overview

This Section XXIX covers the nondiscrimination tests that apply to cafeteria plans under Code § 125. This Section builds on the core concepts of nondiscrimination discussed in Section XXVIII, which should also be consulted for general principles and definitions used in this Section XXIX. If the cafeteria plan includes any of the following component plans, then additional Sections should also be reviewed: a self-insured medical expense reimbursement plan (see Section XXX); a health FSA (see Section XXXI); a DCAP (see Section XXXII); or group term life insurance (see Section XXXIII).

A Note on Terminology. In this Section XXIX, we use the terms "highly compensated individuals," "highly compensated participants," and "key employees" (Keys) to refer to the individuals in whose favor discrimination is prohibited under Code § 125. We use the term "highly compensated employees" (HCEs) to refer to the individuals who are highly compensated under Code § 414(q). In addition, we sometimes use the term HCE as a shorthand term to mean highly compensated individual, highly compensated participant, and highly compensated employee. We also sometimes use the term "prohibited group" to describe highly compensated individuals, highly compensated participants, HCEs, and Keys collectively. See subsections D, E, F, and I for the specific definitions of each of these prohibited group members.

What Should I Do Now to Address the 2007 Proposed Cafeteria Plan Regulations? The 2007 proposed regulations provide additional guidance on the nondiscrimination rules that apply to cafeteria plans under Code § 125 and can be relied on for guidance until final regulations are issued.* As discussed in this Section XXIX, the regulations clarify key nondiscrimination terms and concepts. They also confirm that testing must be completed annually, as of the last day of each plan year. Cautious employers and administrators will begin to analyze the provisions of the regulations now, so that appropriate testing procedures are in place (and any necessary plan design changes can be made) before final regulations are issued and become effective.

* Preamble to 2007 Proposed Cafeteria Plan Regulations, 72 Fed. Reg. 43937 (Aug. 6, 2007).

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B. Cafeteria Plans Cannot Discriminate in Favor of Certain Highly Compensated and Key Employees

Code § 125 permits employers and participants to enjoy tax advantages through the use of a cafeteria plan.[1] However, the tax advantages for the prohibited group are conditioned upon the cafeteria plan's meeting certain nondiscrimination requirements. Congress clearly considered these requirements to be important—over 60% of the words in Code § 125 are devoted to nondiscrimination testing![2]

If the cafeteria plan discriminates in favor of highly compensated participants, there will be adverse tax consequences to them:

> A highly compensated participant or key employee participating in a discriminatory cafeteria plan must include in gross income (in the participant's taxable year within which ends the plan year with respect to which an election was or could have been made) the value of the taxable benefit with the greatest value that the employee could have elected to receive, even if the employee elects to receive only the nontaxable benefits offered.[3]

Thus, if a plan fails certain nondiscrimination tests, the prohibited group members who make salary reductions will be taxed on the amount of those salary reductions. If a plan has a cash-out option (or an option to apply employer contributions to taxable benefits, such as vacation pay or LTD coverage treated as though purchased with after-tax dollars), then the prohibited group members who elect any nontaxable benefits (such as health insurance and health FSA coverage) will be taxed on (1) the maximum cash-out amount (or other taxable benefits) available; plus (2) their actual salary reductions (i.e., the amount by which their gross pay—not counting cash-out amounts—has been reduced for the year).

However, the cafeteria plan will not cease to be a valid Code § 125 plan just because it is discriminatory. The non-highly compensated participants and non-key employees will not lose their tax benefits—i.e., they may still exclude the cost of benefits from income. See subsection K for further discussion of what happens if a cafeteria plan is discriminatory.

In order to avoid adverse consequences to prohibited group members, a cafeteria plan generally must satisfy three specific nondiscrimination tests.[4] A cafeteria plan must not discriminate in favor of:

- highly compensated individuals as to eligibility to participate (the Eligibility Test);[5]
- highly compensated participants as to contributions and benefits (the Contributions and Benefits (C&B) Test);[6] or
- key employees as to concentration of benefits (the Key Employee Concentration Test).[7]

In addition, under the 2007 proposed cafeteria plan regulations, there is a special safe harbor test for premium-only plans; a plan that passes this test is deemed to satisfy the nondiscrimination requirements of Code § 125.

Each of these tests is discussed in detail in this Section XXIX. But before delving into the mechanics of the tests, it is important to understand exactly who are members of the prohibited group for each of the tests. Subsections D and E explain how to identify the highly compensated individuals and highly compensated participants for purposes of the Eligibility Test and the Contributions and Benefits Test. How to identify Keys, which is only relevant for the Key Employee Concentration Test, is explained in subsection I.

C. Where to Find the Cafeteria Plan Nondiscrimination Rules

This subsection C explains where to find the law that prescribes the specific nondiscrimination rules for cafeteria plans. For an explanation of the different types of laws from a general standpoint, see Section IV.[8]

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1 Benefits elected and financed under a cafeteria plan are not included in a participant's gross income "solely because, under the plan, the participant may choose among the benefits of the plan." Code § 125(a).

2 For more on why Congress established nondiscrimination tests for cafeteria plans and their component plans, see Section XXVIII.

3 Prop. Treas. Reg. § 1.125-7(m)(2). See also Code § 125(b)(1), which provides that the safe harbor from constructive receipt is not available to highly compensated participants for any benefit attributable to a plan year for which the plan discriminates in favor of highly compensated individuals as to eligibility to participate, or highly compensated participants as to contributions and benefits.

4 The cafeteria plan's component plans may also be subject to nondiscrimination requirements. See Section XXX for tests applicable to self-insured medical reimbursement plans; Section XXXI for tests applicable to health FSAs; Section XXXII for tests applicable to DCAPs; and Section XXXIII for tests applicable to group term life insurance plans.

5 Code § 125(b)(1)(A).

6 Code § 125(b)(1)(B).

7 Code § 125(b)(2).

8 Section IV explains how various laws come into being and how important they are in relation to other laws (e.g., whether temporary regulations are more or less authoritative than proposed regulations). To find out how these laws are enforced in the event of noncompliance, see Section XXXVIII.

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1. Statutes

Code § 125 (reproduced behind Appendix Tab 1) lays the foundation for nondiscrimination testing for cafeteria plans. Its provisions describe the tests and identify the individuals who are members of the prohibited group (i.e., highly compensated participants, highly compensated individuals, and key employees) and create special rules for collectively bargained plans and health benefit plans.

Other Code provisions may be indirectly applicable as well. For example, it may be necessary to consult Code § 152 in order to identify dependents (certain dependents of highly compensated individuals or participants are also considered to be highly compensated individuals or participants, as applicable). Code § 318 is also relevant in determining constructive stock ownership for certain Keys.[9] These Code sections are reproduced behind Appendix Tab 7.

This Section XXIX makes numerous references to Code provisions affecting qualified retirement plans. In some cases, this is because Code § 125 and the regulations make direct references to these Code provisions. For example, Code § 125(g)(3) specifically incorporates the controlled group rules set forth in Code § 414, and Code § 125(b)(2) specifically incorporates the Code § 416(i)(1) definition of Key Employee.

Other qualified retirement plan Code provisions that are frequently consulted in cafeteria plan administration include Code § 410(b) (for the Eligibility Test),[10] Code § 414(q) (defining highly compensated), and Code § 415(c)(3) (defining participant compensation). We have reproduced certain portions of these Code provisions behind Appendix Tab 7.

> **Warning Regarding Use of Retirement Plan Rules.** Before using a retirement plan statute or regulation as guidance for nondiscrimination testing of cafeteria plans or component benefits, it is important to be aware of the risks involved. Our discussion of the statutory and regulatory provisions applicable to cafeteria plans and their component benefits addresses the support for using retirement plan provisions. Sometimes the connection is clear; in other cases, it is less so (e.g., our reliance may be based on oral, nonbinding statements of IRS officials) or the cafeteria plan rules may include material differences. As a result, retirement plan statutes or regulations should be used with caution, and should not be applied without examining the applicable cafeteria plan rules.

2. Legislative History

Various congressional reports regarding Code § 125's enactment and subsequent amendments assist in the interpretation of the cafeteria plan nondiscrimination tests. However, it is important to consider these reports in light of whether they were made before, after, or in conjunction with the repeal of Code § 89.[11] Excerpts from relevant legislative history are reproduced behind Appendix Tab 8.

3. Regulations

The Code's cafeteria plan nondiscrimination rules are addressed in Prop. Treas. Reg. § 1.125-7 (cafeteria plan nondiscrimination rules), which was issued August 6, 2007. Older proposed regulations on the subject were withdrawn at that time. Taxpayers may rely on the new proposed regulations for guidance until final regulations are issued.[12]

It may also be appropriate to review certain regulations applicable to the qualified retirement plan Code provisions discussed in subsection C.1. Note, however, that this should only be done with a full understanding of the limitations on their use. (See the caution in subsection C.1.) Potentially useful regulations include the following:

- Treas. Reg. § 1.401(a)(4) (plan restructuring concepts);
- Treas. Reg. § 1.410(b)-4 (Eligibility Test);
- Treas. Reg. § 1.414(q) (defining compensation, top-paid group, etc.);
- Treas. Reg. §§ 1.414(b)-1 and 1.414(c)-1 *et seq.* (controlled group rules); and
- Treas. Reg. § 1.416-1, Q/As T-12, T-13, T-14, T-16, and T-17 (guidance regarding who is a Key).

9 See the table in Section IX regarding how Code § 318 applies in various situations.

10 See subsection G.

11 See Section XXVIII for our discussion of Code § 89.

12 *See* Preamble to 2007 Proposed Cafeteria Plan Regulations, 72 Fed. Reg. 43937 (Aug. 6, 2007).

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4. *Other IRS Guidance*

a. Revenue Procedures, Announcements, and Notices

Changes in the threshold levels of compensation for defining who is highly compensated under the Code § 414(q) definition[13] are generally announced each year. See the Table of Indexed Limits behind Appendix Tab 11.

b. Informal Guidance

Helpful guidance in this area may also come from informal, nonbinding remarks of IRS officials at ECFC Symposia, ABA meetings, and other conferences. These comments are noted as applicable in this Section XXIX.

D. Who Is Highly Compensated for Purposes of the Cafeteria Plan Eligibility and Contributions and Benefits Tests?

For purposes of the Eligibility Test and the Contributions and Benefits (C&B) Test,[14] the prohibited group consists of highly compensated individuals and highly compensated participants. The term "highly compensated individuals" is used only for the Eligibility Test. The term "highly compensated participants" is used only for the C&B Test.

Who Is a "Highly Compensated Participant"? Code § 125(e)(1) provides that the term "highly compensated participant" means a participant who is:

- an officer;
- a shareholder owning more than 5% of the voting power or value of all classes of stock of the employer;
- highly compensated; or
- a spouse or dependent (as defined in Code § 125(e)(1)(D)) of an individual described above.*

Each of these categories is described in more detail in the subsections that follow.

* *See also* Prop. Treas. Reg. §§ 1.125-7(a)(3) and (a)(4).

[13] See subsection E.

[14] See subsections G and H for details of how to run the Eligibility and C&B Tests for cafeteria plans.

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The term "highly compensated individual" simply means an individual who satisfies the same criteria as a highly compensated participant.[15] As a practical matter, there is no difference between "individuals" and "participants" in this context. The term "individuals" is used for the Eligibility Test only because using "participant" would beg the question: Is the individual eligible to participate? For this reason, we sometimes use the term "highly compensated participant" in this subsection D to mean both "highly compensated participant" and "highly compensated individual."

Despite the name, the group of highly compensated individuals and participants may include more persons than just those who are highly compensated. Officers, more-than-5% shareholders, and certain spouses and dependents may be considered highly compensated without meeting a threshold level of compensation. In practice, of course, officers and more-than-5% shareholders are likely to earn significant compensation.

The four types of individuals who are highly compensated for purposes of the Eligibility Test and the C&B Test are described in detail below. Also see subsection F for a practical approach to determining who is highly compensated.

1. Officer

The 2007 proposed regulations provide guidance regarding the definition of the term "officer." Under the regulations, the term includes anyone who was an officer during the preceding plan year or the current plan year in the case of an individual's first year of employment. Whether an individual is an officer is determined based on all the facts and circumstances, including the source of the person's authority, the term for which he or she is elected or appointed, and the nature and extent of the officer's duties. Generally, an "officer" means an administrative executive who is in regular and continued service, and it implies a continuity of service, exclusive of those employed for a special or single transaction. Also, an employee with the title of officer, but not the authority of an officer, is not considered to be an officer. For example, many financial institutions give the title "assistant vice president" to persons who often have no real administrative authority—despite the title, they may not qualify as "officers" for Code § 125 purposes. Similarly, an employee who does not have the title of an officer, but who has the authority of an officer, is an officer. Sole proprietorships, partnerships, and associations, among other unincorporated entities, may have officers.[16]

In most respects, this definition parallels the definition of officer in the Code § 416 regulations, which applies when determining who is a Key for purposes of the Key Employee Concentration Test (see subsection I). However, it appears that the limitation on the number of officers under Code § 416[17] does not apply when determining who is an officer for Code § 125 purposes.

It also appears that there is no exception for governmental entities that sponsor cafeteria plans, so they too will have officers for purposes of determining who is a highly compensated participant.[18]

2. More-Than-5% Shareholder

It is fairly easy to determine who is a more-than-5% shareholder—someone owning more than 5% of the voting power or value of all classes of stock of the employer. The 2007 proposed regulations provide that an individual whose stock ownership exceeds the 5% threshold in either the preceding or current plan year is considered a more-than-5% shareholder under Code § 125.[19] Note that an individual who owns exactly 5% of the shares would not qualify under this definition.

The 2007 proposed regulations also clarify that an individual's stock ownership is determined without attribution.[20] Consequently, the Code § 318 attribution rules will not apply in defining a more-than-5% shareholder. However, it would appear that there is attribution via the spouse or dependent rule, discussed next.

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15 Code § 125(e)(2). *See also* Prop. Treas. Reg. § 1.125-7(a)(4).

16 Prop. Treas. Reg. § 1.125-7(a)(7).

17 Code § 416(i)(1)(A).

18 But for purposes of the Key Employee Concentration Test, the term key employee "shall not include any officer or employee of an entity referred to in section 414(d) (relating to governmental plans)." Code § 416(i)(1)(A).

19 Prop. Treas. Reg. § 1.125-7(a)(8).

20 Prop. Treas. Reg. § 1.125-7(a)(8).

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3. Spouse or Dependent

A spouse or a dependent (as defined in Code § 125(e)(1)(D))[21] of an individual who is an officer, a more-than-5% shareholder, or highly compensated also falls within the group of highly compensated individuals subject to the cafeteria plan tests. See Section XI regarding who is a spouse or dependent (the definition of dependent is the same as the one that applies when determining who is a tax dependent for health coverage purposes).

4. Highly Compensated

Most individuals are highly compensated participants for cafeteria plan testing because they fall into the "highly compensated" category. The definition of "highly compensated" in Code § 125 is circular: It simply defines highly compensated participants as those who are "highly compensated," plus officers, more-than-5% shareholders, and certain spouses and dependents. However, the 2007 proposed regulations define the term "highly compensated" as an individual 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 the Code § 414(q)(1)(B) compensation threshold and, if elected by the employer, was also in the "top-paid group" of employees (as determined under Code § 414(q)(3)) for the preceding or current plan year, as applicable.[22] It is unclear whether the compensation threshold for the preceding year or the current year should be used when determining whether a new hire is highly compensated under Code § 125. Pending further guidance, it seems logical to use the compensation threshold for the current year for new hires.

Note, however, that this definition only determines who is "highly compensated" by compensation level—to determine the entire highly compensated group for purposes of Code § 125 testing, the other individuals specified in Code § 125 (officers, more-than-5% shareholders, spouses, and dependents) must also be taken into account. Subsection E describes who is highly compensated under the Code § 414(q) compensation threshold and discusses the top-paid group election.

> **Reminder: Differing Definitions of "Highly Compensated."** The definitions of "highly compensated individual" and "highly compensated participant" used for purposes of Code § 125 testing are not the same as the definition of "highly compensated individual" used for testing a self-insured medical reimbursement plan under Code § 105(h) or the definition of "highly compensated employee" used for testing a DCAP or 401(k) plan. (See Sections XXX, XXXI, and XXXII.) Neither is the definition the same as the definition of "Key" used for running the Key Employee Concentration Test. (See subsection I.)

E. Highly Compensated Employee Under Code § 414(q)

Under Code § 414(q), an employee is an HCE if:

- the employee was a more-than-5% owner of the employer at any time during the current or preceding plan year, applying the attribution rules of Code § 318 (in general, these rules count any ownership of the employee's spouse, parents, children, and grandchildren when determining the employee's ownership percentage); or
- for the preceding plan year, the employee had compensation in excess of a specified dollar threshold,[23] and, if elected by the employer, the employee was also in the "top-paid group" (generally constituting the top 20%, as discussed in subsection E.4).[24]

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[21] Prior to the enactment of the Working Families Tax Relief Act of 2004 (WFTRA), Pub. L. No. 108-311 (Oct. 4, 2004), Code § 125(e)(1)(D) defined the term "dependent" by reference to Code § 152. WFTRA modified (and to some extent narrowed) the definition of dependent under Code § 152 and at the same time also modified Code § 125(e)(1)(D), effective for tax years beginning after December 31, 2004, so that an individual's status as a "dependent" for purposes of Code § 125(e)(1)(D) is to be determined by reference to Code § 152, but without regard to subsections (b)(1), (b)(2), and (d)(1)(B) of Code § 152 (the gross income limitation for a "qualifying relative" and certain other provisions). The modified definition of dependent under Code § 125(e)(1)(D) remains substantially similar to the pre-WFTRA Code § 152 definition and is the same as the modified definition that applies under Code §§ 105(b) and 106 after WFTRA when determining who is a tax dependent for health coverage purposes. See Section XI for details.

[22] Prop. Treas. Reg. § 1.125-7(a)(9).

[23] The 2006 compensation threshold (used for 2007 testing) is $100,000. For other years, see the Table of Limits behind Appendix Tab 11.

[24] Code § 414(q)(1).

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