



Flexible Benefit Plan Discrimination Testing Frequently Asked Questions

What Discrimination Testing is Required for Flexible Benefit Plans?

The IRS requires that Flexible Benefit plans must be tested each Plan Year. FlexMagic Consulting provides certain tests as part of your consulting contract. Since 1978, discrimination testing requirements have been imposed on these programs to ensure that highly compensated and key employees do not receive significantly higher benefits than the average employee. The discrimination tests apply to benefit-eligible employees only. The employer determines who is considered benefit-eligible under the guidelines stated on the Information & Rules Page.

- Employers cannot restrict benefit eligibility beyond three years of employment;
- Employers cannot require employees to be over 21 years of age to be benefit eligible;
- Union employees may be excluded from the group;
- Part-time or seasonal employees can be excluded, as can non-resident aliens with no U.S.A. income;
- Benefit eligibility cannot relate to salary versus hourly-paid employees;
- More than 2% subchapter s-corporation owners, sole proprietors and partners are not eligible to participate; and
- New discrimination testing requirements may be introduced with health care reform.

The employer establishes a waiting period and requires a minimum number of work hours for benefit eligibility. These rules must be in writing, included in the plan document and disclosed to the employees. See your Information & Rules Page for your company's eligibility requirements.

Required Testing

The required basic tests are as follows. FlexMagic provides completion of certain discrimination tests for its clients. Health care reform will potentially impact future discrimination testing requirements.

Cafeteria Plan:

- Eligibility Test
- Contributions and Benefits Test
- Key Employee Concentration Test

NOTE: There is a special safe harbor test for Premium-only-Plans.

Health Spending Account:

- Eligibility Test
- Benefits Test

Dependent Care Spending Account:

- Eligibility Test

- Contributions and Benefits Test
- More than 5% Owner Concentration Test
- 55% Highly-Compensated Average Benefit Test

Other tests apply to pre-tax group term life; self-insured major medical, dental and vision plans; fully insured major medical and dental plans, long term disability plans, accidental death and dismemberment, adoption assistance plans and health savings accounts.

Key Employee Definitions

The following contains the IRS definitions for key and highly-compensated employees. Your flexible benefit plan is tested against these employees' participation to determine that your plan does not favor key and/or highly-compensated employees.

Government employers have no key employees for testing purposes. Additionally, more than 2% s-corporation owners, partners and sole proprietors are not eligible to participate in a flexible benefit plan. Note: The spouse of a sole proprietor who is a bona fide employee of the proprietorship may be eligible to participate in the flexible benefit plan. Officers and owners of c-corporations are eligible to participate in the plan. The determination date for a new plan is the last day of its first plan year. Thereafter, the determination date is the last day of the prior plan year.

A key employee is anyone who, at any time during the determination year or during the look-back year is or was a key officer or key owner as defined below.

Key Officer Definition

An officer having annual compensation in excess of certain dollar limitations for a testing year is a key employee. Whether an employee is an officer is made on the basis of all of the *facts and circumstances* with particular emphasis on the employee's authority, the term for which the employee was elected or appointed, and the nature and extent of the employee's duties.

Generally, a key officer is *an administrative executive who is in regular and continuous service* whether or not that individual has a title. An employee who does not have the title of an officer, but has the authority of an officer, is an officer. For testing purposes the annual compensation limits are indexed each year – See your current Discrimination Testing Data Collection Forms for compensation limits.

The number of employees that can be considered key officers is equal to 10% of all employees, or three, whichever is greater. In no case can the total number of key officers exceed 50. Therefore, if the employer has fewer than 30 employees, no more than three can be considered key officers.

Key Owner Definition

There are two categories of Key Owners:

- A more than 5% owner; and
A 5% owner is a person who owns, directly or indirectly, more than 5% of the stock, capital or profits interests in the employer.
- A more than 1% owner whose annual compensation exceeds \$150,000.
A 1% owner is a person who owns, directly or indirectly, more than 1% of the stock, capital or profits interests in the employer.

Indirect ownership means that the employee is considered as owning the stock, capital or profit interests of his or her spouse, children, grandchildren and parents. In addition, stock, capital or profit interests owned by a corporation, partnership, estate or trust can be attributed to the employee, or vice versa.

Highly Compensated Employee Definition

There are two calculations for highly compensated active employees for each plan year:

- the look-back year calculation; and
- the determination year calculation

The **look-back year** calculation identifies each employee who performs services for the employer during the current plan year and who, during the prior plan year, was more than a 5% owner (as defined for key employee purposes); or who received compensation from the employer of more than the indexed amount during the look-back year, and if the employer elects, was a member of the top-paid group of employees.

For the **determination year** calculation, an employee is a highly compensated employee if the employee is more than a 5% owner at any time during the determination year. Therefore, an employee is a highly compensated employee if the employee meets the definition for either the look-back year or for the determination year. These values are indexed each year.

Excluded Owners

Certain owners of employers are not permitted to participate in a flexible benefit plan. These include more than 2% owners of subchapter s-corporations, partners of a partnership, members of a limited liability company and sole proprietors. These entities may sponsor a flexible benefit plan for the employees, but not for the owners. The owners who may not participate are not counted as "eligible employees." officers and owners of a c-corporation are eligible to participate in a flexible benefit plan. Exception to this is that the sole proprietor's spouse may be eligible to participate if he/she meets all plan design eligibility requirements and is a bona fide employee.