

MONEYWISE SOLUTIONS

Section 125 Premium Only Plans Testing Summary

In order to qualify for tax-favored status, a Section 125 plan must **not** discriminate in favor of highly compensated employees (HCEs) and key employees with respect to eligibility, contributions, and benefits. In order to document compliance an annual test must be performed and the results documented for each Section 125 plan. The results are subject to audit by the IRS. The definition for HCEs and key employees varies by plan and type of test performed. However, they can generally be defined as follows:

- Highly compensated:
 - o Officers.
 - o More than 5% shareholders.
 - o An employee with gross annual compensation over \$110,000.
 - o A spouse or dependent of any of the above defined employees.

- Key employee: employee who at any time during the plan year or any of the four preceding years is:
 - o An officer with gross annual compensation over \$160,000,
 - o An owner of at least 5% of the company, or
 - o An owner of at least 1% of the company with gross annual compensation over \$150,000.

Specific Tests Summary

Although discrimination tests are slightly different depending on the plan being tested, general descriptions are as follows:

- **Eligibility Test:** The IRS requires fair and reasonable employee eligibility requirements whereby the plan may not exclude non-HCEs from participating in favor of HCEs or key employees. Passing the Eligibility Test usually requires the plan to benefit:
 - o 70% or more of all non-excludable employees, regardless of whether they are HCE or non-HCE; and
 - o 80% or more of these employees who are eligible to benefit; and
 - o Employees qualifying under a classification that does not discriminate in favor of highly compensated employees.

- **Contributions and Benefits Test (also called the Utilization Test):** In addition to the Eligibility test, the plan may not discriminate in favor of HCEs in regards to contributions and benefits. Each eligible participant must have an equal opportunity to select the non-taxable benefit. Waiting periods, required employee contributions and maximum benefit levels should be uniform for all participants and their dependents. The following tests are required in order to pass the Utilization Test:
 - o **Key Employee Concentration Test:** Requires no more than 25% of the aggregate of nontaxable benefits provided to all employees under all the plans may be provided to key employees.
 - o **Dependent Care Spending Account Test:** Includes the 55% Average Benefit Test, which is often considered the most crucial test, as it is the one most often failed by employers.
 - o **Owner's Test:** This test demonstrates no more than 25% of the non-taxable dependent care flexible spending account benefits are provided to owners of at least 5% of the company.