24HourFlex Employer Discrimination Testing Guide

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<td>12/7/2015</td>
<td>Document creation</td>
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1 - Discrimination Testing Overview

A cafeteria plan (also referred to as a Section 125 plan) is subject to certain nondiscrimination rules under Internal Revenue Code (IRC) Section 125. Those rules prohibit a cafeteria plan from discriminating in favor of highly compensated individuals (HCIs) as to plan eligibility and benefits.

Many of the tests can be passed simply by properly designing the plan’s eligibility provisions. Other tests need to be actually performed each year based upon participant data.

When to Perform Testing

As outlined under the 2007 proposed regulations, IRS Code Section 125 discrimination testing should be performed as of the last day of the plan year and take into account all non-excludable employees who were employed during the plan year.

It is recommended that employers do one test within the first quarter of a plan year to determine whether additional steps must be taken before the end of the plan year so that the plan passes the non-discrimination tests and preserves the tax treatment for the key and highly compensated employees. A second and final test may then be conducted as of the last day of the plan year if there has been significant changes that could impact any of the tests.

Highly Compensated Employee (HCE) Definition

A more detailed explanation of how the IRS defines HCEs can be found in the definitions section at the end of this guide. The simplified definition is provided below:

An employee is considered to be a Highly Compensated Employee (HCE) in 2016 if they meet one or more of the following criteria:

a) An employee who in the preceding calendar year (2015) had compensation, from this employer, greater than $120,000. Note also that the number of HCEs defined in (a) can be limited to the top 20% of the employees, when ranked by compensation; however, this decision to adopt the top 20% rule must be consistently elected by the 401(k)/403(b) plan and the Cafeteria plan.

b) Someone who is a > 5% owner during the current or prior plan year.

c) If also employed by the company, a spouse, parent, child or grandchild of a more-than-5% owner.

Note that this attribution rule does not apply to HCEs that are highly compensated solely by virtue of their compensation.

Key Employee (KEY) Definition

A more detailed explanation of how the IRS defines Key Employees can be found in the definitions
section at the end of this guide. The simplified definition is provided below:

An employee is considered a Key Employee if in the prior year they met one or more of the following criteria:

a) Officers with compensation greater than $170,000 (2015/16). Officers are limited to 50 employees (max) or, if less, the greater of three employees or 10% of all employees.

b) More than 5% owners (including spouses, children, grandchildren, and parents of the owner).

c) More than 1% owners with compensation over $150,000.

Controlled and Affiliated Service Groups

For plan-testing purposes, the IRS treats two or more employers as a single employer if there is enough common ownership or a combination of joint ownership and common activity. These rules are described in Code Section 414(b), (c), and (m), which are directly incorporated into the cafeteria plan rules. The determination of whether or not there is a controlled group of companies is the responsibility of the employer sponsoring the plan, along with their legal counsel, and is not a determination that is made by 24HourFlex. If providing testing data for a controlled group you must include employees from all companies within the controlled group in one testing template.

Correcting Test Failures

If testing is done early in the plan year, corrections can be made to employee salary reductions in order for the non-discrimination test(s) to pass. The methodology used to correct failures will be outlined in your plan document.

Employee salary reductions cannot be recharacterized as after-tax contributions after the end of the plan year. If it is determined after the close of the plan year that a non-discrimination test has failed the applicable employees will be taxed in accordance with the test rules.

Consequences of a Discriminatory Plan

The cafeteria plan will continue to be a valid Code Section 125 plan even if it is discriminatory. A qualified benefit (the cafeteria plan) does not cease to be a qualified benefit solely because it is taxable as a result of the violation of a nondiscrimination rule. A failure will not affect the favorable tax treatment conferred upon the non-HCEs under the plan.

If a cafeteria plan fails any of the nondiscrimination tests, then the HCEs and Key employees will lose the favorable tax treatment that the cafeteria plan otherwise provides and will have imputed income equal to the taxable benefit amount that they could have elected to receive for the plan year, even if they elected all qualified benefits. So, in the event of a testing failure, all HCEs and Key Employees that made pre-tax salary deductions (that were included in the test) will be taxed on the entire amount of those salary deductions, and not just the portion of the pre-tax salary deduction that caused the testing failure. The employer should treat the amount as taxable income for purposes of Form W-2 wage.
reporting and for purposes of income tax, FICA and FUTA withholding.

When applicable, DCAP testing under Code Section 129 is performed prior to Code Section 125 cafeteria plan testing. Unlike the cafeteria plan testing, if there is a failure in DCAP testing, HCEs are only taxed on the DCAP reimbursements they actually receive that would otherwise have been excluded from their taxable income. A DCAP testing failure does not result in including the total amount of an HCE’s pre-tax DCAP salary reduction election in taxable income. Although this can affect the Code Section 125 testing, DCAP failures are generally corrected before the end of the plan year, so would not usually be a concern.
2 - Discrimination Testing Data

You will need the following information to complete the 24HourFlex Discrimination Testing Form.

Ownership Information

You need to identify any individuals with more than 5% ownership in your company who have dependent care elections.

- This number should include spouses, children, grandchildren, and parents of owners who are also employees in your company.
- **Note**: Government entities and some religious organizations will not have any owners.

1. You will need the total Dependent Care FSA contributions being deducted for individuals with more than 5% ownership in 2016.
   a. Add the total Dependent Care FSA elections in 2016 of all your individuals with more than 5% ownership (plus any dependent care elections for spouses, children, grandchildren, and parents of owners) to get this number.

2. You will need the total Dependent Care FSA contributions being deducted for everyone else in 2016.
   a. Add the total Dependent Care FSA elections in 2016 for non-owners and owners with 5% or less ownership.

Highly Compensated Employee (HCE) Information

1. The total number of HCEs who meet one or more of the following criteria:
   a. An employee who in the preceding calendar year had compensation greater than $120,000.
   b. Someone who is a > 5% owner during the current or prior plan year.
   c. A shareholder owning > 5% of the voting power or value of stock of the employer.
   d. If also employed by the company, a spouse or dependent of one of the above.
      i. **Note**: This should be the total number of HCEs in your company regardless of how many are participating in a Dependent Care FSA.

2. The total number number of non-HCEs in your company/organization.

3. The total annual Dependent Care elections for all your HCEs in 2016.
   a. Add the total Dependent Care FSA elections in 2016 of all your HCEs to get this number.

4. The total annual Dependent Care elections for all your non-HCEs in 2016.
a. Add the total Dependent Care FSA elections in 2016 of all your non-HCEs to get this number.

**Key Employee Information**

You need to identify the total number of Key Employees who meet one or more of the following criteria:

a. Officers with compensation greater than $170,000. Officers are limited to 50 employees (max) or, if less, the greater of three employees or 10% of all employees.

b. More than 5% owners (including spouses, children, and parents of stockholder).

c. More than 1% owners with compensation over $150,000.

**Note**: Government entities and some religious organizations may not have any Key Employees.

1. You will need the total benefit amount that will be deducted through your Section 125 (Cafeteria) Plan for all Key Employees in 2016.
   
   a. This includes all employee or employer paid medical, dental, vision and other premiums being paid on a pre-tax basis.
      
      i. Do not include any premiums that are paid by employees on a post-tax basis.

   b. This includes all employer or employee HSA contributions being deducted/contributed pre-tax to employees.

   c. This includes Medical FSA and Dependent Care FSA contributions.

One example of how to calculate this total is to take one month’s worth of these contributions across all of your employees and to multiply it by 12. If your 5 key employees have a total of $10,000 per month being withheld pre-tax, the amount you would report here would be $10,000 x 12 = $120,000.

2. You will need the total benefit amount that will be deducted through your Section 125 (Cafeteria) Plan for all non-Key employees 2016.

   a. This includes all employee or employer paid medical, dental, vision and other premiums being paid on a pre-tax basis.
      
      i. Do not include any premiums that are paid by employees on a post-tax basis.

   b. This includes all employer or employee HSA contributions being deducted/contributed pre-tax to employees.

   c. This includes Medical FSA and Dependent Care FSA contributions.

One example of how to calculate this total is to take one month’s worth of these contributions across all of your employees and to multiply it by 12. If your 5 key employees have a total of $10,000 per month being withheld pre-tax, the amount you would report here would be $10,000 x 12 = $120,000.
Once you have this data, proceed to filling out the 24HourFlex discrimination testing form.
3 - Definitions

The following definitions provide technical details and background as provided by Thomas Reuters Checkpoint (EBIA).

Highly Compensated Employee (HCE)

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 (for example, the $120,000 threshold for 2015 generally is used to determine HCEs for 2016 plan year testing), and, if elected by the employer, the employee was also in the “top-paid group” (generally constituting the top 20%).

An individual who owns exactly 5% of the employer will not qualify as a more-than-5% owner.

If an individual has an option to acquire stock, then the stock subject to that option is considered to be owned by that person. Also, if an individual has an option to acquire stock, then the stock subject to the stock option is considered to be owned by that person for stock attribution purposes. Generally, stock owned by a qualified plan, such as stock held in an ESOP, is not considered to be owned by the individual even if it is allocated to the participant’s account.

If the employer is a partnership or other form of business entity, ownership is determined on the basis of the individual’s capital or profits interest in the employer.

In identifying ownership for this purpose, the constructive ownership rules of Code §318 apply. For example:

• a spouse is deemed to own the interest held by the other spouse;

• an individual is deemed to own the interest held by his or her parents, children, and grandchildren;

• a partner is deemed to own a proportionate amount of any interest held by the partnership; and

• a shareholder who owns 50% or more of a corporation is deemed to own a proportionate share of any stock owned by the corporation.

Under Code §414(q), the plan year for which the HCE determination is being made is called the determination year (which is the same as the year being tested—the testing year). The prior 12-month period, during which the compensation threshold is examined, is called the look-back year. To be considered an HCE in the determination year, an individual generally must have compensation exceeding the applicable dollar threshold during the look-back year. The following chart illustrates how...
to apply the dollar threshold for a calendar-year plan. The 2007 proposed regulations modified this rule for cafeteria plan purposes by providing that individuals in their first year of employment can be highly compensated individuals or participants based on their compensation during the current plan year. The term “participant's compensation” shall include: (i) any elective deferral (as defined in section 402(g)(3)), and (ii) any amount which is contributed or deferred by the employer at the election of the employee and which is not includible in the gross income of the employee by reason of section 125, 132(f)(4), or 457.

<table>
<thead>
<tr>
<th>Determination Year (Same as Testing Year)</th>
<th>Look-Back Year</th>
<th>Apply Threshold for Look-Back Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>2014</td>
<td>$115,000</td>
</tr>
<tr>
<td>2016</td>
<td>2015</td>
<td>$120,000</td>
</tr>
</tbody>
</table>

Non-calendar-year plans may use the prior plan year as the look-back year or may elect to use the calendar year beginning in the prior plan year as the look-back year (the calendar-year data election). When the look-back year is not a calendar year, the applicable dollar threshold is the dollar threshold for the calendar year in which the look-back year begins. The following chart illustrates how to apply the dollar threshold for a non-calendar plan year that begins on July 1.

<table>
<thead>
<tr>
<th>Determination Year (Same as Testing Year)</th>
<th>Alternative #1: Prior Year as Look-Back Year Begins July 1</th>
<th>Apply Threshold for Calendar Year in Which Look-Back Year Begins</th>
<th>Alternative #2: Calendar Year Beginning in Prior Year as Look-Back Year</th>
<th>Apply Threshold for Calendar Year Beginning in Prior Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>2014</td>
<td>$115,000</td>
<td>2015</td>
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<tr>
<td>2016</td>
<td>2015</td>
<td>$115,000</td>
<td>2016</td>
<td>$120,000</td>
</tr>
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Key Employee (KEY)

Code §125(b)(2) provides that a Key Employee is an individual defined in Code §416(i)(1) (Code §416 contains the top-heavy rules pertaining to qualified retirement plans.) Under the 2007 proposed regulations, Key Employee status is determined based on the preceding plan year. A plan will look to prior year data to determine Key Employee status during the current plan year (i.e., the plan year for which nondiscrimination testing is conducted).

Under Code §416, a Key is any employee (or former employee, including a deceased employee) who, during the plan year, was:

- an officer of the employer with annual compensation in excess of a specified dollar threshold $170,000 (2015), $170,000 (2016);
- a more-than-5% owner of the employer; or
- a more-than-1% owner of the employer with annual compensation in excess of $150,000 (not indexed).

The 2007 proposed regulations provide that a Key Employee covered by a collective bargaining agreement is a Key.

Code §416 regulations provide that compensation may be measured based on the employee's Form W-2 for the calendar year that ends with or within the plan year. For purposes of determining who is a Key, the employer looks at the employee's actual compensation for the relevant period. Therefore, an employee hired late in the year might not exceed the applicable threshold for the first year of employment, even though on an annualized basis the new hire's salary exceeds the threshold.

If an employer has no non-Keys (i.e., everyone is a Key, such as in a small professional company), then the literal requirements of the Key Employee Concentration Test would be violated. The 2007 proposed regulations provide no exceptions or special rules for plans, and the IRS has informally indicated that the literal statutory rule must be followed even when the employer has no non-Keys.

Officer

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. An employee with the title of officer, but not the authority of an officer, is not considered to be an officer. 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.
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.

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

**More Than 5% Shareholder**
Someone owning more than 5% of the voting power or value of all classes of stock of the employer. 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. Consequently, the Code §318 attribution rules will not apply in defining a more-than-5% shareholder.