



Compliance Alert

Cafeteria Plans Series: IRC Dependent Care Assistance Program Nondiscrimination Rules

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Quick Facts:

- Internal Revenue Code (Code) Section 129 allows employees to exclude up to \$5,000 from gross income for eligible dependent care expenses under an employer-sponsored Dependent Care Assistance Program (DCAP).
- DCAPs must pass four nondiscrimination tests to ensure the plan does not favor certain “prohibited groups.”
- Additional Section 125 nondiscrimination and other requirements apply to DCAPs.
- If a DCAP fails testing, the benefits provided to individuals in a prohibited group must be converted to wages or be imputed as taxable income.
- Plan sponsors should conduct Code nondiscrimination tests no later than the last day of the plan year; best practice is to also test prior to or early in the plan year.

This is the fifth in a continuing series of articles on cafeteria plan topics. Prior articles focused on Code Section 125 [election change rules](#), [health flexible spending accounts \(Health FSAs\) and health savings accounts \(HSAs\) interaction](#), and the nondiscrimination rules applicable to [cafeteria plans](#) and [self-funded health plans](#).

Background

Code Section 129 allows employees to exclude up to \$5,000 from gross income for eligible dependent care expenses under an employer-sponsored DCAP. Typically, employees contribute pre-tax salary reductions to DCAPs offered under a Code Section 125 cafeteria plan. Participating in a DCAP reduces employees’ taxable income and both an employee’s and employer’s tax liability, thus lowering participants’ net dependent care costs.



Section 129 nondiscrimination tests

To retain its tax advantages, a DCAP must pass certain tests to ensure that it does not discriminate in favor of certain highly compensated employees (HCEs) or owners (or their respective spouses and dependents). If a DCAP fails nondiscrimination testing, such individuals lose the tax benefits of participating in the DCAP, and their salary reductions become taxable. All companies within a controlled group must be included in the testing process.

In general, a DCAP must satisfy four nondiscrimination tests under Section 129:

1	Eligibility Test	This test looks at whether a sufficient number of non-HCEs are eligible to participate in the DCAP. If too many non-HCEs are ineligible to participate, the DCAP will fail this discrimination test. Also, any exclusion of an employee class from a DCAP benefit must be based on bona fide non-benefit business purpose.
2	Benefits and Contributions Test	This test is designed to ensure a plan's contributions and benefits are available on a nondiscriminatory basis.
3	More-than-5% Owners Concentration Test	This test looks at whether more than 25% of the amounts paid or incurred by the employer for dependent care assistance for a plan year are provided to individuals who are more-than-5% owners of the employer (or their spouses or dependents).
4	55% Average Benefits Test	This test checks whether the average DCAP benefit for non-HCEs is at least 55% of the average benefit for HCEs. This is a utilization test. All DCAPs within a controlled group are included in this test. Of all the Section 129 tests, DCAPs most commonly fail the 55% average benefits test.

What is an HCE or more-than-5% owner?

Under Code Section 129, an employee is an HCE or a more-than-5% owner if:

- for the preceding plan year, the employee had compensation in excess of a specified dollar threshold (\$120,000 for 2018; \$125,000 for 2019); or
- at any time during the current or preceding plan year the employee was a shareholder or owner of more than 5% of employer stock, capital or profits interest.



Excludable employees

For Section 129 testing purposes, employees may be excluded who:

- are under age 21 (if the plan excludes such employees from participation);
- have less than one year of service with the employer (if the plan excludes such employees from participation); or
- are not eligible for the DCAP but covered under a collective bargaining agreement (if DCAP benefits were subject to good faith bargaining).

In addition, in the case of any benefits provided through salary reduction, employees with less than \$25,000 in annual compensation may be excluded from the 55% Average Benefits Test (whether or not eligible for the DCAP).

When to conduct testing

At a minimum, Section 129 nondiscrimination tests should be conducted as of the last day of the plan year, taking into account all non-excludable employees who were employed on any day during the plan year. For practical reasons, the best policy is to perform pre-testing (before the start of the plan year) to adjust prospective elections early in the plan year. Testing prior to or early in the plan year provides an opportunity to make corrections before the end of the year, so that the DCAP passes testing and preserves the tax treatment for HCEs and more-than-5% owners. Testing to check for final discrimination issues would then be conducted no later than the last day of the plan year.

Impact of failed testing

For a failure determined after the close of the plan year, the DCAP reimbursement benefits provided to any participating HCEs and more-than-5% owners must be reported as wages and imputed as taxable income. Non-HCEs are not affected by the failure to pass the nondiscrimination tests – their benefits may continue to be tax favored.

Avoiding DCAP testing failures

The following types of limitations imposed on non-HCEs are examples of plan designs that can cause a DCAP to be discriminatory, which should therefore be avoided:

- delayed participation (longer waiting periods) for non-HCEs; and
- lower annual election limits for non-HCEs and non-owners.

DCAPs frequently fail testing because of low participation by non-excludable non-HCEs who are concerned about the risk of losing contributions due to potentially incorrectly predicting future dependent care expenses and the forfeiture rule. Consequently, HCE participation often exceeds non-HCE participants, causing testing failure.



Education and clear communications about the cost-saving aspects of DCAP benefits are essential to achieving higher participation and avoiding testing failure. When employees understand that the risk of losing their contributions is very low compared to the potential benefit, they are more likely to participate in a DCAP.

Conclusion

DCAPs that discriminate in favor of HCEs and more-than-5% owners lose the tax benefits available under the DCAP. DCAPs are subject to additional compliance rules in order to permit tax-free contributions. These requirements include maintaining a written plan document, making benefit elections irrevocable and subjecting elections to “use or lose” forfeiture rules.

FSA administrators often conduct testing for the DCAPS and Health FSAs they administer. However, prudent selection of testing vendors is important because not all vendors collect data needed to help a plan pass testing (such as information about excludable employees) nor do they utilize all testing options.

If any plans fail testing, EPIC recommends that plan sponsors confirm all available exclusions and testing options have been used, and consider obtaining a second opinion for major failures.

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