Complete year-end nondiscrimination testing ASAP

by Kevin Semanick
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The end of the year brings celebration and holidays. It is also time to stop procrastinating on the annual to-do list. For HR professionals, mid-year nondiscrimination testing needs to be at the top of that list.

Waiting to test until the completion of the year can have severe negative consequences. Any pre-taxed benefits enjoyed by highly compensated employees in discriminatory health and welfare plans must be included in gross income and taxed accordingly.

Since Dependent Care Flexible Spending Account Plans are the most common plans to fail nondiscrimination testing, many plan administrators perform these tests early in the year. This provides time to adjust the HCE contribution maximum. The employees still receive a pre-tax benefit, albeit a smaller one.

The danger is that a plan can still fail, even after passing mid-year nondiscrimination testing. Compounding problems, it is usually only detected after the year has been completed. At that time, adjustments are no longer allowed, leaving some employees with a hefty tax bill.

Typically, a small percent of employees contribute to these plans. Therefore a few employees can radically affect nondiscrimination testing, particularly the 55% Average Benefits Test. This test ensures the ratio of contributions to salary for HCEs does not exceed 55% of that ratio for the rest of employees.

The good news is that very few events can cause a plan that originally passed midyear testing to later fail once the year is over. Below are common issues that can alter these ratios and force unexpected failure.

Termination of employees

A plan is at risk for failure if non-highly compensated employees with Dependent Care FSA contributions terminate after the midyear testing.

A plan will generally use annualized contributions for testing. When an employee terminates before the end of the year, the employee contributes less than the plan expected. This results in the plan overstating contributions and negatively affects the testing.

Rehiring employees

If we assume that a look-back period for salaries is used consistently throughout the testing, then anyone earning more than $25,000 in the previous year cannot be excluded from the 55% Average Benefits Test. Therefore, it’s possible that a rehired employee could cause the ratios to change.

Rehires that earned more than $115,000 in the previous year and contribute to the plan could lead to a discriminatory plan. Likewise, rehires that earned between $25,000 and $115,000 in the previous year and don’t contribute could also result in plan failure.

New babies

Since the birth of a baby or adoption of a child is a change in status event, it can result in new elections to Dependent Care FSA accounts. Although plans will have plenty of preparation time, be alert if highly compensated employees start welcoming new additions to the family.

These are only some of the issues that can appear between midyear nondiscrimination testing and the end of the year. Since plans might not want to perform the tests multiple times throughout the year, it is recommended to include a buffer when making adjustments to HCE contribution maximums. This will alleviate some of the worry at a time of year that should be filled with serenity.

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