Nondiscrimination Testing - Section 125

What is Section 125 Nondiscrimination Testing?

Your plan allows employees to pay for their health care and dependent care expenses on a pre-tax basis. This saves both the employer and the employee money on Income taxes and Social Security taxes. In order for Highly Compensated and Key Employees to receive these benefits, the plan must not discriminate in their favor. That is, Key Employees and Highly Compensated Employees cannot receive a better benefit than other employees. You must include all Section 125 benefits to carry out the testing. Please see 'About the Tests' below for more information on each test.

About the Tests

If you sponsor a Cafeteria/Section 125 Plan, there are three tests to complete. If you also offer Health Flexible Spending Account (FSA) or Dependent Care FSA benefits, there are additional tests to complete. All of the possible tests are listed below.

Cafeteria Plan Tests

1. Cafeteria Plan Eligibility Test: To automatically pass the test, your plan must be offered to all of your employees except union employees and non-resident aliens. In addition, the requirements to join the plan must be the same for all employees, the premium paid through the plan must be the same for all employees and the waiting period must be less than three years. Please consult your plan document for the eligibility requirements of your plan.
2. Cafeteria Contributions and Benefits Test: A plan cannot discriminate in favor of highly compensated participants as to contributions and benefits. If the plan consists solely of health insurance benefits and the employer pays for 100% of the cost of health benefits; or, pays 75% of the cost of the most expensive plan offered, the plan is deemed to be not discriminatory. If additional benefits are included (i.e. FSA benefits), the rule is that the percentage of benefit dollars compared to compensation for the Highly Compensated Employee group should be equal to or less than the same percentage for non-Highly Compensated Employees.
3. Cafeteria Plan Key Employee Concentration Test: This test measures the amount of pre-tax benefits provided to key employees versus all other employees. This is the test that small employers most often fail. Key employees cannot receive more than 25% of the pre-tax benefits from the plan.

Health FSA Tests

1. Health FSA Eligibility Test: Under the Health FSA Eligibility Test, a plan may not discriminate in favor of HCIs as to eligibility to participate. A plan may satisfy any of these three sub-tests in order to pass:
2. Subtest 1: The plan benefits 70% of all non-excludable employees.
3. Subtest 2: The plan benefits 80% or more of all non-excludable employees who are eligible to benefit, if 70% or more of all non-excludable employees are eligible to benefit under the plan.
4. Subtest 3: Nondiscriminatory Classification Test. Safe Harbor and Unsafe Harbor Percentage Tests.
5. Health FSA Benefits Test: Under the Health FSA Benefits Test, a plan may not discriminate in favor of HCIs and all participants should be benefiting from the plan in the same way as HCIs.

The Benefits Test consists of two requirements that must be met in order for the Health FSA to pass.

- First Requirement: No Discrimination on the Face of the Plan.
- Second Requirement: No Discrimination in Operation

In order for a Health FSA to be nondiscriminatory on its face, it must satisfy the following conditions as a matter of plan design and in operation. Examples of this include:

- The required employee contributions must be identical for each benefit level;
- The maximum benefit level that can be elected cannot vary based on percentage of compensation, age, or years of service;
- The same type of benefits (e.g., medical expenses) provided to HCIs must be provided to all other participants; and
- Do not impose disparate waiting periods.

Dependent Care Tests

1. Dependent Care Eligibility Test: The Eligibility Test is designed to ensure that a minimum percentage of non-HCE's are eligible to participate in the plan and that benefits are available to them on a nondiscriminatory basis.
2. Dependent Care Contributions and Benefits Test: This test is used to determine if non-HCEs are benefiting from the plan in the same way as HCEs. This is a subjective test. As long as the benefit maximum is the same for all employees the plan will pass this test.
3. Dependent Care More-Than-5% Owners Test: This test is used to determine if owners are receiving too much benefit from the Dependent Care benefit. As long as more-than-5% owners are receiving less than 25% of the total DCAP benefits then the plan will pass this test.
4. Dependent Care 55% Average Benefits Test: This test is used to determine if HCEs are receiving too much benefit from the Dependent Care (DCAP) benefit. If the average DCAP benefit for the non-HCE group is at least 55% of the average DCAP benefit for the HCE group then the plan will pass this test.

Important Definitions

Though Key Employee and Highly Compensated Employees may vary based on each employer and plan design, the definitions generally follow these guidelines (subject to change annually):

Highly Compensated Individual (HCI): (To be used for the Cafeteria Plan Eligibility Test)

- An Officer during preceding plan year (or current plan year in the case of the first year of employment)
- A more-than 5% owner of the employer during the preceding or current plan year
- An employee with annual compensation more than the "Highly Compensated Employee" specified dollar threshold for the preceding year (or current plan year in the case of the first year of employment)
    - $160,000 in 2025 and $155,000 in 2024
- Spouse or dependent of any of the above

Highly Compensated Participant (HCP): (To be used for the Cafeteria Plan Contributions and Benefits Test)

- HCI who is eligible to participate

Key Employee: (To be used for the Cafeteria Plan Key Employee Concentration Test)

- An Officer of the employer with annual compensation in excess of a specified dollar threshold ($230,000 in 2025 and $220,000 for 2024);
- 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)

Highly Compensated Individual (HCI): (To be used for Health FSA Eligibility and Benefits Tests)

- One of the five highest paid Officers;
- A shareholder who owns more than 10% in value of the stock of an employer; or,
- Among the highest paid 25% of all employees (other than excludable employees who are not participants)

Please Note: In determining the top 25% of employees by pay, you can exclude all of the following IF they're not participating: Those with less than 3 years of service, those who are under age 25, part-time and seasonal employees, union employees and non-resident aliens with no U.S. source income.

Highly Compensated Employee (HCE): (To be used for the Dependent Care Eligibility, Contributions and Benefits, and 55% Average Benefits Tests)

- A more-than 5% owner of the employer; or
- An employee with annual compensation in excess of the "Highly Compensated Employee" specified dollar threshold for the preceding year
    - $160,000 in 2025 and $155,000 in 2024

What is Required

The IRS requires that these tests are performed on an annual basis, once the plan year is complete. Unlike other benefits testing, the Section 125 and FSA tests are not filed with any government agency. They are to be performed and kept on file to produce in the event of a Plan audit. If testing is performed and the Plan fails, the usual course of action is to include the effected benefits as taxable income for Key and Highly Compensated Employees. In order to prevent this from occurring, an employer may test before or even early into the plan year and make corrections prior to the end of the plan year.

How Sentinel Group Can Help

Sentinel offers a self-testing portal for you to test your Plan at any point in the year. The portal can be found here: https://www.sentinelgroup.com/section-125-nondiscrimination-testing-suite

Additionally, Sentinel can run the various tests for you when we are provided the data to do so. The data can be collected via the spreadsheet found here: Testing Sheet

Please be sure to complete all three tabs which include Employer Information, Plan Design and Census. For the Census data, please be sure to include information on all employees, regardless of whether or not they are eligible for benefits. The standard fee for Sentinel to conduct the testing is $350 (unless otherwise specified in your Service Agreement).

Where to Send the Information

If Sentinel Group is to help in conducting the tests, completed spreadsheets may be sent to

FSAServiceTeam@sentinelgroup.com . If you need assistance or have questions, please contact your account manager.