SECTION 129 DEPENDENT CARE ASSISTANCE PROGRAM NONDISCRIMINATION RULES: A GUIDE FOR EMPLOYERS

Generally, Section 129 of the Internal Revenue Code (IRC) provides an income tax exclusion for benefits received through an employer-sponsored dependent care assistance program (DCAP), also referred to as a dependent care flexible spending account (DCFSA). The maximum annual DCAP exclusion depends on the employee's federal income tax filing status: $5,000 for most filers (single or married filing jointly); $2,500 for married filing separately. The maximum annual DCAP exclusion is measured per calendar year, regardless of whether the employer administers the plan according to a non-calendar plan year. Further, the maximum annual DCAP exclusion is measured per employee (i.e., on an individual basis); employees with more than one employer during a calendar year must take care not to exceed the maximum annual exclusion. The DCAP maximums are not subject to annual cost of living adjustments.

In order to qualify for Section 129 tax exclusions, a DCAP must satisfy certain nondiscrimination rules. These rules generally prohibit plan designs that intentionally or unintentionally favor highly compensated employees.

In order to qualify for Section 129 tax exclusions, a DCAP must satisfy certain nondiscrimination rules. These rules generally prohibit plan designs that intentionally or unintentionally favor highly compensated employees (HCEs, as further defined below). So, while employers have flexibility to design the terms of DCAP eligibility, benefits, and contributions as they desire, they need to consider the DCAP nondiscrimination tests – particularly the 55% average benefits test (which looks at actual DCAP benefit utilization) – when designing and administering their DCAP plans.

Employers, human resource managers, plan administrators, and company executives should be aware of the nondiscrimination rules under Section 129. This publication examines the DCAP nondiscrimination requirements, problematic plan designs, timing of testing, the definition of HCE, the types of tests that must be satisfied, the consequences of a discriminatory plan design, and the methods for correcting nondiscrimination failures. It includes a chart of **IRS Limits on Retirement Benefits and Compensation**, including the HCE thresholds for current and prior years (Appendix A, relevant for DCAP nondiscrimination testing), and a **Sample Employee Communication** for notifying HCEs of benefit election adjustments that may be required to satisfy nondiscrimination testing (Appendix B).

Note: While the focus of this publication is on DCAPs, self-insured group health plans (including health reimbursement arrangements (HRAs)) and cafeteria plans (pre-tax contribution arrangements, including health FSAs) are subject to a different set of nondiscrimination rules, found in IRC Sections 105 and 125, respectively. For further information on those two sets of rules as well as a high level summary of nondiscrimination rules, see the PPI publications **Sections 105 and 125 Nondiscrimination Rules: A Guide for Employers** and **Quick Reference Chart: Nondiscrimination Rules**. For further information about the application of Section 79 nondiscrimination rules to employer-provided group term life insurance – another popular employee benefit – see the PPI publication **Group Term Life Insurance: A Guide for Employers**.

TYPES OF PLANS SUBJECT TO NONDISCRIMINATION RULES

Section 129 applies to benefits received by employees through employer-sponsored DCAPs (including those funded with pre-tax salary reduction dollars). DCAP benefits include not only reimbursements from the DCAP itself, but also direct payments of dependent care expenses by employers and the fair market value of any on-site dependent care services that are not paid for by employees on an after-tax basis.

GENERAL REQUIREMENTS AND PROBLEMATIC PLAN DESIGNS

General Requirements

Section 129 contains four basic nondiscrimination tests (described in greater detail in the Details of Section 129 Nondiscrimination Tests section below):

- **An eligibility test.** The DCAP must benefit employees who qualify under an eligibility classification that does not discriminate in favor of HCEs.
- **A benefits and contributions test.** The benefits or contributions provided under the DCAP must not discriminate in favor of HCEs.
- **The "5% owner test."** Not more than 25% of the total benefits under the DCAP can be provided to individuals who own more than 5% of stock, capital, or profit interest of the employer company.
- **The "55% average benefits test."** The average benefits provided to non-HCEs must be at least 55% of the average benefits provided to HCEs.

Problematic Plan Designs

DCAPs that exclude certain categories of employees from participation (e.g., part-time, hourly, specific location) or that are only available to employees of one member employer of a controlled group may have difficulty satisfying the nondiscrimination testing requirements. In addition, because the 55% average benefits test is a utilization test, even DCAPs that are available to all employees on the same terms often struggle to pass nondiscrimination testing.

GENERAL CONCEPTS: CONTROLLED GROUPS AND TESTING TIMEFRAME

Controlled Groups (Companies Under Common Ownership)

Generally, the Section 129 nondiscrimination testing rules apply on a per plan basis, and single employer plans are tested on their own. That said, the controlled group and affiliated service group rules of Section 414(b), (c), and (m) are expressly applied to Section 129 nondiscrimination testing. This means that where two or more employers are under common ownership, employees of all employers must be included in determining the HCE group and in performing the nondiscrimination tests. Employers should confer with legal counsel as needed to determine whether a group of companies is under common ownership.

When to Perform Nondiscrimination Testing

The rules do not prescribe a specific date or timeframe for performing nondiscrimination testing; they simply say that the DCAP must not be discriminatory. Thus, it is presumed that testing will occur at the end of the plan year.

Our Observation:	Note that the DCAP exclusion and related reporting (Form W-2 for employers and Forms 1040 and 2441 for employees) are based on a participant's taxable year, which is typically the calendar year. Although not required, it is advisable to test the DCAP on a calendar year basis, even for non-calendar year plans. This approach can be beneficial for various reasons, including nondiscrimination testing, and may be more practical even if other benefits are provided on a non-calendar year basis.

To help ensure that the plan will pass testing, a general best practice is to perform nondiscrimination testing shortly after open enrollment (prior to the start of the plan year for calendar year DCAPs) or early in the calendar year (for non-calendar year DCAPs). This gives employers ample time to determine whether additional steps must be taken before the end of the plan year.

Employers should also monitor and revisit the testing at least once during the plan year, particularly if there are significant changes in employee composition, such as new hires, reorganization, business acquisition, etc. In addition, employers should

perform the tests (or confirm prior tests) at the end of the calendar year to confirm compliance by the last day of the plan year. Employers should note that the tests take into account all non-excludable employees who were employed on any day during the calendar year, including employees who are no longer active participants as of the testing date. Lastly, if the employer is involved in a business reorganization (such as a merger or acquisition), the testing should be reviewed as part of the reorganization process. For further discussion of nondiscrimination testing and other compliances concerns in the context of mergers and acquisitions, see the PPI publication Health Benefits Compliance Considerations in Mergers and Acquisitions: A Guide for Employers.

Definition of Highly Compensated Employee

Generally, status as an HCE for DCAP testing purposes is determined using the same definition of HCE that is used to identify HCEs for testing qualified retirement plans (e.g., 401(k) plans) for discrimination. Under Section 129, the definition of HCE includes a more-than-5% owner/shareholder and any employee with compensation in excess of the indexed threshold for HCEs (see Appendix A).

Section 129 explicitly directs employers to use the prior plan year's compensation amounts in determining whether an employee has compensation greater than the indexed threshold. (Note that the HCE definition relies on plan year compensation figures.) An employee is a more-than-5% owner/shareholder of the employer company for a particular year if at any time during that year the employee owns more than 5% of the value of the outstanding stock of the corporation or stock that represents more than 5% of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a more-than-5% owner/shareholder is any employee who owns more than 5% of the capital or profit interest of the employer company.

DETAILS OF SECTION 129 NONDISCRIMINATION TESTS

Nondiscrimination testing is implicated any time an employer offers a DCAP plan, regardless of whether the employer varies eligibility, contributions, or benefits. While DCAPs can be offered on the same terms to all employees, the 55% average benefits test, which is a utilization test, leaves employers particularly vulnerable to nondiscrimination failures.

To be considered nondiscriminatory under Section 129, a plan must satisfy four tests: the eligibility test, the benefits and contributions test, the 5% owner test, and the 55% average benefits test.

Eligibility Test

Under the eligibility test generally, a plan must not discriminate in favor of HCEs as to eligibility to participate. A plan that is offered on the same terms to all employees will satisfy this test. However, if some employee classifications are not eligible to participate, then the plan must be designed to benefit "a classification of employees that is found by the Secretary of the Treasury (i.e., the federal government) not to discriminate in favor of HCEs." This is known as the "reasonable classification test."

With respect to the reasonable classification test, IRS regulations simply provide that the classification must be reasonable and must not favor HCEs. Without explicit direction, many practitioners believe a plan will satisfy the reasonable classification test if it satisfies the two-step nondiscriminatory classification test applied under Section 410(b). The first step requires that the classification of employees is based on a bona fide employment classification consistent with the employer's usual business practice. Examples of such bona fide classifications include full-time versus part-time status; current versus former employee status; union versus non-union status; different geographic location, occupation type, or business line; and date of hire. The second step requires that the classification of employees also be considered nondiscriminatory based on a certain safe harbor percentage rate described in IRS regulations. Since this test involves making a determination based on the facts and circumstances of each particular case, employers that seek to satisfy the reasonable classification test should consult with their testing vendor or legal counsel.

With respect to the eligibility test, certain employees may be excluded when making the calculations. Excludable employees include:

- Employees covered by a collective bargaining agreement (if DCAP benefits have been a subject of good faith bargaining)
- Employees with less than one year of service
- Employees who have not attained age 21 as of the testing date

Note that employees who have not met the plan's service and age requirements may be excluded for testing purposes only if they are also excluded from participation in the plan.

Benefits and Contributions Test

With respect to the benefits and contributions test, both HCEs and non-HCEs must generally be provided with the same benefits. That is, DCAP benefits and contributions must not favor HCEs. This is generally a facts-and-circumstances analysis that considers whether HCEs receive different or greater benefits – or pay less for the same benefits – than others. There is no quantitative test for determining whether this requirement is satisfied. Practically speaking, the majority of DCAPs are funded solely through employee salary reduction and are provided on the same terms to all eligible employees (or limits are imposed only on the amounts that HCEs can contribute to pass the 55% average benefits test). For this reason, most DCAPs will automatically satisfy the benefits and contributions test. However, if one member of a controlled group makes separate employer contributions to its DCAP (e.g., "seed" money, matching contributions, or employer-paid on-site dependent care services) and others do not, the plan could potentially fail this test.

5% Owner Test

In contrast to the eligibility and benefits/contributions tests, the 5% owner test is a utilization test: it looks at actual DCAP benefits paid to owners and shareholders versus non-owners. At a high level, the test is meant to confirm that principal owners and shareholders of the employer are not disproportionately receiving DCAP benefits. To satisfy this test, not more than 25% of the amounts paid or incurred by the employer for DCAP benefits during the year may be provided to 5% owners of the employer. Practically speaking, most plans satisfy the 5% owner test because owners generally don't participate in a DCAP (most owners are considered self-employed and are therefore unable to participate in a Section 125 pre-tax contribution DCAP) or because they don't participate to a level of receiving 25% or more of the DCAP benefits.

55% Average Benefits Test

Similar to the 5% owner test, the 55% average benefits test is a utilization test that looks at actual DCAP benefits paid out. Specifically, under this test, the average DCAP benefits provided to non-HCEs must be at least 55% of the average benefits provided to HCEs. Thus, on average, for every $100 reimbursed to HCEs, at least $55 in benefits must be reimbursed to non-HCEs.

There is some ambiguity on treatment of DCAP forfeitures (amounts left in an employee's DCAP at the end of the plan year or upon employee termination) under the rules. Where the DCAP is provided through a Section 125/cafeteria plan (almost always the case), the "benefits provided" to employees are the reimbursements actually received under the DCAP, not the elected salary reduction amounts. Based on that, it would seem that unused DCAP amounts forfeited by an employee should not count toward the DCAP "benefits provided" for purposes of the test. On the other hand, given that DCAP claims can be submitted until the close of the plan's run-out period, performing nondiscrimination testing based on actual benefits provided may not be administratively feasible (as potential forfeitures might not be known at the end of the calendar year). With no direct answer in the rules, and considering practicalities, the more cautious approach is to consider all elected amounts as benefits provided.

55% Average Benefits Test Example

Employer XYZ has seven employees—A, B, C, D, E, F, and G. A and B are HCEs; C, D, E, F, and G are non-HCEs. All employees are eligible to participate in XYZ's DCAP as of their date of hire. A, B, C, and D participate in the DCAP through the cafeteria plan, using salary reduction agreements, but E, F, and G do not participate in the DCAP at all. A, B, C, and D have each reduced their salaries by $5,000 and are each provided benefits worth $5,000 under the plan (i.e., there are no forfeitures).

In running the 55% average benefits test, XYZ must compare the average benefits of the HCEs with those of the non-HCEs. The average benefit provided to the HCEs is $5,000 [($5,000 + $5,000) ÷ 2]. The average benefit provided to the non-HCEs is $2,000 [($5,000 + $5,000 + $0 + $0 + $0) ÷ 5]. The average benefit provided to the non-HCEs is 40% of the average benefit provided to the HCEs ($2,000 ÷ $5,000 = 0.4). Consequently, the DCAP fails the 55% average benefits test.

METHODS FOR AVOIDING AND/OR CORRECTING NONDISCRIMINATION FAILURES

Because HCEs typically participate in DCAPs at much higher rates than non-HCEs, it is common for DCAP plans to fail nondiscrimination testing, particularly the 55% average benefits test. To reduce or avoid the likelihood of failure, employers may consider completely excluding HCEs from participating in the DCAP. A less restrictive approach is to cap HCE DCAP elections during open enrollment, before the plan year starts. Yet another approach is to cap HCE elections after tests are conducted during the plan year. Employers can also take general steps to increase and improve plan communications to help non-HCEs understand the value of DCAP participation. In addition, employers can offer matching contributions (or seed money) to non-HCEs who participate in the DCAP.

As far as correcting nondiscrimination failures, the cafeteria plan or the DCAP plan document should give the plan administrator authority to reduce or discontinue participants' salary reductions as needed to comply with the nondiscrimination rules. Plan

documents that include this provision allow plan administrators to cut back HCE salary reductions into the DCAP, thereby preserving the exclusion for all participants. Another possible (if aggressive) practice is to re-characterize a portion of the HCE DCAP benefits as taxable (i.e., by imputing income and withholding applicable income and employment taxes) to the extent necessary for the DCAP to pass the applicable test. An employer that takes this approach might re-characterize an equal percentage of each HCE's benefits or use a "bubble-down" approach under which re-characterizations are made beginning with the HCEs whose benefits are greatest. So long as this is done before the close of the calendar year, such a correction would place a participant in a similar position to that of a prospective cutback in their DCAP salary reductions.

Overall, employers must consider the advantages and disadvantages of each approach to avoiding or correcting nondiscrimination failures. If an employer expects to fail the tests or has capped the DCAP elections of HCEs, tests should be conducted as early in the year as practical, and the employer should clearly communicate any salary reduction changes to HCEs whose DCAP elections must be adjusted to satisfy nondiscrimination testing (see **Sample Employee Communication** in Appendix B).

CONSEQUENCES OF A DISCRIMINATORY DCAP PLAN DESIGN

Under Section 129, a discriminatory plan design (i.e., one that fails any one or more of the four DCAP nondiscrimination tests) results in adverse tax consequences for HCEs. Specifically, HCEs lose the applicable tax exclusion and have the value of the benefit included in their income; that is, their DCAP reimbursements become taxable.

Importantly, non-HCEs are not affected by a discriminatory plan design; they still qualify for all of the tax advantages associated with the DCAP. In addition, there are no additional monetary penalties for employers providing a discriminatory plan, but discriminatory amounts included in income for the particular employee may be subject to employment taxes (in addition to income taxes). It is important for employers to consult with their tax experts to determine the appropriate amount of income and tax reported and whether Forms W-2 need to be amended.

SUMMARY

Employers of all sizes and types must consider the Section 129 nondiscrimination rules – particularly the problematic 55% average benefits test – to ensure that the plan design doesn't intentionally or unintentionally favor HCEs. In doing so, employers must first identify which employees are HCEs and ensure that the eligibility, benefits/contributions, 5% owner, and 55% average benefits tests are all completed before the end of the plan year (and that adjustments are made if there are failures). Employers must also remember that all employers in a controlled group should be included in the nondiscrimination testing.

PPI BENEFIT SOLUTIONS

APPENDIX A

IRS Limits on Retirement Benefits and Compensation

	2025	2024	2023
401(k) and 403(b) plan elective deferrals	$23,500	$23,000	$22,500
Catch-up contributions (age 50 and older)	$7,500*	$7,500	$7,500
Annual compensation limit	$350,000	$345,000	$330,000
Highly compensated employee threshold**	$160,000	$155,000	$150,000
Key employee compensation threshold**	$230,000	$220,000	$215,000
Defined contribution 415 limit	$70,000	$69,000	$66,000
Defined benefit 415 limit	$280,000	$275,000	$265,000
SIMPLE employee contribution limit	$16,500	$16,000	$15,500

See **www.irs.gov** for more information.

*New effective 1/1/2025: individuals who attain age 60, 61, 62, or 63 in 2025 can make catch-up contributions up to $11,250 in 2025.

**In general, compensation means total compensation from the employer, including bonuses or commissions as well as contributions made through a 401(k) plan (or similar retirement plan) or through a cafeteria plan or qualified transportation benefit plan.

The chart above is excerpted from the PPI publication **Employee Benefits Annual Limits**. See that publication for other annual limits that affect group health plans.

PPI BENEFIT SOLUTIONS

APPENDIX B

Sample Employee Communication

To: [Personalized Name of Affected HCE Plan Participant]

Subject: Nondiscrimination Testing for [Name of Benefit Plan] for Plan Year [YYYY]

In order for [Name of Company] to pass nondiscrimination testing for the above-referenced benefit plan, we are required from time to time to take corrective measures that include reducing the pre-tax benefit plan contributions of highly compensated employees. This action allows us to maintain the plan's favorable tax status and safe harbor provisions.

Based on the most recent nondiscrimination tests, we have determined that we must reduce your benefit plan election for the referenced plan year as follows:

[Insert details of original and revised plan year election amounts]

If you have already contributed more than the revised plan year amount as of the date of this notice, the excess amount will be returned to you as taxable income as soon as administratively practicable.

Please contact the Human Resources department at [HR email contact] if you have any questions.

PPI BENEFIT SOLUTIONS