**NON-DISCRIMINATION TESTING - SECTION 129 (DEPENDENT DAYCARE FSA)**

**Overview:**

Section 129 of the Internal Revenue Code permits employers to sponsor a flexible spending account (FSA) which employees may use to reimburse qualified dependent daycare expenses. Employers must annually run four non-discrimination tests (NDT) to ensure the tax-favored benefits flowing through the plan do not overly favor highly compensated employees (HCEs).

**Applies To:**

All size employers sponsoring a dependent daycare FSA, regardless of whether employer funded and/or employees fund pre-tax through the §125 cafeteria plan.

**Go Deeper:**

There are four non-discrimination tests under §129 for the dependent daycare FSA:

1. Eligibility Test
2. Contributions and Benefits (C&B) Test
3. More-than-5% Owners Concentration Test
4. 55% Average Benefits Test *(this is the test failed most often)*

*Note that employers allowing employees to fund this pre-tax from their paychecks are also subject to completely separate tests under §125 cafeteria plan rules. Cafeteria plan tests are not discussed here.*

Employers are allowed to vary benefits or contributions by reasonable classifications as long as they don’t overly favor HCEs. For example, many employers exclude part-time employees, which is permissible if testing is passed.

The plan cannot overly favor HCEs, defined as follows:

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| **Highly Compensated Employees** |
| Compensation exceeded $155,000 in 2023 for 2024 NDT  *>$160,000 in 2024 for 2025 NDT* |
| More-than-5% owners in the current or preceding year |
| Also includes spouses and dependents of HCEs noted |

Pass-through entity K-1 owners are typically not able to participate in pre-tax dependent daycare FSAs, so they are generally not part of this testing.

*1. Eligibility Test*

The first test needs to show that enough non-HCEs are eligible to participate. If employees who have not attained age 21 are not eligible, and/or employees who have not completed at least one year of service are not eligible, then they can be excluded from the testing respectively.

The plan needs to satisfy two eligibility tests:

1. A bona fide business classification for any exclusion; and
2. A sufficient ratio of eligible non-HCEs to eligible HCEs (a numeric test).

*2. Contributions and Benefits (C&B) Test*

This is a facts and circumstances test. HCEs cannot be eligible for more dependent daycare benefits than non-HCEs, and cannot be eligible for more employer contributions toward dependent daycare benefits than non-HCEs. This is looking for discrimination on its face, not a numeric utilization test.

*3. More-than-5% Owners Concentration Test*

This test may not be widely applicable for pass-through entities with self-employed K-1 owners, as they typically cannot pay pre-tax toward a dependent daycare FSA and thus are largely excluded from participating in a dependent daycare FSA since there is no tax advantage to do so.

However, for an employer with more-than-5% owners participating, they (and their spouses or dependents) cannot receive “more than 25% of the amounts paid or incurred” during the year. Failing this test results in taxation for all HCEs, not just taxing the more-than-5% owners.

*4. 55% Average Benefits Test*

This test is failed by most employers and can be failed every single year, so it is vitally important to run preliminary testing early in the new plan year.

We discussed under the eligibility test above two classes of employees the employer might choose to exclude from coverage and thus exclude from testing. In addition to those two exclusions also being available for this test, the employer can also exclude anyone with less than $25,000 compensation, even if they are eligible to participate, which may help, particularly for an employer with a lot of part-time or other employees earning less than $25,000.

The average benefits received by all non-HCEs must be at least 55% of the average benefits received by all HCEs.

* This is calculated by first calculating the total benefits received by HCEs during the year and dividing by the total compensation of all HCEs for that year (whether they participate or not). That determines the HCE average.
* The same calculation is run on non-HCEs, dividing their total benefits received by total compensation of all non-HCEs (whether they participate or not).
* The non-HCE average must be at least 55% of the HCE average.

The fundamental issue with this test is when calculating averages, the employer must include all nonexcludable employees in each respective testing class, not just those participating. For most employers, that means everyone earning at least $25,000 is included. So, all nonexcludable non-HCEs receiving $0 from the dependent daycare FSA are bringing down the non-HCE average.

**Consequences of Non-Compliance:**

If the dependent daycare FSA fails any of the four tests, then all daycare expense reimbursements HCEs received that year are reported as taxable income on their W-2. Even failing the more-than-5% owners concentration test results in taxing all HCEs, not just the more-than-5% owners.

If a failure is discovered after issuing forms W-2, then revised forms W-2 must be issued to HCEs, which may result in them having to refile their taxes if they have already filed. This can be an unfortunate consequence when the plan provides a 90-day run-out to submit receipts for daycare expenses incurred the prior year.

For these reasons, preliminary testing is strongly advised.

Failing NDT does not disqualify the entire plan or have any impact on non-HCEs.

**Practical Implications for Employers:**

Section 129 is concerned most with limiting employees and spouses to $5,000 of total non-taxable benefits combined per calendar year and ensuring forms W-2 of HCEs correctly reports their reimbursements as taxable if they were overly favored. Therefore, §129 NDT makes the most sense to run at the end of each calendar year. The trickiest part is addressing potential run-out claims.

Running the last day of the calendar year ensures they include all employees hired and terminated throughout the year. However, employers often run a preliminary test so they can make proactive adjustments that hopefully prevent tax headaches later.

If the employer is in a controlled group or other close arrangement with other related employers, NDT rules expect them to test as if they are one large employer. Employee leasing entities may also be implicated. These complicated situations make it worth outsourcing the testing to an NDT expert.

Employers sponsoring a dependent daycare FSA typically hire a third-party administrator (TPA) to administer. These TPAs can be an ideal partner to hire for NDT (including preliminary tests if you want to proactively ensure your plan looks like it will pass).

Issues can sometimes arise when:

* Non-HCEs on average do not elect as frequently (i.e., $0 elections bring down the non-HCE average election).
* Members of a related group of corporations or businesses have different dependent daycare FSA benefits, contributions, waiting periods, etc.

Testing results are kept on file and do not have to be reported, but they must be provided to the IRS upon request and might be requested as part of a merger/acquisition due diligence review.