

# Chapter 2

## Testing Protocols

### Introduction

Testing Protocols are discussed in these sections:

Outline of Protocol  
Discrimination Tests  
Safe Harbor Tests  
Classification of Tests  
Data Summary Tables  
When Tests are Not Met  
Terms Defined  
Engager Instructions

### Outline of Protocol

#### I. All tests-General Logic

##### A. Each Plan is Tested in Two parts:

##### 1. First is the Safe Harbor Test

- a. If it passes the plan is nondiscriminatory.
- b. If it fails the reason for the failure is one of the following:
  - i. Eligibility Tests
  - ii. Utilization Tests.

##### 2. Eligibility Tests

The Eligibility Tests should be redone using the Employee Database. With such database two additional tests should be made:

- i. Average Compensation by Class Test
- ii. Benefits Ratio Test

##### 3. Utilization Tests

A failure of the Utilization Test must result in one of two steps:

- i. Plan is accepted as discriminatory

ii. Remedial action is taken.

**B. Certain Exceptions**

**IRC Section 105(h) Test**

If the Eligibility Test is redone using the Employee Database, the expanded Utilization Tests must be done (i.e., the Benefits and Contributions Test must be done).

**II. IRC Section 105(h) (MRP and HRA)**

**A. Safe Harbor Test**

**1. Eligibility**

**a. Percentage Test**

If percentage test fails, go to Employee Database Test.

**2. Utilization Test**

a. *Per Se* Test

b. Potential for Discrimination Test

If Utilization Test fails seek remediation.

**B. Employee Database Tests**

**1. Eligibility**

a. Percentage Test

b. Average Compensation by class test

c. Benefit Ratio Test

**2. Utilization Tests**

a. *Per Se* Test

b. Potential for Discrimination Test

c. Benefits and Contributions Test

**III. IRC Section 125 (CAF, FSA and POP)**

**A. Cafeteria Plan (Full-Flex)**

**1. Safe Harbor Test**

**a. Eligibility**

1. Percentage Test

If percentage Test fails, go to Employee Database Test.

**b. Utilization Test**

i. *Per Se* Test

ii. Potential for Discrimination Test

- iii. Key Employee Concentration Test  
If Utilization Test fails seek remediation.

**B. Cafeteria Plan (FSA)**

1. **Safe Harbor**

a. **Eligibility**

- i. *Per Se* Test
- ii. Potential for Discrimination Test  
If Utilization Test fails seek remediation.

**C. Cafeteria Plan (POP)**

a. **Eligibility**

- i. Percentage Test  
If percentage Test fails, go to Employee Database Test.

b. **Utilization Test**

- i. There are no such tests for POP.

**IV. IRC Section 129 (DCAP)**

A. **Safe Harbor**

1. **Eligibility Test**

a. **Percentage Test**

If percentage Test fails, go to Employee Database Test.

2. **Utilization Tests**

- a. 5% Owners Test
- b. 55% of Average Benefit Test  
If Utilization Test fails seek remediation

## **Discrimination Tests**

The nine discrimination tests are briefly described as follows:

**Eligibility**

- Percentage Tests
- Benefits Ratio Tests
- Average Compensation by Class Test

**Utilization**

**Quantification**

- Benefits and Contributions Test
- Key Employee Concentration Test

5-Percent Owners Concentration Test  
55% Average Benefits Test

**Non-Quantification**

*Per Se* Test  
Potential for Discrimination Test

**Eligibility**

**Percentage Test.** The plan meets the Eligibility Test if either (a) the participants are at least 70% of the employees or (b) the participants (omitting the non-excludibles) are at least 80% of the employees (omitting the excludibles) subject to the ratio of excludible employees to total employees being less than 20%. Using the Table A Eligibility Table (a) the 70% Tests fails because 16 is less than  $.7 \times 26$  (18), (b) the 80% test fails because 14 is less than  $.8 \times 20$  (16) and 6 exceeds  $.2 \times 26$  (5). Being eligible for benefits means (a) actual enrollment for a MRP and (b) having the right to exercise the right to gain a benefit for an IRC Section 125 or 129 plan.

**Benefit Ratio Test.** The plan meets the Eligibility Test if the Benefit Ratio is within the Safe Harbor Range set forth in Attachment A. Using Table B as illustrative data (a) non-HCI concentration percent is  $9 \div 20$  or 45%; (a) the Safe Harbor Range for the Benefit Ratio is 50-40% and (b) the Benefit Ratio is (i) Numerator  $6 \div 9$  or .667 and (ii) denominator  $8 \div 11$  or .727 with the ratio being  $.667 \div .727$  or .917 and (c) Benefits Ratio Test is met because .917 is in the Safe Harbor zone (i.e., in excess of 50%).

**Average Compensation by Class Test.** The plan meets the Average Compensation by Class Test if there is a rational relationship among the various employee classes as measured by Average Compensation. Using Table B the following data is developed:

<b><u>Employee Grouping</u></b>	<b><u>Number</u></b>	<b><u>Total Compensation</u></b>	<b><u>Average Compensation</u></b>
<b><u>Non-Participants</u></b>			
Excludible	4	303,000	75,700
Non-Excludible	<u>6</u>	<u>406,000</u>	<u>67,667</u>
<b>Total</b>	10	709,000	70,900
<b><u>Participants</u></b>			
HCI	8	73,000	46,625
Non-HCI	<u>8</u>	<u>649,000</u>	<u>81,125</u>
<b>Total</b>	16	1,022,000	63,875
<b><u>All Employees</u></b>	26	1,731,000	66,577

**Utilization**

**Quantification**

**Benefits and Contribution Test.** The plan meets the Benefits and Contributions Test if there is a rational relationship between the highly compensated and non-highly compensated with respect to net plan benefits (i.e., benefits less participant contributions). Using Table B, this data is developed:

<b>Plan Participant Class</b>	<b>(1) Number</b>	<b>(2) Qualified Benefits</b>	<b>(3) Participant Contributions</b>	<b>Net Benefit Index [(2) – (3)] ÷ (1)</b>
HCI	8	67,000	17,000	6,250
Non-HCI	8	28,000	20,000	1,000
<b>Total</b>	16	95,000	37,000	3,625

**Key Employee Concentration.** The Full-Flex Cafeteria plan meets the key Employee Concentration Test if the Qualified Benefits of the Key Employees do not exceed 25% of the total plan benefits. Using Table C, the following data is developed:

<b>Employee Grouping</b>	<b>Number</b>	<b>Qualified Benefits</b>	<b>Percent</b>
Key Employee	2	14,000	35%
Non-Key Employees	18	26,000	65
<b>Total</b>	20	40,000	100%

**5% Owners Concentration Test.** The Plan meets the 5% Owners Concentration if the Qualified Benefits of the Key Employees does not exceed 25% of the total plan benefits. Using Table D, the following data is developed:

<b>Employee Grouping</b>	<b>Number</b>	<b>Qualified Benefits</b>	<b>Percent</b>
5% Owners	2	3,000	6%
Other	43	47,000	94
<b>Total</b>	45	50,000	100%

**55% Average Benefits Test.** The Plan meets the 55% Average Benefits if average benefit for the Non-HCE is at least 55% of such average benefit for the HCE. Using Table E, the following data is developed:

<b>Employee Grouping</b>	<b>Number</b>	<b>Qualified Benefits</b>	<b>Average Benefit</b>
HCE	5	15,000	3,000
Non-HCE	45	35,000	778
<b>Total</b>	50	50,000	

### Non Quantification Tests

**Per Se Test.** The plan meets the *per se* tests if there is no instance where a HCI or HCE is given an unfair advantage as with respect (a) eligibility, (b) benefits, (c) contributions or (d) tenure/compensation.

**Potential for Discrimination Test.** At no time during the test year were an benefits or contributions offered to any employee group that would permit the potential for discrimination in farm of the highly compensated.

The safe harbor test is not met since (a) the ratio  $16 \div 26$  is less than 70% and (b) the ratio  $14 \div 20$  is less than 80%.

**Average Compensation by Class Test.** This test is used if the test results of the Benefits Ratio test are in the inconclusive range. Summarize the total employee population as follows:

<u>Class of Employee</u>	<u>Number</u>	<u>Annualized Compensation</u>	<u>Average</u>
<b><u>Non-Participants</u></b>			
Excludible	4	303,000	75,750
Non-Excludible	<u>6</u>	<u>406,000</u>	<u>67,667</u>
<b>Subtotal</b>	10	709,000	70,900
<b><u>Participants</u></b>			
Non-HCI	8	373,000	46,625
HCI	8	649,000	81,125
<b>Subtotal</b>	<u>16</u>	<u>1,022,000</u>	<u>63,875</u>
	26	1,731,000	66,577

**All Employees**

The Fair Cross Section Test is subjective but will be met if (a) the 16 participants are not significantly higher in compensation than the 10 nonparticipants and (b) the 8 HCI participants have an average compensation (81,125) that is not disproportionately higher than the total participants (63,875)

**Benefit Ratio Test**

Summarize the total population as follows:

<u>Class</u>	<u>Participants</u>			<u>Non-Participants</u>			<u>Total</u>		
	<u>Non-Excel</u>	<u>Excel</u>	<u>Total</u>	<u>Non-Excel</u>	<u>Excel</u>	<u>Total</u>	<u>Non-Excel</u>	<u>Excel</u>	<u>Total</u>
Non-HCI	6	2	8	3	1	4	9	3	12
HCI	<u>8</u>	<u>0</u>	<u>8</u>	<u>3</u>	<u>3</u>	<u>6</u>	<u>11</u>	<u>3</u>	<u>14</u>
<b>Total</b>	14	2	16	6	4	10	20	6	26

Concentration Test  $9 \div 20 = 50\%$   
 Safe Harbor Range (See Attachment A)



Eligible Employees	20
All Participants (omitting the Excludibles)	14
Ratio	14 ÷ 20
	70%

## Classification of Tests

<u>Category of Test</u>	<u>Benefit Plan</u>					
	<u>IRC Section</u>	<u>MRP HRA</u>	<u>CAF</u>	<u>FSA</u>	<u>POP</u>	<u>DCAP</u>
<b>Eligibility</b>						
Percentage	105(h)	Yes	Yes	Yes	Yes	Yes
Avg. Comp/Class	105(h)	Yes	No	No	No	Yes
Ben Ratio	410(b)	Yes	Yes	Yes	Yes	Yes
<b>Utilization</b>						
<i>Per Se</i>	105(h)	Yes	Yes	Yes	No	No
Potent for Disc	105(h)	Yes	Yes	Yes	No	No
Ben and Cont.	105(h)	Yes	No	No	No	No
Key Concent	125	No	Yes	No	No	No
5% of Avg. Comp	129	No	No	No	No	Yes
55% of Avg. Ben	129	No	No	No	No	Yes

## Data Summary Tables

**Table A- Eligibility Table (IRC Sections 105(h) and 125)**

<u>Grouping</u>	<u>Excludible</u>	<u>Non-Excludible</u>	<u>Total</u>
Participants	2	14	16
Non-Participants	<u>4</u>	<u>6</u>	<u>10</u>
<b>Total</b>	6	20	26

**Table B – Multi-Purpose Table (IRC Section 105(h))**

<u>Grouping</u>	<u>HCI</u>			<u>Non-HCI</u>			<u>Total</u>		
	<u>Non-Excel</u>	<u>Excel</u>	<u>Total</u>	<u>Non-Excel</u>	<u>Excel</u>	<u>Total</u>	<u>Non-Excel</u>	<u>Excel</u>	<u>Total</u>
Participant									
Number	8	0	8	6	2	8	14	2	16
Qual. Ben.	N/A	N/A	67,000	N/A	N/A	28,000	N/A	N/A	9,5000
Part. Cont.	N/A	N/A	17,000	N/A	N/A	20,000	N/A	N/A	37,000
Comp.	N/A	N/A	373,000	N/A	N/A	28,000	N/A	N/A	9,5000

### Non-Participant



Number	3	3	6	3	1	4	6	4	10
Compensation	N/A	N/A	N/A	N/A	N/A	N/A	406,000	303,123	709
<b>Total</b>									
Number	11	3	14	9	3	12	20	6	26
Qual. Ben.	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Part. Comp.	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Compensation	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	1,731,000

**Table C – Key Employee Table**

Participant Grouping	Number	Qualified Benefits
Key	2	14,000
Non-Key	18	26,000
<b>Total</b>	20	40,000

**Table D – Over – 5% Owners**

Employee Grouping	Number	Qualified Benefits
Key	2	3,000
Non-Key	43	47,000
<b>Total</b>	45	50,000

**Table E – Highly Compensated Employee**

Grouping	Number	Benefits
HCE	5	15,000
Non-HCE	40	35,000
<b>Total</b>	45	50,000

## When Tests Are Not Met

If the Benefits Test is not met for a MRP, the affected HCI must be given a W-2 (Block 1 only) for the amount of benefit received as a consequence of such discrimination. Example: Employer induces John, A HCI, to accept employment by waiving his 90-day probationary period; during such period, John has an auto accident and is reimbursed \$ 100,000 by the plan for his medical expenses; Employer gives John a W-2 for the \$100,000.

If the Eligibility Test is not met; a fraction must be computed, defined as follows:

$$\frac{\text{All Benefits Paid to HCI Only}}{\text{All Benefits Paid to All Participants.}} = \frac{100,000}{300,000} = .33$$

This fraction is multiplied by the benefit paid to each HCI with the product becoming taxable income to such HCI as set forth in a W-2. Given Mary's benefits to have been \$2,000 for the Test year, the W-2 taxable amount would be  $2,000 \times .33$  or \$666.

To the greatest extent possible the attesting actuary urges that the Certification show that both the *Eligibility Test* and the *Benefits Test* are met; to do otherwise creates a plethora of problems all of which are best avoided. That is, while the remediation of a failed Eligibility Test or Benefits Test may be possible by using the Classification Test or Cross-Section Test, such reliance thereof should be under advice by legal counsel and not be deemed a risk/actuarial matter; furthermore, if the Eligibility Test is not met and no remediation is sought, the preparation of the requisite W-2 should be under advice of accounting counsel. The Work-Product is useful in (a) identifying the HCIs and their plan benefits as well as (b) computing the requisite ratios above cited.

## Terms Defined

**Employee Database means** the AWPSE-stored data on all of the employees of the Employer and is the basis of accessing data for the determination of the highly compensated.

**Five Percent Owner** is any person owning more than 5% of the Employer's stock.

**Highly Compensated** includes the (a) HCI, (b) HCE and (c) 5% owners.

**Highly Compensated Employee** means any employee who (a) is more than 5% Share holder, (b) has compensation in excess of the IRC Section 414(q) limit (with COLA Adjustments) or (c) is an officer.

**Highly Compensated Individual** means any person who is (a) one of the top-five officers in compensation, (b) a shareholder of one 10% of the employers stock or (c) one of the top 25% employees in compensation.

**Per Se Test** means one that is or is not discriminatory *on its face*.

**Prohibited Class** means either (a) HCI, (b) or (c) 5% owner.

## Engager Instructions

### General Instructions

#### Step One

Once the Employer and its health care plan become the target for discrimination testing, the Engager begins the process by sending the completed Data Transmission Form to the

Actuary. The task of so completing this Form will usually be done jointly by the Engager and the Employer.

## **Step Two**

The Actuary enters and processes the submitted data and documentation using methods and protocols that it is willing to defend. The Actuary will have two paths to follow: (a) the Plan meets the discrimination tests and a favorable opinion is offered or (b) the Plan fails to meet the discrimination tests but an unfavorable opinion is withheld giving the end-user the opportunity to make remedial changes.

## **Step Three**

The Actuary stands ready and willing to assist in the remedial process but such typically will involve the advice and counsel of the Plan's risk manager, attorney or accountant.

## **Completing the Data Transmittal Memorandum**

### **In General**

The Transmittal Memorandum is useful in (a) gathering the requisite data together in a convenient format and (b) allowing the data-entry to be a clerical function. The goal of these Work-Products is to allow the database and the computer to accomplish all discrimination-type functions, regardless of variations with plan, employer, benefits, purpose, etc.

Questions relative the management of [www.awpse.com](http://www.awpse.com), once the Username/Password has been entered are dealt with as a website matter. Also, see the online book titled *Discrimination Text* posted at the *Discrimination Subsite*.

### **Addressees**

Few issues with addressees are worthy of mention. However (a) the Addressee Number 1 is reserved for the Engager of the Risk Manager/Actuary, (b) the Addressee Number 2 is reserved for the one who actually is responsible for the data entering, (c) Addressee Number 3 is the significant other (usually the Plan Sponsor), (d) it is common that all three addressees are taken with vendors only and (e) the Work-Product is emailed to that address belonging to the addressee with the E-Code.

ID codes are five-place (R0003, e.g.) where (a) E is Eligible User, (b) R is risk manager, broker, consultant, etc., (c) T is TPA, (d) P is Plan Sponsor, (e) A is accountant and (f) I is insurer or HMO.

### **Plan and Employer Data**

It is sufficient in the Plan Section to know that the Employer is one that participates in the subject Plan and identify it with either an informal designation (XYZ, e.g.) or a more formal designation (last four digits of the EIN, or the entire nine digits if preferred) or even both. That the Employer shares the Plan with another participating Employer is shown in the Valuation Section. It is not need for discrimination purposes to know that the Employer is or is not the Plan Sponsor. The organizational structure of the Employer is useful information for advisory/consulting purposes.

The Plan Name and DOL Number is needed. The Plan Designation is helpful but is not required. Whether the discrimination is for a medical reimbursement, cafeteria plan, e.g., is needful.

The isolation of those instances where the plan permits ad hoc discrimination (by eligibility, benefits, contributions, tenure or compensation) is set forth in this Section.

### **Valuation Data**

Test Year may be either Plan Year Calendar year but Plan Year will be typically the more convenient. For privacy reasons, the suppression of the Prohibited Employee data will often be suppressed. A most important parameter is whether the named Employer shares the Plan under discrimination testing with a controlled, affiliated employer.

The Concentration Tests of the Cafeteria Plan and also the DCAP each require a definition of highly compensated. The annualized compensation needed thereto is shown as a parameter adjusted for the appropriate inflation-indexing as provided by the Code.

### **Database**

The Database is in four parts: (a) participants in the subject Plan who are employees of a controlled/affiliated employer of the subject Employer, (b) employees of the subject Employer who are not participants in the subject Plan, (c) participants in the subject Plan who are not employees of the subject Employer, (d) participant-employees who are in the prohibited class and (e) participant-employees who are in the non-prohibited class. Access to prohibited status is gained by being a shareholder or an officer.

The likelihood of a non-employee being a participant is common enough; the question is: what if such non-employee is also a more-than-10% shareholder? Because such situation is so rare, this work-product (a) makes note of it as a remote possibility and (b) recommends that it be handled as a manual adjustment thereto. A more-than-10% shareholder who is not a plan participant is treated as a non-event.

Examples of being an employee non-participant for a statutory reason are: age, newly-employed, seasonal, part-time, under a union contract or non-resident alien-worker. If the plan is limited to salaried employees, an hourly worker would be an employee non-participant because of plan provisions. Employee opt-out is an elective opt-out. A qualified benefit is one with the tax advantages of IRC Section 105(a).

If an employee is in the Database as a 6% Shareholder and his spouse (not an employee) owns in her name 5%, the shareholding attributable to the employee is 11%. This attribution question will not arise when the shares are jointly- owned.

## **Specific Data Considerations**

### **Single v. Multiple Employers**

Where more than a single affiliate/controlled share the same plan, such employers are to be treated as a single employer for testing purposes. Affiliated/controlled employers that do not participate in the same plan that is being tested, have no impact on the testing protocol.

### **Single v. Multiple Plans**

The discrimination test is made with respect to a particular plan, defined as one with a unique DOL number. Employers that are affiliated/controlled are free to separate or combine plan(s) by amending them and reassigning DOL numbers in order to improve the discrimination results. This process is called aggregating or disaggregating.

## Attachment A

### Nondiscriminatory Classification Table

Non-HCI Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage	Non-HCI Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage
0-60	50.00	40.00	80	35.00	25.00
61	49.25	39.25	81	34.25	24.25
62	48.50	38.50	82	33.50	23.50
63	47.75	37.75	83	32.75	22.75
64	47.00	37.00	84	32.00	22.00
65	46.25	36.25	85	31.25	21.25
66	45.50	33.50	86	30.50	20.50
67	44.75	34.75	87	29.75	20.00
68	44.00	34.00	88	29.00	20.00
69	43.25	33.25	89	28.25	20.00
70	42.50	32.50	90	27.50	20.00
71	41.75	31.75	91	26.75	20.00
72	41.00	31.00	92	26.00	20.00
73	40.25	30.25	93	25.25	20.00
74	39.50	29.50	94	24.50	20.00
75	38.75	28.75	95	23.75	20.00
76	38.00	28.00	96	23.00	20.00
77	37.25	27.25	97	22.25	20.00
78	36.50	26.50	98	21.50	20.00
79	35.75	25.75	99	20.75	20.00