

## Cafeteria Plan Eligibility: S-Corporation Owners

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National Specialty Practices



**Questions:** We are organized as an S-Corporation and have heard there are special rules concerning who can participate in a Code Section 125 cafeteria plan (Section 125 plan). Can we sponsor a Section 125 plan? If so, what are the special rules about who can participate in such a plan? What would happen if we let an ineligible individual participate in the Section 125 plan?

### Summary:

An S-Corporation (S-Corp) is an eligible employer that can sponsor a Section 125 plan for its **employees**. The proposed regulations under Internal Revenue Code (Code) Section 125 (and employers may rely on the proposed regulations) provide that only employees can participate in Section 125 plans. More than 2% owners of an S-Corp are considered to be self-employed individuals and not employees. Therefore, greater than 2% owners of an S-Corp cannot participate in the Section 125 plan even if they work for the S-Corp. However, owners who own 2% or less of the S-Corp and work for the S-Corp can participate in the Section 125 plan.

Also certain family members of a more than 2% owner in an S-Corp cannot participate. In the detail below we go into these rules more fully and also cover sole-proprietorships, partnerships, and limited liability companies (LLCs) that are taxed as partnerships.

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#### **Detail:**

Any employer with employees subject to U.S. income taxes can sponsor a Section 125 plan. A Section 125 plan is defined as (i) a written plan where participants can choose between cash and one or more qualified (tax-favored) benefits under which (ii) all participants are employees.<sup>1</sup> Proposed regulations expressly state that self-employed individuals are not considered employees and cannot participate in a Section 125 Plan.<sup>2</sup>

#### **A. Self-employed Individuals**

For purposes of the Code Section 125 rules, self-employed individuals include: sole proprietors, partners in a partnership, directors serving on a corporation’s board of directors, and more than 2% shareholders of an S-Corp.<sup>3</sup> Self-employed individuals also include “members” of LLCs that elect to be taxed as partnerships (and most LLCs elect to be taxed as partnerships).<sup>4</sup> Similarly, limited liability partnerships (LLPs) are by definition partnerships and thus their partners are considered self-employed individuals for purposes of the Code Section 125 rules as well.

The regulations have a special dual status rule that permits board members who are also employees of a company to participate in the Section 125 plan but only in their capacity as employees and not as directors.<sup>5</sup> The dual status rule does not apply to more than 2% owners of an S-Corp.<sup>6</sup>

#### **B. Why the Rules are Different for Self-employed Owners**

You might wonder why there would be special rules for self-employed owners excluding them from participating in Section 125 plans. The answer is derived from the way self-employed individuals are taxed. Under IRS rules, self-employed persons can take an above-the-line deduction for amounts paid during the year for medical premiums.<sup>7</sup> The net effect of taking that deduction essentially puts self-employed individuals in the same place as they would have been if they had been able to make pre-tax contributions through a Section 125 plan. So, allowing self-employed individuals to participate in a Section 125 plan would allow them to double-dip.

#### **C. Companies Whose Owners Are Self-employed Can Sponsor a Section 125 Plan**

Even though self-employed individuals cannot participate in a Section 125 plan, it is important to remember that partnerships, S-Corporations, LLCs and LLPs can still sponsor a Section 125 plan for their employees.<sup>8</sup> To avoid inadvertent participation in the Section 125 plan by ineligible employees, those doing payrolls and administering the Section 125 plan must take care to understand the special rule for self-employed individuals.



#### ***D. Family members of Self-employed Individuals***

Spouses and family members of sole proprietors and partners can participate in the Section 125 plan sponsored by the employer so long as they are bona fide employees (and are not considered self-employed individuals themselves).

Spouses and certain family members of more than 2% owners of an S-Corp, however, cannot participate. The proposed regulations incorporate the definition of a more than a 2% shareholder from Code Section 1372(b) which then includes the stock attribution rules of Code Section 318.

Code Section 318, in turn, provides that an individual will be deemed to own the S-Corp stock of the individual's spouse (other than a spouse who is legally separated

from the individual under a decree of divorce or separate maintenance) as well as the stock of the individual's children, grandchildren and parents. The proposed regulations provide the following example:

(i) Employer K, an S corporation, maintains a cafeteria plan for its employees (other than 2-percent shareholders of an S corporation). Employer K's taxable year and the plan year are the calendar year. On January 1, 2009, individual Z owns 5 percent of the outstanding stock in Employer K. Y, who owns no stock in Employer K, is married to Z. Y and Z are employees of Employer K. Z is a 2-percent shareholder in Employer K (as defined in section 1372(b)). Y is also a 2-percent shareholder in Employer K by operation of the attribution rules in section 318(a)(1)(A)(i).<sup>9</sup>

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### **E. S-Corp Owner Sells His/Her Stock**

The incorporation of Code Section 1372(b) into the proposed regulations also means that an individual who owns more than 2% of an S-Corp (or is deemed to own more than 2% of a S-Corp through family attribution) will be considered to own that stock for the entire taxable year even if the stock is sold during that year. The proposed regulations continue with the example above to illustrate the rules of a stock sale.

(ii) On July 15, 2009, Z sells all his stock in Employer K to an unrelated third party, and ceases to be a 2-percent shareholder. Y and Z continue to work as employees of Employer K during the entire 2009 calendar year. Y and Z are ineligible to participate in Employer K's cafeteria plan for the 2009 plan year.

### **F. Consequences of Including an Ineligible Employee in a Section 125 Plan**

If an ineligible employee is permitted to participate in a Section 125 plan that would be a failure to operate the plan in accordance with Code Section 125 and the regulations

(and most likely the plan document which should contain a requirement that only employees are eligible to participate). The result may be a total disqualification of the Section 125 plan, resulting in taxation of the "pretax" benefits to all participants.<sup>10</sup> At a minimum, it would result in taxation to the ineligible participants.<sup>11</sup>

### **G. Same Rules Apply to HRAs**

Just like with Section 125 plans, only employees can participate in Health Reimbursement Arrangements (HRAs).<sup>12</sup> Self-employed individuals are not employees for this purpose and cannot participate in HRAs.<sup>13</sup>

### **H. C Corporation Shareholders Can Participate in Section 125 Plans**

Shareholder owners of C Corporations are not considered to be self-employed individuals. Therefore, any shareholder owners who work as employees for a C Corporation can participate in the Section 125 just like any other employee.

## **Conclusion:**

U.S. employers of all types can sponsor a Section 125 plan and permit their employees to pay for qualified benefits on a pretax basis. However, if the employer's organizational structure is such that the owners are considered to be self-employed individuals, then the owners cannot participate in the Section 125 plan. Adverse tax consequences will occur if any self-employed individual is permitted to participate in the Section 125 plan.

### **References**

- 1 - Internal Revenue Code Section 125(d).
- 2 - Prop. Treas. Reg. §1.125(g)(2).
- 3 - Prop. Treas. Reg. §1.125(g)(2)(i).
- 4 - For federal tax purposes, LLCs are permitted to elect to be taxed as partnerships or corporations.
- 5 - Prop. Treas. Reg. §1.125-1(g)(2)(iii).
- 6 - Prop. Treas. Reg. §1.125-1(g)(2)(iii).
- 7 - See [https://www.irs.gov/publications/p535#en\\_US\\_2017\\_publink1000208843](https://www.irs.gov/publications/p535#en_US_2017_publink1000208843) and <https://www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues>.
- 8 - Prop. Treas. Reg. §1.125-1(g)(2).
- 9 - Prop. Treas. Reg. §1.125-1(g)(2)(iv) Example 1 (ii).
- 10 - Prop. Treas. Reg. §1.125-1(c)(7).
- 11 - See Private Letter Ruling 9546018 (Aug. 18, 1995) (IRS addressed the impact of providing tax-favored benefits to an individual who was not an employee under common law rules stating that the employer should report the value of the benefits as taxable income).
- 12 - See Notice 2002-45, 2002 CB 93, 06/26/2002, IRC Sec(s). 105, Part III.
- 13 - Notice 2002-45, 2002 CB 93, 06/26/2002, IRC Sec(s). 105, Part III.



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