5. Self-Employed Individuals and Individuals Who Are Not Spouses, Children Under Age 27, or Tax Dependents

Self-employed individuals (e.g., sole proprietors, partners, and more-than-2% Subchapter S corporation shareholders) may not participate in an HRA on a tax-favored basis. As stated in the 2002 IRS guidance, “The term ‘employee’ does not include a self-employed individual as defined in [Code] §401(c). See [Code] §105(g).”[14]

Certain Family Members of More-Than-2% Subchapter S Corporation Shareholders May Not Be HRA Participants. Self-employed individuals, including partners in a partnership and more-than-2% shareholders in an S corporation, cannot participate in an HRA on a tax-favored basis. A sole proprietor, partnership, or an S corporation can have an HRA for its common-law employees; however, in the case of an S corporation, neither the employee-spouse of the more-than-2% shareholder, nor the more-than-2% shareholder's children, parents, and grandparents, can participate in the S corporation's HRA. This is because of the ownership attribution rules contained in Code §318.*

* *See* Code §1372(b) (Code §318 attribution rules apply when determining who is a more-than-2% Subchapter S corporation shareholder) and Code §318(a)(1). Note that the definition of “children, grandchildren, and parents” does not impose any age restriction. Consequently, a 50-year-old man would be deemed to own an interest held by his 28-year-old daughter and his 75-year-old mother.

Some partnerships have apparently attempted to circumvent the restriction on tax-favored partner participation in HRAs and certain other employee benefit plans by claiming that their partners are employees of a non-corporate entity that is wholly owned by the partnership. Generally, the Code disregards such entities—it does not treat them as separate from their owner—but one of the regulations refining that general rule states that disregarded entities will be treated as corporations for employment tax purposes.[14.1]That recognition of separate status is later rescinded for self-employment taxes, but some taxpayers have argued that the rescission applies only to sole proprietorships and not to partners.[14.2] To clarify the regulations and assure that the same rules apply to sole proprietors and partners, the IRS amended the self-employment tax regulations in May 2016 to explicitly provide that a non-corporate entity that is wholly owned by a partnership will not be treated as a corporation for self-employment tax purposes. Instead, the entity will be disregarded, and partners of the partnership owning the entity will be subject to the same self-employment tax rules as partners in entities that do not own disregarded entities.[14.3] While the amendment to the regulation clearly seeks to reinforce the restrictions on partner participation in benefit plans, the preamble to the regulations suggests that the IRS is not entirely opposed to changing the rule for some individuals who are called partners but who lack the usual attributes of partners and have a relationship to the partnership that is more like employment. To help it determine whether some tiered partnership situations might justify treating some partners as employees, the IRS has invited comment on the issue, and on what effect employee treatment might have on employee benefits plans and employment taxes.

The fact that self-employed individuals cannot be participants does not appear to prevent them from being beneficiaries of another individual's HRA if they happen to also be the spouse, child under age 27, or tax dependent of an individual that can and does participate in an HRA. This should be equally true of individuals who are treated as self-employed because of the family member attribution rules noted above.

Example: Owner by Attribution May Be Covered as a Beneficiary. Donna works in the office of FamCo, an S corporation owned in part by her parents, who are both more-than-2% shareholders of FamCo. Donna does not own any shares of FamCo, but she cannot participate in FamCo's HRA because, under the ownership attribution rules in Code §318, Donna is considered a more-than-2% owner.

Donna marries Todd, a non-owner employee of FamCo who does participate in FamCo's HRA. Even though Donna cannot have an HRA account of her own, her attributed ownership will not adversely affect her new spouse's ability to participate.* As Todd's spouse, Donna's qualifying medical expenses should be reimbursable from Todd's HRA (assuming the HRA reimburses the expenses of a participant's spouse) regardless of Donna's attributed ownership.

* *See* Code §318(a)(5) (precluding re-attribution).