B. Which Individuals Are Ineligible to Participate in a Cafeteria Plan?

Anyone who does not fall within one of the categories described in subsection A is ineligible to participate in a cafeteria plan.

> **What Are the Consequences of Including an Ineligible Individual in the Cafeteria Plan?** Allowing ineligible individuals to participate in a cafeteria plan could cause the entire plan to be disqualified, resulting in taxation to all participants.* At a minimum, the ineligible individuals would be taxed on their pre-tax benefits.†

* *See* Prop. Treas. Reg. §1.125-1(c)(7).

† In Private Letter Ruling 9546018 (Aug. 18, 1995), the IRS addressed the potential impact of providing tax-favored benefits to an individual who was not an "employee" under a common-law facts-and-circumstances test, ruling that the employer should report on IRS Form 1099 the value of any benefits made available to the individual under the cafeteria plan (using the rationale in now-withdrawn Prop. Treas. Reg. §1.125-1, Q/A-11 (1984) (withdrawn) to determine the value of benefits).

1. Spouses and Dependents Cannot Participate in the Employee's Cafeteria Plan, but Employees Can Elect Coverage for Them

Virtually all cafeteria plans and component medical and dental plans permit employees to elect coverage for their spouses and dependent children. While these individuals may not participate in a cafeteria plan (e.g., a spouse cannot sign an election form), the plan may nevertheless provide benefits for them—the IRS approves of this common plan design:

The spouse or dependents of employees may not be participants in a cafeteria plan unless they are also employees. However, a cafeteria plan may provide benefits to spouses and dependents of participants. For example, although an employee's spouse may benefit from the employee's election of accident and health insurance coverage or of coverage through a dependent care assistance program, the spouse may not participate in a cafeteria plan (that is, the spouse may not be given the opportunity to elect or purchase benefits offered by the plan).[24]

Note that in order to avoid penalties under health care reform's employer shared responsibility (play or pay) provisions, employers may be required to extend coverage to employees' dependent children.[24.1] While this does not require pre-tax participation in a cafeteria plan, allowing such participation on a pre-tax basis simplifies health plan administration.

> **Who Is a Spouse?** As used in this discussion and for federal tax purposes, the term "spouse" includes all legally married same-sex or opposite-sex spouses, regardless of state of residence. Individuals in registered domestic partnerships, civil unions, or similar relationships are not considered spouses for this purpose. The rules for determining who is a spouse are discussed in Section XI.

An employee's spouse does not participate in a cafeteria plan merely because the spouse has the right, upon the employee's death, to elect among settlement or distribution options with respect to the deceased employee's benefits under a 401(k) plan, HSA, or group term life insurance policy offered through the cafeteria plan.[25]

What If an Employee Elects Coverage for Someone Who Turns Out Not to Be a Spouse, Child Under Age 27, or Tax Dependent? A cafeteria plan can only offer pre-tax benefits, like health and dental benefits, for employees, spouses, children who are under age 27 as of the end of the taxable year, and individuals who otherwise qualify as an employee's tax dependents for health coverage purposes. A cafeteria plan could be disqualified if it offers pre-tax health coverage for other individuals (e.g., a 27-year-old child or domestic partner who does not otherwise qualify as a dependent for such purposes). See Section X regarding offering such coverage as a taxable benefit under a cafeteria plan.

As discussed in more detail below, self-employed individuals, partners, and more-than-2% shareholders of Subchapter S corporations cannot participate in a cafeteria plan. However, it does not appear that these individuals are prevented from receiving cafeteria plan benefits as a spouse, child under age 27, or tax dependent for health coverage purposes of someone else who can and does participate in a cafeteria plan. This should be equally true of a spouse, child under age 27, or tax dependent who is treated as self-employed, a partner, or a more-than-2% S-corporation shareholder because of ownership attribution rules discussed in subsection D.

Example: Owner by Attribution May Receive Cafeteria Plan Benefits as Spouse. Donna works for FamCo, an S corporation owned in part by her parents, who are both more-than-2% shareholders of FamCo. Famco offers major medical coverage and a health FSA under its cafeteria plan. Donna does not own any shares of FamCo, but she cannot participate in its cafeteria plan because she is considered a more-than-2% shareholder under the ownership attribution rules in Code §318 (see subsection B.4).

Donna marries Todd, a non-owner employee of FamCo who has elected major medical and health FSA coverage under FamCo's cafeteria plan. Even though Donna cannot participate in FamCo's cafeteria plan, her attributed ownership will not adversely affect her new spouse's ability to participate.* And as Todd's spouse, Donna may benefit from Todd's elections of coverage under FamCo's cafeteria plan, notwithstanding her attributed ownership. This means that Todd can elect major medical coverage for Donna and that her eligible medical expenses should be reimbursable from his health FSA (assuming that the health FSA reimburses the expenses of a participant's spouse).

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

2. Self-Employed Individuals Cannot Participate (but Their Employee-Spouses and Other Family Members Who Are Employees May Participate, in Some Cases)

Self-employed individuals are not considered to be employees and cannot participate in a cafeteria plan, whether set up by themselves or by another entity.[26] As discussed in Section VIII, however, self-employed individuals (or their business entities) may sponsor a cafeteria plan for their employees.[27]

The 2007 proposed regulations expressly provide that "the term *employee* does not…include a self-employed individual or a [more-than-2%] shareholder of an S

corporation."[28] As examples of self-employed individuals, the regulations list a sole proprietor, a partner in a partnership, and a director serving on a corporation's board of directors who does not otherwise provide services to the corporation as an employee. The regulations also provide a special rule for certain "dual-status" individuals. Under the dual-status rule, an individual who is an employee of an employer and also provides services to the employer as a director or independent contractor (e.g., an individual who is both an employee and a director of a subchapter C corporation) is eligible to participate in the employer's cafeteria plan, although solely in his or her capacity as an employee. However, the dual-status rule does not apply to partners or more-than-2% shareholders in a subchapter S corporation.[29]

An individual may also be treated as self-employed with respect to one business or organization and as a common-law employee of another employer. For example, an attorney who is a common-law employee of a corporation (e.g., in-house counsel) might also maintain an office in which he or she practices law as a self-employed individual.

Can the Employee-Spouse of a Self-Employed Individual Participate in a Cafeteria Plan? Yes, in some cases. A sole proprietor (the employer-spouse) may sponsor a cafeteria plan under which his or her spouse (the employee-spouse), who is an employee of the sole proprietorship, can participate. The employee-spouse can fill out the election form and elect health insurance coverage for the whole family, including for the employer-spouse.*

However, two requirements must be met in order for the employee-spouse to participate in the cafeteria plan (and thus in order for the employer-spouse to receive "indirect" coverage). First, the employee-spouse must be a bona fide employee.† Second, the employee-spouse must not be deemed to be self-employed (i.e., the employee-spouse must not have invested his or her own assets in the business and must not be an owner under state marital or community property laws). If the IRS determines that the self-employed individual's spouse is self-employed, then the spouse cannot participate in the cafeteria plan and the self-employed individual cannot receive coverage—there would be adverse tax consequences. See below for details. Note that a different rule and result apply to more-than-2% shareholders of Subchapter S corporations.

Caution. As a practical matter, allowing an employee-spouse to participate in a cafeteria plan may cause the plan to fail nondiscrimination testing, especially the Key Employee Concentration Test—see Section XXIX for details.‡

* Code §318 rules do not apply to make the spouse a self-employed individual by attribution. See subsection D.

† *See, e.g.*, *Speltz v. Comm'r*, T.C. Summ. Op. 2006-25 (2006) (finding bona fide employer-employee relationship between sole proprietor and spouse);*Haeder v. Comm'r*, T.C. Memo 2001-7 (2001) (concluding that sole proprietor's spouse was not a bona fide employee).

‡ While the attribution rules under Code §318 do not apply for purposes of determining whether someone is self-employed (unless the business is a Subchapter S corporation—see subsection B.4), they do apply for purposes of running the Key Employee Concentration Test. See subsection D and Section XXIX for details.

Who Is a Spouse? As used in this discussion and for federal tax purposes, the term "spouse" includes all legally married same-sex or opposite-sex spouses, regardless of state of residence. Individuals in registered domestic partnerships, civil unions, or similar relationships are not considered spouses for this purpose. The rules for determining who is a spouse are discussed in Section XI.

IRS guidelines address the issue of an employer-spouse providing family accident and health coverage for an employee-spouse.[30] The guidelines conclude that if the employee-spouse is a bona fide employee and is not determined to be self-employed, then the cost of the accident and health coverage is deductible by the employer-spouse. In addition, the cost of such coverage and medical reimbursements is excludable from the gross income of the employee-spouse. Critical factors include whether the employee-spouse works more than nominally, invests his or her own assets in the business, and has an ownership interest.

If the IRS determines that the spouse is self-employed, however, then the spouse cannot participate. It provides the following guidance for making that determination:

A spouse may be a self-employed individual engaged in the trade or business as a joint owner, co-owner, or partner. For example, a significant investment of the spouse's separate funds in (or significant co-ownership or joint ownership of) the business assets may support a finding that the spouse is self-employed in the business rather than an employee…Marital property or community property laws that give a spouse an ownership interest in a business operated by a self-employed individual may be relevant, but not necessarily conclusive, for determining whether the spouse is also self-employed in that business. Note that state laws that impose on one family member a legal obligation to support another family member are generally irrelevant in determining the tax treatment of fringe benefits.[31]

Self-Employed Insurance Deduction Rate. Although self-employed individuals cannot participate in a cafeteria plan, they may be able to deduct up to 100% of the amount paid for medical and qualified long-term care insurance for themselves, their spouses, their children who are under age 27 as of the end of the taxable year, and other individuals who qualify as their tax dependents.* A self-employed individual could also establish an HSA and could deduct the contributions to the HSA on his or her income tax return, although he or she could not contribute to the HSA through a cafeteria plan. HSAs are covered in detail in *Consumer-Driven Health Care* (Thomson Reuters/Tax & Accounting, 2004-present, updated quarterly).

* Code §162(l); IRS Publication 502 (Medical and Dental Expenses). *See also* IRS Chief Counsel Advice 201228037 (May 1, 2012) (addressing Medicare premiums of self-employed individuals).

Members of a sole proprietor's family other than a spouse who are employed by the sole proprietorship may also participate in a cafeteria plan sponsored by the sole proprietorship, provided that (a) they are bona fide employees; (b) they are not deemed to be self-employed; and (c) the cafeteria plan passes nondiscrimination testing. The sole proprietor must be able to establish that the coverage is extended to the spouse or other family member by virtue of the employment relationship, that the related person satisfies any eligibility requirements applicable under the plan (e.g., a waiting period or minimum-hours requirement), and that the value of coverage is reasonable in relation to the services rendered. Of course, whenever family members are involved in a business, the IRS is likely to carefully scrutinize the situation for any possible abuses.

Statutory non-employees, such as direct sellers and licensed real estate agents, are treated as self-employed for all federal tax purposes, including income and employment taxes.[32]Consequently, they should not be eligible to participate in a cafeteria plan.

3. Partners in a Partnership Cannot Participate (but Their Employee-Spouses and Other Family Members Who Are Employees May Participate, in Some Cases)

General partners in a general or limited partnership cannot participate in a cafeteria plan—partners are self-employed individuals and are expressly excluded under the cafeteria plan regulations.[33] However, they may be able to deduct up to 100% of the amount they have paid (or that was paid by the partnership and included in the partner's income) for medical and qualified long-term care insurance for themselves and their spouses and dependents.[34] Furthermore, both general and limited partnerships may have cafeteria plans for their employees (see Section VIII).We review general partnerships and limited partnerships separately in this subsection to discuss the eligibility of spouses, limited partners, and other employees. Also see the discussion of limited liability partnerships in subsection B.6.

Who Is a Spouse? As used in this discussion and for federal tax purposes, the term "spouse" includes all legally married same-sex or opposite-sex spouses, regardless of state of residence. Individuals in registered domestic partnerships, civil unions, or similar relationships are not considered spouses for this purpose. The rules for determining who is a spouse are discussed in Section XI.

What Happens If an Employee Becomes a Partner Midyear? Cindy is employed as an associate at Drafting, Wills & Briefs law firm, a partnership. She is invited to join the partnership and becomes a partner on July 1, 2012. Upon becoming a partner, Cindy will be ineligible to participate in the firm's calendar-year cafeteria plan.* There is no "entire-year" rule for partners as there is for more-than-2% shareholders of Subchapter S corporations (see subsection B.4), so Cindy is not ineligible for the entire year, just from the time she becomes a partner. Furthermore, if Cindy's husband is an employee at the firm, he remains eligible for the cafeteria plan to the extent that a partner's spouse can participate (see the discussion below).†

* Informal, nonbinding remarks of Kevin Knopf, Attorney-Advisor, Office of Tax Policy of the Treasury Department, Apr. 25, 2008 ECFC Annual Conference.

† Again, the rules for more-than-2% shareholders of Subchapter S corporations are different. See subsection B.4.

a. General Partnerships

As self-employed individuals, general partners in a general partnership cannot participate in a cafeteria plan.[35] Nevertheless, it may be possible for a general partner to be covered "indirectly" through an employee-spouse. Although the issue is not entirely clear, it appears that, as with sole proprietorships, a partner's spouse or other family member who is a bona fide partnership employee (and who is not deemed to be a partner—see the caution in subsection B.2)[36] may participate in the partnership's cafeteria plan.[37] An employee-spouse who is eligible to participate in the partnership's cafeteria plan could

elect family health coverage and pay for the partner-spouse's coverage on a pre-tax basis through the cafeteria plan.

b. Limited Partnerships

A limited partnership must have at least one general partner (which may be a corporation) and one or more limited partners. A general partner who is an individual is considered to be self-employed and cannot participate in a cafeteria plan.[38] The status of limited partners is more complex. Limited partners who are not employees of the partnership (e.g., passive investors) generally would be treated as self-employed individuals and could not participate in the partnership's cafeteria plan. Limited partners who are also employees of the partnership but receive guaranteed payments from the partnership (as described in Code §707(c)) may also be considered to be self-employed and thus would also be unable to participate in the partnership's cafeteria plan. However, individuals will not be considered to be self-employed solely because they are limited partners, so long as they are not entitled to any such guaranteed payments.[39] Thus, limited partners who are also employees of a limited partnership and are not entitled to guaranteed benefits can participate in the limited partnership's cafeteria plan (but only to the extent of their compensation as employees). In addition, as discussed above with respect to general partnerships, it may be possible for a general or limited partner in a limited partnership who is not eligible to participate in the partnership's cafeteria plan to be covered "indirectly" through an employee-spouse.

Plans Jointly Sponsored by Subchapter C Corporation and Partnership or Subchapter S Corporation. What if a cafeteria plan is sponsored jointly by a Subchapter C corporation and by a partnership, or is sponsored jointly by a Subchapter C corporation and by a Subchapter S corporation?* Can a partner or more-than-2% shareholder in the Subchapter S corporation who is also an employee of the Subchapter C corporation participate in the cafeteria plan, on the basis that the entities are treated as a single employer with one set of employees?

Perhaps, but the IRS may challenge the arrangement. The dual-status rule in the 2007 proposed regulations does not apply to partners or more-than-2% shareholders of Subchapter S corporations, so the IRS could take the position that the partner/more-than-2% shareholder of the Subchapter S corporation is ineligible, which may taint the plan.† It is unclear whether establishing separate cafeteria plans for the two companies would eliminate the problem. Note also that IRS regulations prohibit partners in a partnership who work for a separate entity that is not a corporation and is wholly owned by the partnership from being treated as employees of the entity.‡

* We assume here that the joint sponsors are related entities within the meaning of the controlled group rules. See subsection A and Section XXVIII.

† Prop. Treas. Reg. §1.125-1(g)(2)(iii). For details, seesubsection B.2.

‡ Temp. Treas. Reg. §301.7701-2T.

4. More-Than-2% Shareholders in a Subchapter S Corporation Cannot Participate (Nor Can Their Employee-Spouses or Certain Other Family Members Who Are Employees)

More-than-2% shareholders in a Subchapter S corporation cannot participate in a cafeteria plan. The Code treats them like partners in a partnership for benefit purposes—consequently, they are self-employed individuals and are expressly excluded under the cafeteria plan regulations.[40]

The 2007 proposed regulations refer to "2% shareholders" as defined in Code §1372(b), which in turn defines a "2% shareholder" as any person who owns (or is considered under the Code §318 attribution rules as owning) *more than 2%* of the outstanding stock of the Subchapter S corporation or stock possessing *more than 2%* of the total combined voting power of all stock of the corporation on any day of the corporation's taxable year.[41] Thus, an individual who becomes or ceases to be a more-than-2% shareholder during the course of a Subchapter S corporation's taxable year is treated as a more-than-2% shareholder for the entire year. This "entire-year" rule must be taken into account when determining the eligibility of Subchapter S shareholder-employees to participate in a cafeteria plan and has the potential to result in an individual being retroactively disqualified from participating in the plan.[42]

Like a sole proprietorship, a Subchapter S corporation can have a cafeteria plan for its common-law employees. Unlike in a sole proprietorship, however, 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 Subchapter S corporation's cafeteria plan. This is because of the ownership attribution rules contained in Code §318.[43] See subsection D for details.

Who Is a Spouse? As used in this discussion and for federal tax purposes, the term "spouse" includes all legally married same-sex or opposite-sex spouses, regardless of state of residence. Individuals in registered domestic partnerships, civil unions, or similar relationships are not considered spouses for this purpose. The rules for determining who is a spouse are discussed in Section XI.

Example: More-Than-2% Shareholders. Nina and her husband Eric are both employees of Smallco, a Subchapter S corporation. Nina also owns 5% of Smallco's outstanding stock, while Eric owns no stock in Smallco. Smallco sponsors a calendar-year cafeteria plan; the calendar year is also Smallco's taxable year. Neither Nina nor Eric can participate in Smallco's cafeteria plan because they are both more-than-2% shareholders of Smallco. (Eric is a more-than-2% shareholder because he is considered as owning Nina's stock under the ownership attribution rules that apply for this purpose.) Moreover, if Nina were to sell all of her Smallco stock on July 15, 2014, she and Eric would remain ineligible to participate in Smallco's cafeteria plan until January 1, 2015, because they are both considered to be more-than-2% shareholders for all of 2014.*

* Adapted from Prop. Treas. Reg. §1.125-1(g)(2)(iv), Example 1.

Although a more-than-2% shareholder-employee cannot participate in a cafeteria plan, he or she may be able to deduct up to 100% of the amount paid by the individual for medical

and qualified long-term care insurance for the individual, spouse, and dependents.[44] In addition, under IRS guidance issued in 2008, more-than-2% shareholder-employees may also be eligible for an above-the-line deduction for premiums for insurance that constitutes medical care that are paid or reimbursed by the Subchapter S corporation in consideration for services rendered and are included in the shareholder-employee's gross income, if the plan that provides the medical care coverage is "established by" the corporation as defined in the guidance.[45] (Additional requirements must also be met.) Note that it is unclear whether these more-than-2% shareholder arrangements would create an after-tax employer-payment plan within the meaning of agency guidance under which certain arrangements that pay or reimburse individual major medical insurance premiums will subject the employer to potential penalties for failure to comply with health care reform's mandates.[45.1] However, the IRS has indicated that pending further guidance, excise taxes will not be asserted as a result of a more-than-2% shareholder arrangement's failure to satisfy health care reform's mandates, and that taxpayers may continue to rely on the 2008 guidance with regard to tax treatment of the arrangements described therein unless and until further guidance is issued.[45.2] This relief does not apply to reimbursements of individual health insurance premiums with respect to employees who are not more-than-2% shareholders, although health care reform's mandates do not apply to an arrangement that reimburses premiums for only a single employee (whether or not that employee is a more-than-2% shareholder).[45.3]

Caution: Shareholders in a Subchapter C Corporation. Although shareholders in a Subchapter C corporation are not precluded from participating in a cafeteria plan (unlike a more-than-2% shareholder in a Subchapter S corporation), the Code's nondiscrimination rules may prohibit them from taking full advantage of the pre-tax benefits. For example, the Key Employee Concentration Test for cafeteria plans includes more-than-5% owners and more-than-1% owners with annual compensation in excess of $150,000 (among others) in the prohibited group for testing purposes; the participation of shareholders may cause the cafeteria plan to fail the test. See Section XXIX.

5. Outside Directors Generally Cannot Participate

Directors of corporations who are not also employees of the company (outside directors) cannot participate in the company cafeteria plan because they are not employees.[46] Outside directors who receive fees for their services generally would be treated the same as self-employed individuals.

What If a Director Is Also an Employee? Tania is an employee of Widgets, Inc. and is also one of its directors. Widgets is a Subchapter C corporation with a cafeteria plan. Tania's annual compensation as an employee of Widgets is $50,000; she also receives $3,000 in directors' fees each year. Tania can participate in the Widgets cafeteria plan in her capacity as an employee and can elect to make salary reductions from her employee compensation for benefits under the plan. However, she cannot elect to reduce her directors' fees for benefits under the plan.* See the discussion of dual-status individuals in subsection B.2.

* Adapted from Prop. Treas. Reg. §1.125-1(g)(2)(iv), Example 2.

Note that directors may also be owners of a corporation, in which case the rules regarding ownership attribution (see subsection D)and more-than-2% shareholders of a Subchapter

S corporation (see subsection B.4) could also preclude them and their family members from participating in the cafeteria plan.

6. Members of LLCs and Partners in LLPs Generally Cannot Participate

Many partnerships and sole proprietorships attempt to limit personal liability by taking steps to become limited liability companies (LLCs). These entities are owned by one or more "members." No IRS guidance specifically addresses the status of LLC members for purposes of cafeteria plan participation.

At the state level, an LLC is a separate legal entity, similar in many ways to a corporation. At the federal level, an LLC can elect to be taxed as a partnership or can elect to be taxed as a corporation (in which case its members would draw salary as corporate officers). For federal tax purposes, most LLCs are treated as partnerships unless they elect to be treated as a corporation or are "disregarded" as discussed below.[47] (See subsection B.3 for a discussion of the rules that apply to partnerships.) Thus, non-employee members of LLCs generally are treated the same as self-employed individuals. Accordingly, such individuals generally cannot participate in a cafeteria plan.

> **What If an LLC Member Is Treated as an Employee for Tax Purposes?** Some LLC members may be treated as employees for certain federal tax purposes (e.g., Form W-2reporting) and may be treated as self-employed in other cases. * To the extent that individual members of an LLC are treated as partners in a partnership or as self-employed, they clearly may not participate in a cafeteria plan—it is unclear whether other LLC members may do so. For example, an individual with only a profits interest in the LLC (i.e., an interest granted only in the LLC's future profits, not in existing capital) arguably should not be treated as a partner. Without further IRS guidance, however, we recommend not allowing any LLC member to participate in a cafeteria plan, unless the LLC has elected to be taxed as a Subchapter C corporation.

* *See, e.g.*, Treas. Reg. §301.7701-3(b)(1) (an LLC with only one member will be treated as a sole proprietorship unless association status is elected).

Similarly, a partnership can be established as a limited liability partnership (LLP), which helps to limit the liability of partners for certain purposes. LLPs are almost always taxed as partnerships and therefore are subject to the same rules with respect to cafeteria plan eligibility as general partnerships (see subsection B.3). Thus, partners in an LLP are treated as self-employed and cannot participate in a cafeteria plan sponsored by the partnership.

Some LLCs are established with a corporation as the sole owner (e.g., to hold a particular piece of property or to operate a separate line of business). For tax purposes, such an LLC is "disregarded" as a separate entity and treated as a mere division of the parent unless otherwise elected by the LLC.[47.1] Therefore, employees of a disregarded LLC owned by a C corporation should be eligible to participate in a cafeteria plan, even if the employees might also be owners of the C corporation.

Both LLCs and LLPs can sponsor cafeteria plans for their common-law employees. See Section VIII regarding which employers can sponsor cafeteria plans.