



COMPLIANCE SNAPSHOT

Section 125: Eligibility Rules

A Section 125 plan, or a cafeteria plan, allows employees to pay for certain benefits on a pre-tax basis. In order to receive these tax advantages, a cafeteria plan must comply with the rules of Internal Revenue Code (Code) Section 125 and related regulations. This Compliance Snapshot explains the rules regarding eligibility and participation in a Section 125 cafeteria plan.

Who Can Sponsor?

Any employer may sponsor a Section 125 plan for its eligible employees. This includes private sector businesses, including corporations, partnerships, limited liability companies and nonprofit organizations, as well as public sector employers.

Who Can Participate?

As a general rule, an employer may allow **any common-law employee** to participate in its Section 125 plan. In addition, former common law employees (for example, COBRA participants receiving severance pay) and leased employees, as defined under Code Section 414(n), may participate in an employer's Section 125 plan.

Who Cannot Participate?

The Section 125 rules specifically prohibit the following individuals from participating (although they can sponsor a Section 125 plan for their employees):

- Self-employed individuals;
- Partners within a partnership;
- More than 2% shareholders in a subchapter S corporation (S corporation); and
- Directors of corporations who are not also employees.

In addition, under the ownership attribution rules of Code Section 318, the spouse, children, parents and grandparents of a more than 2% shareholder cannot participate in the S corporation's Section 125 plan.

Spouses and Dependents

- Only employees are allowed to make elections under a Section 125 plan, but a Section 125 plan may provide non-taxable benefits for an employee's spouse, dependent child who is under age 27 or is a tax dependent.
- A "spouse" means an employee's spouse as defined under federal tax law, including same-sex and opposite-sex spouses. This definition, however, does not include domestic partners.

"Dual Status" Individuals

The Section 125 regulations provide rules for individuals moving between employee and non-employee status. If an individual is an employee of an employer and also provides services to that employer as an independent contractor or director (for example, an individual is both a director and an employee of a C corporation), the individual is eligible to participate in that employer's cafeteria plan **solely in their capacity as an employee**. This rule does not apply to partners or to 2% shareholders of an S corporation.

Provided to you by **AssuredPartners**

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