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Prop. Reg. Section 1.125-1(g)(2)

Cafeteria plans; general rules.

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(g) *Employee for purposes of section 125 --(1) Current employees, former employees.* The term employee includes any current or former employee (including any laid-off employee or retired employee) of the employer. See paragraph (g)(3) of this section concerning limits on participation by former employees. Specifically, the term *employee* includes the following--

(i) Common law employee;

(ii) Leased employee described in section 414(n);

(iii) Full-time life insurance salesman (as defined in section 7701(a)(20)); and

(iv) A current employee or former employee described in paragraphs (g)(1)(i) through (iii) of this section.



(2) *Self-employed individual not an employee --(i) In general.* The term *employee* does not include a self-employed individual or a 2-percent shareholder of an S corporation, as defined in paragraph (g)(2)(ii) of this subsection. For example, a sole proprietor, a partner in a partnership, or a director solely serving on a corporation's board of directors (and not otherwise providing services to the corporation as an employee) is not an employee for purposes of section 125, and thus is not permitted to participate in a cafeteria plan. However, a sole proprietor may sponsor a cafeteria plan covering the sole proprietor's employees (but not the sole proprietor). Similarly, a partnership or S corporation may sponsor a cafeteria plan covering employees (but not a partner or 2-percent shareholder of an S corporation).

(ii) *Two percent shareholder of an S corporation.* A 2-percent shareholder of an S corporation has the meaning set forth in section 1372(b).

(iii) *Certain dual status individuals.* 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 corp), the individual is eligible to participate in that employer's cafeteria plan solely in his or her capacity as an employee. This rule does not apply to partners or to 2-percent shareholders of an S corporation.

(iv) *Examples.* The following examples illustrate the rules in paragraphs (g)(2)(ii) and (g)(2)(iii) of this section:

Example 1.

Two-percent shareholders of an S corporation. (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).

(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.

Example 2.

Director and employee. T is an employee and also a director of Employer L, a C corp that sponsors a cafeteria plan. The cafeteria plan allows only employees of Employer L to participate in the cafeteria plan. T's annual compensation as an employee is \$ 50,000; T is also paid \$ 3,000 annually in director's fees. T makes a timely election to salary reduce \$ 5,000 from his employee compensation for dependent care benefits. T makes no election with respect to his compensation as a director. T may participate in the cafeteria plan in his capacity as an employee of Employer L.

(3) *Limits on participation by former employees.* Although former employees are treated as employees, a cafeteria plan may not be established or maintained predominantly for the benefit of former employees of the employer. Such a plan is not a cafeteria plan.

(4) *No participation by the spouse or dependent of an employee --(i) Benefits allowed to participant's spouse or dependents but not participation.* 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).

(ii) *Certain elections after employee's death.* An employee's spouse is not a participant in a cafeteria plan merely because the spouse has the right, upon the death of the employee, to elect among various settlement options or to elect among permissible distribution options with respect to the deceased employee's benefits through a section 401(k) plan, Health Savings Account, or certain group-term life insurance offered through the cafeteria plan. See § 54.4980B-2, Q & A 8 and § 54.4980B-4, Q & A-1 of this chapter on COBRA rights of a participant's spouse or dependents.

(5) *Employees of certain controlled groups.* All employees who are treated as employed by a single employer under section 414(b), (c), (m), or (o) are treated as employed by a single employer for purposes of section 125. Section 125(g)(4); section 414(t).

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