

## **SIMPLE Cafeteria Plans Available In 2011; Owners Can Only Be Covered In C Corporations.**

The health reform law includes a provision creating “simple cafeteria plans” for small businesses, effective for years beginning in 2011. Simple cafeteria plans will be treated as meeting nondiscrimination requirements applicable to cafeteria plans if they meet minimum eligibility, participation, and contribution requirements. This safe harbor covers the regular cafeteria plan nondiscrimination requirement of section 125(b), the 25% concentration test, and the nondiscrimination requirements of 79(d), 105(h), and 129(d) applicable to group term life insurance, a self-insured health insurance or medical reimbursement plan, and dependent care assistance benefits (child care).

Unfortunately, many of the changes proposed in the sample legislation drafted by the Small Business Council of America were not adopted. Where a business wants to avoid the 25% concentration test and contribute for owner-employees, only a regular C corporation can do so. Long term care insurance is still a prohibited benefit. Under 125(h)(3), a “qualified benefit” does not include any qualified health plan as defined in section 1301(a) of the Patient Protection and Affordable Care Act or “PPACA”) offered through an Exchange unless the employer is a qualified employer under 1312(f)(2) of PPACA offering the employee the opportunity to enroll through such an Exchange in a qualified health plan in a group market.

The SIMPLE rules give a free pass on 125(b) and 105(h) testing for nondiscrimination. Therefore, the SIMPLE cafeteria plan should pass testing if it offers all participants eligibility under the SIMPLE rules and offers the same benefits to those similarly situated. Under 105(h), only the benefits offered are tested. All benefits provided for highly compensated employees and their dependents are also offered for all other participants and their dependents. Reg. §1.105-11(c)(3)(i) provides: “This test is applied to the benefits subject to reimbursement under the plan rather than the actual benefit payments or claims under the plan.” Similarly, Reg. §1.105-11(c)(3)(ii) states: “The determination of whether plan benefits discriminate in operation in favor of highly compensated individuals is made on the basis of the facts and circumstances of each case. A plan is not considered discriminatory merely because highly compensated individuals participating in the plan utilize a broad range of plan benefits to a greater extent than do other employees participating in the plan.”

**100 Or Fewer Employees.** An employer is eligible to implement a simple cafeteria plan if, during either of the preceding two years, the business employed 100 or fewer employees on average (based on business days). For a new business, eligibility is based on the number of employees the business is reasonably expected to employ. Businesses maintaining a simple cafeteria plan that grow beyond 100 employees can continue to maintain the simple arrangement until they have exceeded an average of 200 or more employees during a preceding year. Employees include leased employees.

**Controlled & Affiliated Service Groups One Employer.** The employer aggregation rules under IRC Sections 52 (applying the rules of section 1563, except “more than 50 percent” is substituted for “at least 80 percent” in section 1563(a)(1), and subsections 1563(a)(4) and (e)(3)(C) are disregarded) and 414 (controlled and affiliated service groups) apply for purposes of determining an eligible employer. Additionally, an employer includes a “predecessor employer,” which term is undefined.

Simple Cafeteria Plan Eligible “Employees.” All non-excludable employees who had at least 1,000 hours of service during the preceding plan year must be eligible to participate in a simple cafeteria plan.

Unfortunately, the new rules continue the regular cafeteria plan requirement that to a participant can only be an “employee” and thus excludes partners, LLC members taxed as partners, 2% or more owners of S corporations, and sole proprietors.

Simple Cafeteria Plan Qualified Employees. The term “qualified employee” means any employee who is not a highly compensated employee under section 414(q) or key employee under section 416(i) and who is eligible to participate in the plan.<sup>1</sup> This definition of qualified employee is relevant only to the two alternative minimum contribution requirements, discussed below, and that HCEs and key employees may participate like everyone else so long as they are “employees” and do not receive disproportionate employer regular or matching contributions.

Section 125(j)(3)(C) allows comparable contributions for HCEs and key employees, as it provides: Subject to subparagraph (B)(regarding matching contributions), nothing in this paragraph shall be treated as prohibiting an employer from making contributions to provide qualified benefits under the plan in addition to contributions required under subparagraph (A). The required contributions in (A) are for “qualified employees” but the employer contributions for at least 2% of pay are for all employees under (A)(i), not just qualified employees, and (B) indicates that matching contributions can be made for HCEs and key employees.

Simple Cafeteria Plan Excludable Employees. Excludable employees are those who:

- have not attained age 21 (or a younger age provided in the plan) before the end of the plan year;
- have less than one year of service as of any day during the plan year;
- are covered under a collective bargaining agreement; or
- are nonresident aliens.

An employer may have a shorter age and service requirement but only if such shorter service or younger age applies to all employees.

Employees who previously worked 1000 in a plan year but do not currently can be excluded, as employees who do not have a year of service in the current plan year can be excluded. However, since the rule is that they can be excluded if they don't have a year of service on any day in the year, they will have 1000 hours if they go from full time to part time at the beginning of the current year. This is an important point where the employee's salary is less than the health benefits. They should be entitled to the entire maximum benefit if elected,

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<sup>1</sup> For 2010, an individual is an HCE if his or her compensation from the same employer in 2009 exceeded \$110,000 or the person is an officer, more than 5% owner, a spouse or dependent working for the same employer. For 2010, an individual is a key employee if:

- An officer earning more than \$160,000 in the 2009 plan year; or
- A more than a 5% owner; or
- A more than a 1% owner receiving compensation in excess of \$150,000 in the prior plan year.
- Government entities do not have Key Employees.

even if greater than their compensation in order to safeguard SIMPLE status.

Benefit Nondiscrimination. Each eligible employee must be able to elect any benefit under the plan under the same terms and conditions as all other participants.

Minimum Contribution Requirement. The minimum must be available for application toward the cost of any qualified benefit (other than a taxable benefit) offered under the plan.

Employer contributions to a simple cafeteria plan must be sufficient to provide benefits to non-highly compensated employees (NHCEs) under 125(j)(3)(A) of at least either:

- (i) A uniform percentage of at least two percent of compensation (defined as it is under 414(s) for retirement plan purposes, whether or not the employee makes salary reduction contributions to the plan; or
- (ii) The lesser of a 200% matching contribution or six percent of the employee's compensation. Under 125(j)(C), additional contributions can be made, but the rate of any matching contribution for HCEs or key employees cannot be greater than the rate of match for NHCEs under 125(j)(B).

The same method must be used for calculating the minimum contribution for all NHCEs. The rate of contributions for key employees and HCEs cannot exceed that for NHCEs.

Compensation for purposes of this minimum contribution requirement is compensation with the meaning of section 414(s).

Safe Harbor From Nondiscrimination Rules.

Simple cafeteria plans are treated as meeting the nondiscrimination requirements of IRC Section 125(b), including the concentration test that currently limits key employees' benefits to 25% of the total of nontaxable benefits provided for all employees under the plan.

Nondiscrimination tests applicable to individual benefits are deemed to be satisfied, including the Section 79(d) rules for group-term life insurance, the Section 105(h) rules for self-insured medical expense reimbursement plans, and the dependent care rules of Section 129(d)(2),(3) and (8).

These nondiscrimination rules have discouraged utilization of cafeteria plans by small businesses. For example, if a small office with two key employees and two non-key employees provided identical dollar amounts of benefits to all employees under a cafeteria plan, the 25% concentration test would be failed because 50% of total benefits go to the key employees. The new simple cafeteria plan safe harbor addresses this problem but only for small employers organized as traditional C corporations since only common law "employees" and not the self employed are eligible.

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Revised Internal Revenue Code Adding Simple Cafeteria Plan

**125(j) Simple cafeteria plan for small businesses.**

**(1) In general.**

An eligible employer maintaining a simple cafeteria plan with respect to which the

requirements of [this subsection](#) are met for any year shall be treated as meeting any applicable nondiscrimination requirement during such year.

**(2) Simple cafeteria plan.**

For purposes of [this subsection](#), the term “simple cafeteria plan” means a cafeteria plan—

- (A) which is established and maintained by an eligible employer, and
- (B) with respect to which the contribution requirements of [paragraph \(3\)](#), and the eligibility and participation requirements of [paragraph \(4\)](#), are met.

**(3) Contribution requirements.**

(A) In general. The requirements of [this paragraph](#) are met if, under the plan the employer is required, without regard to whether a qualified employee makes any salary reduction contribution, to make a contribution to provide qualified benefits under the plan on behalf of each qualified employee in an amount equal to—

- (i) a uniform percentage (not less than 2 percent) of the employee's compensation for the plan year, or
- (ii) an amount which is not less than the lesser of
  - (I) 6 percent of the employee's compensation for the plan year, or
  - (II) twice the amount of the salary reduction contributions of each qualified employee.

(B) Matching contributions on behalf of highly compensated and key employees. The requirements of [subparagraph \(A\)\(ii\)](#) shall not be treated as met if, under the plan, the rate of contributions with respect to any salary reduction contribution of a highly compensated or key employee at any rate of contribution is greater than that with respect to an employee who is not a highly compensated or key employee.

(C) Additional contributions. **Subject to [subparagraph \(B\)](#), nothing in [this paragraph](#) shall be treated as prohibiting an employer from making contributions to provide qualified benefits under the plan in addition to contributions required under [subparagraph \(A\)](#).**

(C) Definitions. For purposes of [this paragraph](#) —

- ((i)) Salary reduction contribution. The term “salary reduction contribution” means, with respect to a cafeteria plan, any amount which is contributed to the plan at the election of the employee and which is not includible in gross income by reason of [this section](#).
- ((ii)) Qualified employee. The term “qualified employee” means, with respect to a cafeteria plan, any employee who is not a highly compensated or key employee and who is eligible to participate in the plan.
- ((iii)) Highly compensated. The term “highly compensated employee” has the meaning given such term by [section 414\(q\)](#).
- ((iv)) Key employee. The term “key employee” has the meaning given such term by [section 416\(i\)](#).

**(4) Minimum eligibility and participation requirements.**

(A) general. The requirements of [this paragraph](#) shall be treated as met with respect to any year if, under the plan—

(i) all employees who had at least 1,000 hours of service for the preceding plan year are eligible to participate, and

(ii) each employee eligible to participate in the plan may, subject to terms and conditions applicable to all participants, elect any benefit available under the plan.

(B) Certain employees may be excluded. For purposes of [subparagraph \(A\)\(i\)](#), an employer may elect to exclude under the plan employees—

(i) who have not attained the age of 21 before the close of a plan year,

(ii) who have less than 1 year of service with the employer as of any day during the plan year,

(iii) who are covered under an agreement which the Secretary of Labor finds to be a collective bargaining agreement if there is evidence that the benefits covered under the cafeteria plan were the subject of good faith bargaining between employee representatives and the employer, or

(iv) who are described in [section 410\(b\)\(3\)\(C\)](#) (relating to nonresident aliens working outside the United States). A plan may provide a shorter period of service or younger age for purposes of [clause \(i\)](#) or [\(ii\)](#).

**(5) Eligible employer.**

For purposes of this subsection—

(A) In general. The term “eligible employer” means, with respect to any year, any employer if such employer employed an average of 100 or fewer employees on business days during either of the 2 preceding years. For purposes of this, a year may only be taken into account if the employer was in existence throughout the year.

(B) Employers not in existence during preceding year. If an employer was not in existence throughout the preceding year, the determination under [subparagraph \(A\)](#) shall be based on the average number of employees that it is reasonably expected such employer will employ on business days in the current year.

(C) Growing employers retain treatment as small employer.

(i) In general. If—

(I) an employer was an eligible employer for any year (a “qualified year”), and

(II) such employer establishes a simple cafeteria plan for its employees for such year, then, notwithstanding the fact the employer fails to meet the requirements of [subparagraph \(A\)](#) for any subsequent year, such employer shall be treated as an eligible employer for such subsequent year with respect to employees (whether or not employees during a qualified year) of any trade or business which was covered by the plan during any qualified year.

(ii) Exception. [This subparagraph](#) shall cease to apply if the employer employs an average of 200 or more employees on business days during any year preceding any such subsequent year.

(D) Special rules.

(i) Predecessors. Any reference in [this paragraph](#) to an employer shall include a reference to any predecessor of such employer.

(ii) Aggregation rules. All persons treated as a single employer under subsection (a) or (b) of [section 52](#), or subsection(n) or (o) of [section 414](#), shall be treated as one person.

**(6) Applicable nondiscrimination requirement.**

For purposes of [this subsection](#), the term “applicable nondiscrimination requirement” means any requirement under [subsection \(b\)](#) of this section, [section 79\(d\)](#), [section 105\(h\)](#), or paragraph (2), (3), (4), or (8) of [section 129\(d\)](#).

**(7) Compensation.**

The term “compensation” has the meaning given such term by [section 414\(s\)](#).

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As I read the Code below, they are effective for years beginning in 2011 with the provision for indexing of the \$2500 in effect in 2013 even though by its terms indexing doesn't start until 2014. However, the explanation by the Joint Committee on Taxation, at the end of its explanation, simply says:

*Effective Date*

The provision is effective for taxable year beginning after December 31, 2012.

Here is what the revised Code says:

**Caution: Code Sec. 125(i), following, is effective for tax. yrs. begin. before 1/1/2011. For Code Sec. 125(i), effective for tax. yrs. begin. after 12/31/2010, and Code Sec. 125(i), effective for tax. yrs. begin after 12/31/2012, see below.**

**(i) Cross reference.**

For reporting and recordkeeping requirements, see [section 6039D](#) .

**Caution: Code Sec. 125(i), following, is effective for tax. yrs. begin. after 12/31/2010.** For Code Sec. 125(i), effective for tax. yrs. begin. before 1/1/2011, see above.

<sup>4</sup>**(i) Limitation on health flexible spending arrangements.**

For purposes of [this section](#) , if a benefit is provided under a cafeteria plan through employer contributions to a health flexible spending arrangement, such benefit shall not be treated as a qualified benefit unless the cafeteria plan provides that an employee may not elect for any taxable year to have salary reduction contributions in excess of \$2,500 made to such arrangement.

**Caution: Code Sec. 125(i), following, is effective for tax. yrs. begin. after 12/31/2012.** For Code Sec. 125(i), effective for tax. yrs. begin. before 1/1/2011, and Code Sec. 125(i), effective for tax. yrs. begin. before 1/1/2013, see above.

**<sup>5</sup>(i) Limitation on health flexible spending arrangements.**

**(1) In general.**

*For purposes of [this section](#) , if a benefit is provided under a cafeteria plan through employer contributions to a health flexible spending arrangement, such benefit shall not be treated as a qualified benefit unless the cafeteria plan provides that an employee may not elect for any taxable year to have salary reduction contributions in excess of \$2,500 made to such arrangement.*

**(2) Adjustment for inflation.**

*In the case of any taxable year beginning after <sup>1R</sup> December 31, 2013, the dollar amount in [paragraph \(1\)](#) shall be increased by an amount equal to—*

*(A) such amount, multiplied by*

*(B) the cost-of-living adjustment determined under [section 1\(f\)\(3\)](#) for the calendar year in which*

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