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Health and Accident Insurance for "2%" S Corporation Shareholders

-by Neil E. Harl*

Recent developments[1] have called into question the availability of the "above-the-line" deduction for federal income tax purposes for "2 percent" shareholders of S corporations under certain circumstances.[2] The problem is particularly acute for sole shareholders of S corporations.[3]

Requirements for deductibility

The statute[4] allows an individual who is an employee to claim a deduction for insurance which pays for medical care for the taxpayer, spouse and dependents. Similarly, a self-employed individual with earned income can be treated as an employee for this purpose.[5] Moreover, the amount of the deduction cannot exceed the taxpayer's earned income derived from the trade or business with respect to which the plan providing medical care coverage is established.[6] The deduction is limited further by the fact that a deduction is not allowed during any month during which the taxpayer is eligible to participate in any subsidized health plan maintained by any employer of the taxpayer or of the spouse of the taxpayer.[7]

The 2005 ruling

In a private letter ruling issued in mid-2005,[8] the question was posed whether a sole proprietor could claim the above-the-line deduction where the individual had purchased health insurance in the sole proprietor's own name, not in the name of the sole proprietorship, and to treat the sole proprietorship income as the trade or business for which the plan was established.[9] The ruling states that a sole proprietor could purchase health insurance in the sole proprietor's name and claim an above-the-line deduction for the costs in providing coverage for the sole proprietor, the spouse and dependents.[10]

The situation for S corporation shareholders

For enumerated fringe benefits, including amounts paid under accident and health plans, an S corporation is treated as a partnership and any shareholder who owns more than two percent of the S corporation stock is treated as a partner.[11] In 1991, the Internal Revenue Service ruled that accident and health insurance premiums paid by a partnership (or S corporation) on behalf of a partner are considered guaranteed payments[12] if the premiums are paid for services rendered in that capacity and to the extent the premiums are determined without regard to partnership income.[13] With the status of guaranteed payments, the premiums are

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deductible by the partnership as salary and wages[14] and includible in the recipient's gross income.[15] If the requirements are met, the shareholder-employee may deduct the cost of the premiums to the extent permitted.[16] The premiums are not excludible from the recipient's gross income.[17]

The problem is that if a sole-shareholder employee purchases health insurance in his or her own name instead of the corporation's name, the S corporation has not established a plan to provide medical coverage.[18] In that case, there is no fringe benefit paid to the two percent shareholder, the S corporation is not treated as a partnership and the sole shareholder is not treated as a partner.[19] As a result of not being treated as a partner, the sole shareholder is not considered to be self-employed and, therefore, is not able to deduct the medical insurance costs as an above-the-line deduction.[20] The sole shareholder can, of course, deduct the cost of health insurance as an itemized deduction but that deduction is subject to the 7.5 percent adjusted gross income limitation.[21] To many that is a less than palatable solution. Moreover, that is a dramatically different outcome than is faced by a sole proprietor who purchases a policy in the sole proprietor's name and is eligible for an above-the-line deduction.[22]

A complicating factor

The obvious solution is to have the S corporation purchase the health insurance in its own name. But the problem with that is that some states do not allow a corporation to purchase a health insurance plan with only one participant. This precludes the S corporation from acquiring a health insurance plan and means that the only practical solution is to have the sole shareholder purchase the plan in his or her own name. The Internal Revenue Service has made it clear that the state law limitation ". . . does not override the requirements that the S corporation must provide fringe benefits to its employees in order to have the 2% shareholder qualify for the IRC Sec162(l) benefits."[23]

The solution

In a perfect world, a Congress sensitive to inequities in the tax system would respond with an amendment to make it clear that a shareholder-employee purchase of health insurance would be deemed a plan providing medical coverage on the part of the S corporation. However, this is viewed as a minor issue, especially in an era when even major tax issues are commanding little Congressional attention.

Footnotes

[1] See Ltr. Rul. 200524001, May 17, 2005; Headliner, "Health Insurance Covering S Corporation Shareholders," Vol. 163, May 15, 2006.

[2] See generally 4 Harl, *Agricultural Law* § 28.02[6][d][i], [v][H] (2006); Harl, *Agricultural Law Manual* § 7.02[4][c] (2006).

[3] See note 1, *supra*.

[4] I.R.C. § 162(l)(1)(A).

[5] I.R.C. §§ 401(c)(1), 162(l)(1).

[6] I.R.C. § 162(l)(2)(A).

[7] I.R.C. § 162(l)(2)(B).

[8] Ltr. Rul. 200524001, May 17, 2005.

[9] I.R.C. § 162(l)(2)(A).

[10] Ltr. Rul. 200524001, May 17, 2005.

[11] I.R.C. § 1372(a).

[12] See I.R.C. § 707(c).

[13] Rev. Rul. 91-26, 1991-1 C.B. 184.

[14] I.R.C. § 162.

[15] I.R.C. § 61.

[16] I.R.C. § 162(l).

[17] I.R.C. § 106.

[18] See I.R.C. § 162(l)(2)(A).

[19] I.R.C. § 1372.

[20] I.R.C. § 162(l)(1)(A).

[21] I.R.C. §§ 62, 213(a).

[22] Ltr. Rul. 200524001, May 17, 2005.

[23] Headliner, "Health Insurance Covering S Corporation Shareholders," Vol. 163, May 15, 2006.