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More Guidance for “2%” S Corporation Shareholder-Employees

-by Neil E. Harl*

Compared to regularly-taxed or C corporations, S corporations are treated differently and, in general, less advantageously when it comes to employee benefits.¹ Employee benefits of any person owning more than two-percent of the stock of an S corporation are treated in the same manner as partners are treated in a partnership.² That provision applies to the exclusion from income of amounts paid for accident and health plans, the exclusion from income of amounts paid by an employer to an accident and health plan, the exclusion for the cost of group term life insurance up to \$50,000 of coverage on an employee’s life and the exclusion from income of meals and lodging furnished for the convenience of the employer.³ These are significant items in many farm and ranch corporations.

In 1991, the Internal Revenue Service provided a detailed run-down on how accident and health insurance premiums paid by an S corporation on behalf of a two-percent shareholder as consideration for services rendered are treated as guaranteed payments.⁴ In late 2007, IRS issued *Notice 2008-15* which fine tuned the message and added some key requirements. Here, step-by-step, is the list of points governing the handling of the deduction for health and accident insurance premiums by a two-percent shareholder.⁶

Deducting health and accident insurance premiums

Health and accident insurance premiums for a two-percent shareholder for services rendered are treated as guaranteed payments in a partnership⁷ with the S corporation entitled to deduct the cost⁸ if the requirements of I.R.C. § 162(l) are met.⁹ The premium payments are included in wages for purposes of income tax withholding on the shareholder-employee’s Form W-2 but are not wages subject to Social Security and Medicare taxes if the requirements for exclusion under I.R.C. § 3121(a)(2)(B) are satisfied.¹⁰ The two-percent shareholder must include the premium amount in gross income.¹¹ Section 106 of the Internal Revenue Code contains an exclusion from gross income for an employee for employer-provided health and accident plan coverage.¹² However, a two-percent shareholder in an S corporation *is not treated as an employee for this purpose*¹³ so the premiums are not excludible from the shareholder-employee’s income under that provision.¹⁴

Section 162(l) of the Internal Revenue Code, in an interesting twist, allows an individual who is deemed to be an employee under I.R.C. § 401(c)(1) (which defines “employee” to include self-employed persons with earned income from a trade or business in which personal services of the taxpayer are a material income determining factor even though there were no net profits from the trade or business for the taxable year)¹⁵ to claim a deduction

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for amounts paid for insurance that constitutes medical care for the taxpayer, spouse and dependents.¹⁶ The deduction is not allowed to the extent that the amount of the deduction exceeds the earned income derived by the taxpayer from the trade or business with respect to the plan providing the medical coverage in question.¹⁷ Also, the deduction is not allowed to the extent the taxpayer is eligible to participate in any subsidized health plan maintained by an employer of the taxpayer *or the taxpayer's spouse*.¹⁸ That deduction can be claimed by a two-percent shareholder of an S corporation *if the plan providing medical care coverage for the two-percent shareholder-employee is established by the S corporation*.¹⁹

When a plan is “established” by an S corporation

A plan providing medical care coverage for a two-percent shareholder-employee of an S corporation is considered to have been established by the S corporation if (1) the S corporation makes the premium payments in the current taxable year; or (2) the two-percent shareholder makes the premium payments and is reimbursed by the S corporation in the current taxable year.²⁰ In the event the premiums are not paid or reimbursed by the S corporation and included in the shareholder-employee's gross income, the plan is not considered established by the S corporation *and the two-percent shareholder is not allowed a deduction under I.R.C. § 162(l)*.²¹

IRS points out that, in order for a two-percent shareholder-employee to deduct the amount of the premiums, the S corporation must report the premiums paid or reimbursed as wages on a Form W-2 in that same year.²² Also, the shareholder-employee must report the premium payments or reimbursements as income.²³

IRS suggests amended returns

IRS states that taxpayers who did not claim deductions for accident and health insurance premiums may amend their tax returns (in a timely manner) to claim the deduction if the requirements outlined are met.²⁴ The statement, “Filed Pursuant to Notice 2008-1” is to be written at the top of any amended return.²⁵

IRS also states that payments of accident and health insurance premiums by an S corporation on behalf of a two-percent shareholder-employee are not considered to be distributions for purposes of the single class of stock requirement.²⁶ That passage lays to rest concerns that had been raised about S corporation payment of premiums.

FOOTNOTES

¹ I.R.C. § 1372. See generally 7 Harl, *Agricultural Law* § 56.09[3] (2008); Harl, *Agricultural Law Manual* § 7.02[3][c] (2008); Harl, *Farm Income Tax Manual* § 7.04[7][a] (2007 ed.). See also Harl, “Health and Accident Insurance for ‘2%’ S Corporation Shareholders,” 17 *Agric. L. Dig.* 169 (2006); Headliner, “Health Insurance Covering S Corporation Shareholders,” Vol. 163, May 15, 2006.

² I.R.C. § 1372(a).

³ S. Rep. 97-640, 97th Cong., 2d Sess. 22 (1982).

⁴ Rev. Rul. 91-26, 1991-1 C.B. 184.

⁵ 2008-1 C.B. 251.

⁶ Notice 2008-1, 2008-1 C.B. 251.

⁷ I.R.C. § 707(c).

⁸ I.R.C. § 162(l).

⁹ Rev. Rul. 91-26, 1991 C.B. 184; Notice 2008-1, 2008-1 C.B. 251.

¹⁰ I.R.C. § 3121(a)(2)(B). See Ann. 92-16, I.R.B. 1992-5, 53.

¹¹ I.R.C. § 61(a).

¹² I.R.C. § 106(a).

¹³ Treas. Reg. § 1.106-1. See I.R.C. § 1372(a).

¹⁴ *Id.*

¹⁵ I.R.C. § 401(c)(1)(B), (2)(A).

¹⁶ I.R.C. § 162(l)(1)(A).

¹⁷ *Id.*

¹⁸ I.R.C. § 162(l)(2)(B).

¹⁹ Rev. Rul. 91-26, 1991-1 C.B. 184. See Notice 2008-1, 2008-1 C.B. 251.

²⁰ Notice 2008-1, 2008-1 C.B. 251.

²¹ Notice 2008-1, 2008-1 C.B. 251.

²² *Id.*

²³ *Id.*

²⁴ Notice 2008-1, 2008-1 C.B. 251.

²⁵ *Id.*

²⁶ I.R.C. § 1361(b)(1)(D).

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