

Health insurance for S corporation shareholders

Scope: This course will cover how health insurance, including medical insurance and accident insurance, should be handled for S corporations and S corporation shareholder-employees. In particular, the course will focus on IRS Notice 2008-1, Special Rules for Health Insurance Costs of 2-Percent Shareholder-Employees.

Learning Objectives

- Review the employment status of shareholders in an S corporation
- Review how to treat medical insurance premiums in an S corporation
- Understand which rules apply to two-percent shareholder-employees in S corporations
- Understand how IRS Notice 2008-1, Special Rules for Health Insurance Costs of 2-Percent Shareholder-Employees, affects deductions
- Review how to report medical insurance premiums on both shareholder-employee 1040 and W-2 forms

Outline

- 1) Employment status of shareholders
 - a) Veterinary Surgical Consultants, P.C. vs. Commissioner, 117 T.C. 141 (2001)
 - b) Joseph M. Grey Public Accountant, P.C. vs. Commissioner, 119 T.C. 121 (2002)
- 2) Why 2-Percent Shareholders Are Treated as Partners
- 3) Treating Medical Insurance Premiums as Wages
- 4) Special Rules for Health Insurance Costs of 2-Percent Shareholder-Employees (IRS Notice 2008-1)
 - a) Overview of U.S.C. Title 26, §162(l)
 - i) Allowance of deduction and applicable percentage
 - ii) Limitations on dollar amount, other coverage, long-term care premiums
 - iii) Coordinating with medical deduction
 - iv) Deduction not allowed for self-employment tax purposes
 - v) Treatment of certain S corporation shareholders
 - b) How to treat an S corporation
 - i) How 2-percent shareholders are to be treated
 - c) Accident and health insurance premiums purchased by S corporation on behalf of 2-percent shareholder
 - i) Treatment as income, §707(c)
 - ii) Deductions for S corporation under §162
 - (1) Requirements that need to be satisfied under § 263
 - iii) Inclusion as wages on W-2
 - iv) Whether premiums are subject to Social Security and Medicare taxes under §3121(a)(2)(B)
 - d) Why a 2-percent shareholder is not an employee and not subject to exclusion of premiums from gross income under §106
 - e) Deductions under §162(l)(1)(A) for employees defined under §401(c)(1) in computing adjusted gross income for amounts paid during taxable year for medical insurance for employee, spouse, and children

- i) Whether deduction exceeds earned income within meaning of §401(c)(2)
 - ii) Whether taxpayer is eligible for subsidized health plan paid for by employer or spouse, §162(l)(1)(B)
- f) 2-percent shareholder eligibility for deduction if shareholder meets requirements of §162(l)
 - i) Plan is established by S corporation
 - (1) S corporation pays premiums covering the 2-percent shareholder in the taxable year; or
 - (2) 2-percent shareholder makes payments, furnishes proof, and is reimbursed by S corporation
 - ii) How to report on W-2 so that 2-percent employee can deduct amount of medical insurance premiums
 - iii) How to report on 1040 of 2-percent shareholder for employee deductions
- 5) Filing Amended Returns for Previous Taxable Years
 - a) Ability to file timely notices under §162(l)
 - b) Statement to include on amended returns
 - c) Distributions for purposes of single class of stock requirement of §1361(b)(1)(D)
- 6) Examples
- 7) Alternative Methods to Deduct Health Insurance
- 8) Advantage to Establishing Plan Under Business
- 9) Common Mistakes
- 10) Health Savings Accounts

Appendix A: IRS Notice 2008-1

Appendix B: Sample W-2 with Medical Insurance Premiums included

Appendix C: Sample 1040 with Medical Insurance Premiums included

Appendix D: Blank 1040X with Notice Pursuant to 2008-1 included

Now that the health care reform legislation has passed in Congress, three S corporations all want to start offering health insurance to their shareholders: Widmore Enterprises, Shepard's Spine Clinic, and Mittelos Bioscience. All are duly organized under the applicable state and federal statutes as S corporations, which have fewer than 100 shareholders.¹ Widmore Enterprise's primary shareholders are Benjamin Linus, who performs work on behalf of Widmore Enterprises and owns 75 percent of the S corporation's stock, and Charles Widmore, who owns 25 percent of the S corporation's stock and performs minimal tasks on behalf of the S corporation. Shepard's Spine Clinic is an S corporation run by Jack Shepard, who considers himself self-employed. Mittelos Bioscience is owned by Ethan Rom and Juliet Burke, who own equal shares of the S corporation's stock and perform an equal amount of tasks on behalf of the corporations.

Under Internal Revenue Service regulations², the costs of health insurance premiums for shareholder-employees are considered deductible for the S corporation and for the shareholder-employee, provided certain conditions are met.

First, we have to determine whether or not the shareholder in the S corporation is an employee, which will determine whether or not any health insurance premiums paid on behalf of the shareholders are considered wages and need to be included as wages on the shareholder-employee's W-2 Form.

1) Employment status of shareholders

Shareholders in an S corporation who provide more than minor services to their corporation and receive, or are entitled to receive, compensation are subject to federal employment taxes. Benjamin Linus, a shareholder in Widmore Enterprises who performs bookkeeping services, solicits clients, and engages in other essential business tasks on behalf of Widmore Enterprises, is an employee for federal tax purposes.

If an officer does not perform services to the corporation or is not entitled to compensation for those services, then the officer is not considered an employee for federal tax purposes. Charles Widmore is a shareholder of Widmore Enterprises but performs minimal duties, so he is not an employee of Widmore Enterprises for federal tax purposes. His income does not need to be treated as such. Charles can take his income from the S corporation as a distribution, dividend, or other form of compensation.

Because of the potential for shareholder-employees to attempt to avoid federal income and employment taxes, the courts have found that shareholder-employees are subject to employment taxes even when shareholders take their wages in the form of distributions, dividends, or other types of compensation instead of straight wages.

Two court cases uphold the position of the Internal Revenue Service that shareholders who provide services to the corporation and are entitled to compensation for those services are employees and should be treated as such for federal tax purposes.

¹ S corporations are more explicitly defined in Title 26, United States Code §1361, S Corporation Defined.

² See IRS Notice 2008-1, included in Appendix A.

- a) Veterinary Surgical Consultants, P.C. v. Commissioner of Internal Revenue, 117 T.C. 141 (2001)

The federal tax court needed to decide if Kenneth K. Sadanaga, D.V.M. was an employee for the period in question for the purposes of federal employment taxes. In making its determination, the court looked at the hours Dr. Sadanaga worked for the petitioner Veterinary Surgical Consultants, how much money he made for the petitioner, and whether or not Dr. Sadanaga performed substantial services for the petitioner. The court noted that Dr. Sadanaga worked approximately 33 hours per week for the petitioner, and that the petitioner's only revenue was from the work that Dr. Sadanaga performed on its behalf. While the petitioner classified the money it paid to Dr. Sadanaga as a distribution of its net income, the court stated that the payments were to be considered remuneration for services rendered to the petitioner by Dr. Sadanaga. The court stated:

Regardless of how an employer chooses to characterize payments made to its employees, the true analysis is whether the payments represent remuneration for services rendered.³

The court also found that, as the petitioner's sole full-time worker, Dr. Sadanaga needed to be treated as an employee for federal tax purposes, and that the monies paid to him during the period in question were, in fact, wages.

Noting that the tax code allows relief from employment tax liability under §530(a)(1) if two conditions are satisfied, the court further stated that Dr. Sadanaga only met one of the conditions: that he was not treated as an employee for any period. The petitioner had filed its tax returns reflecting all withdrawals from Dr. Sadanaga as distributions of petitioner's income, not wages. However, the court was quick to point out that the second section of §530(a)(1) was not satisfied because the petitioner had no reasonable basis for not treating Dr. Sadanaga as an employee.

- b) Joseph M. Grey Public Accountant, P.C. v. Commissioner, 119 T.C. 121 (2002)

Similarly, Joseph M. Grey was the petitioner's sole shareholder and president. Grey performed a wide range of duties for the petitioner, which made him an employee in the eyes of the court and prevented the petitioner from receiving relief under §530.

Generally, if the S corporation is named after someone (i.e. "Joseph M. Grey Public Accountant, P.C."), it's very likely that the named person is performing the work of an employee for the S corporation and should be treated as such for federal tax purposes.

For the purposes of this course, we are only referring to shareholders that are considered employees for federal tax purposes, which includes Benjamin Linus, Jack Shepard, Ethan Rom, and Juliet Burke. Once we have established that the shareholder is, in fact, an employee, we can then decide how to treat health insurance premiums paid by the S corporation or paid by the shareholder-employee and reimbursed to the shareholder-employee by the S corporation. The

³ Quoting Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990) and Joseph Radtke, S.C. v. United States, 895 F.2d 1196 (7th Cir. 1990).

shareholder-employee and the S corporation have three options in order to receive the appropriate deductions:

- The S corporation can purchase the health and accident insurance in the S corporation's name and pay the premiums itself;
- The shareholder-employee can purchase the health and accident insurance in his name, and the S corporation can pay the premiums; or
- The shareholder-employee can purchase the health and accident insurance in his name and pay the premiums, and upon furnishing proof of premium payment, the S corporation can reimburse the shareholder-employee for the premium payments.

Before we delve into the requirements for health insurance plans in order to qualify for this double deduction, however, we must first explore how health insurance premiums should be treated, and why 2-percent shareholders are considered partners for this deduction.

2) Why 2-Percent Shareholders Are Treated as Partners

For the purposes of fringe benefits, which includes medical and accident insurance, as well as long-term care insurance, S corporations are treated as partnerships. All 2-percent shareholders are treated as partners for the purposes of fringe benefits as well.⁴

The IRS further defines 2-percent shareholders in the Tax Code as anyone owning 2 percent or more of the stock of the S corporation.⁵ Charles Widmore, Benjamin Linus, Jack Shepard, Juliet Burke, and Ethan Rom are all 2-percent shareholders of their respective S corporations.

3) Treating Medical Insurance Premiums as Wages

Depending on whether the shareholder-employee holds greater than 2 percent of the company, health and accident insurance premiums paid on the shareholder-employee's behalf could be considered wages and would need to be treated as such for income tax withholding purposes. Any shareholder that holds 2 percent or greater of the shares of an S corporation is considered a 2-percent shareholder.

For example, Benjamin Linus holds greater than 2 percent of Widmore Enterprises. Widmore Enterprises pays for Linus's health and accident insurance premiums, and these premiums would be considered wages that would need to be reported accordingly on Linus's W-2.

4) Special Rules for Health Insurance Costs of 2-Percent Shareholder-Employees⁶

Health insurance costs for 2-percent shareholder-employees of S corporations fall under their own special set of rules. Remember that any shareholder that owns 2 percent or more of the stock of the S corporation is considered a 2-percent shareholder. Therefore, even if Benjamin

⁴ Title 26, United States Code, §1372(a)

⁵ Title 26, United States Code, §1372(b)

⁶ IRS Notice 2008-1, which is included in Appendix A for reference.

Linus owns 75 percent of the stock of Widmore Enterprises, he is still considered a 2-percent shareholder, according to the IRS.

a) Overview of U.S.C. Title 26, §162(l)

There are a variety of trade or business expenses that can be deducted for tax purposes, including medical or accident insurance premiums for policies provided to employees.⁷ Section 162(l) explains the special rules for health insurance costs of self-employed individuals.

i) Allowance of deduction and applicable percentage

The law allows self-employed individuals to deduct health insurance costs for themselves, their spouses, and their dependents. They are allowed to deduct 100% of these health insurance costs costs, beginning in 2003. If Jack Shepard, a self-employed individual who runs Shepard's Spine Clinic, pays health insurance premiums for himself and his family that amount to \$10,000, he may consider that a deductible expense, which can then be deducted on both his own 1040 Form and the S corporation's return.

ii) Limitations on dollar amount, other coverage, long-term care premiums

However, self-employed individuals cannot deduct more than they earned as a self-employed individual. If Jack Shepard claims to have earned only \$2,000 in 2009, he cannot deduct the full \$10,000 in premiums he paid for himself and his family.

Additionally, if Mrs. Shepard's employer offers her a health plan which Jack and his family can enroll in, Jack is not entitled to the health insurance deduction. Jack is also not eligible for the deduction if he is eligible for health insurance through other methods, such as through his day job as a spinal surgeon. However, if neither Jack nor Mrs. Shepard are eligible for health insurance through their employers, they may deduct the cost of health insurance premiums from Jack's income as a self-employed individual.

If Jack chooses to participate in a long-term care plan⁸, he may also deduct the costs of those premiums in addition to the deduction he takes for medical insurance as a self-employed individual.

iii) Coordinating with medical deduction

When Jack's accountant is preparing his tax return, the accountant will then separate the medical insurance premiums paid by Jack from the out-of-pocket medical expenses Jack paid⁹, such as prescriptions, co-pays, contact lenses, and other expenses that exceed 7.5% of Jack's gross income. The out-of-pocket expenses get entered separately from the medical insurance premiums.

⁷ Title 26, United States Code, §26.

⁸ Title 26, U.S. Code, §7702B defines long term care plans that are eligible for deduction.

⁹ See Title 26, U.S. Code, §213 for more information on out-of-pocket medical expenses that are deductible.

iv) Deduction not allowed for self-employment tax purposes

The deduction that Jack takes for the medical insurance premiums does not count toward net earnings from self-employment¹⁰. Jack's net earnings from self-employment include his gross income earned from Shepard's Spine Clinic, less the allowable deductions for the operation of his business, such as wages to employees, waiting room magazines, telephone service, cleaning services, and clinic supplies (like those paper gowns his patients wear while waiting to see him.)

v) Treatment of certain S corporation shareholders

This entire subsection applies to anyone who is a partner¹¹, which treats S corporations as partnerships and treats 2-percent shareholders as partners for the purposes of fringe benefits.

Also for the purposes of this subsection, an individual's wages¹² from the S corporation are considered earned income. Ethan Rom's wages from Mittelos Bioscience are considered earned income, as are Juliet Burke's.

b) How to treat an S corporation

As we've established, S corporations are partnerships for the purposes of fringe benefits, including health insurance.¹³ Even though Jack Shepard is the sole shareholder of Shepard's Spine Clinic, his business is treated as a partnership because he established the clinic as an S corporation.

The rules are further defined¹⁴ as to how to handle the treatment of 2-percent shareholders of S corporations and the deductions they can claim¹⁵ for health insurance premiums paid for either by the S corporation or reimbursed by the S corporation.

i) How 2-percent shareholders are to be treated

We've established that 2-percent shareholders are to be treated as partners of the S corporation¹⁶. Thus, Juliet Burke, a research scientist for Mittelos Bioscience who owns 50 percent of the stock of this S corporation, is considered a 2-percent shareholder for the purposes of §1372. Benjamin Linus, Ethan Rom, and Jack Shepard are also 2-percent shareholders. We're not including Charles Widmore for the purposes of this course because he is not considered an employee for tax purposes; he is, however, a 2-percent shareholder.

c) Accident and health insurance premiums purchased by S corporation on behalf of 2-percent shareholder

¹⁰ Net earnings from self-employment are defined in Title 26, U.S. Code, §1402(a).

¹¹ Defined in Title 26, U.S. Code, §1372.

¹² Defined in Title 26, U.S. Code, §1372.

¹³ Title 26, U.S. Code, §1372.

¹⁴ IRS Notice 2008-1.

¹⁵ Title 26, U.S. Code, §162(l).

¹⁶ Title 26, U.S. Code, §1372(a).