



S Corporation Owner Health Insurance Deduction
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S Corporation Health Insurance Modification

In May of 2006, the IRS posted a "headliner" on their website that caused significant concern for S corporation shareholders that had individually written medical policies. The document indicated that, in such cases, no self-employed health insurance deduction would be allowed since there was not a plan established by the S corporation. However, the guidance was silent on whether a program similar to that allowed to employers under §106 as described in Revenue Ruling 61-146 would cause the payments to be considered part of a plan established by the S corporation.

The IRS has now issued Notice 2008-1 that essentially holds that a plan of the sort described in Revenue Ruling 61-146 would suffice to make the premiums paid under a "plan" of the S corporation and eligible for treatment as self-employed health insurance premiums under §162(l). The shareholder otherwise

meets the requirements to claim the self-employed health insurance deduction, the premiums on the individually written policy will qualify if either

- The S corporation pays the premiums directly to the insurance by the end of the year *or*
- The shareholder pays the premiums, furnishes proof of payment to the S corporation and the corporation reimburses the shareholder prior to the end of the year.

Additionally, the notice holds that in order for any premiums to qualify for this treatment, the premiums must be included in the shareholder-employee's W-2 for the year in question, and the shareholder-employee must actually report the amount as income on their Form 1040.

The Notice applies to any open year where the taxpayer would have qualified for the self-employed health insurance deduction under these standards. The Notice indicates that any refund claims filed due to this notice should have "Filed Pursuant to Notice 2008-1" written on the top of the amended return.

Part III – Administrative, Procedural, and Miscellaneous

Special Rules for Health Insurance Costs of 2-Percent Shareholder-Employees

Notice 2008-1

PURPOSE

This notice provides rules under which a 2-percent shareholder-employee in an S corporation is entitled to the deduction under §162(l) of the Internal Revenue Code for accident and health insurance premiums that are paid or reimbursed by the S corporation and included in the 2-percent shareholder-employee's gross income.

LAW AND ANALYSIS

Section 1372(a) provides that, for purposes of applying the income tax provisions of the Code relating to employee fringe benefits, an S corporation shall be treated as a partnership, and any 2-percent shareholder of the S corporation shall be treated as a partner of such partnership. For purposes of § 1372, the term "2-percent shareholder" is any person who owns (or is considered as owning within the meaning of § 318) on any day during the taxable year of the S corporation more than 2 percent of the outstanding stock of such corporation or stock possessing more than 2 percent of the total combined voting power of all stock of such corporation. Section 1372(b).

Accident and health insurance premiums paid or furnished by an S corporation on behalf of its 2-percent shareholders in consideration for services rendered are treated for income tax purposes like partnership guaranteed payments under § 707(c) of the Code. Rev. Rul. 91-26, 1991-1 C.B. 184. An S corporation is entitled to deduct the cost of such employee fringe benefits under § 162(a) if the requirements of that section are satisfied (taking into account the rules of § 263). The premium payments are

included in wages for income tax withholding purposes on the shareholder-employee's Form W-2, Wage and Tax Statement, but are not wages subject to Social Security and Medicare taxes if the requirements for exclusion under section 3121(a)(2)(B) are satisfied. See § 3121(a)(2)(B); Ann. 92-16, 1992-5 I.R.B. 53. The 2-percent shareholder is required to include the amount of the accident and health insurance premiums in gross income under § 61(a).

Section 106 provides an exclusion from the gross income of an employee for employer-provided coverage under an accident and health plan. A 2-percent shareholder is not an employee for purposes of §106. Treas. Reg. §1.106-1; section 1372(a). Accordingly, the premiums are not excludible from the 2-percent shareholder-employee's gross income under §106.

Section 162(l)(1)(A) allows an individual who is an employee within the meaning of § 401(c)(1) to take a deduction in computing adjusted gross income for amounts paid during the taxable year for insurance that constitutes medical care for the taxpayer, his or her spouse, and dependents. The deduction is not allowed to the extent that the amount of the deduction exceeds the earned income (within the meaning of section 401(c)(2)) derived by the taxpayer from the trade or business with respect to which the plan providing the medical care coverage is established. Section 162(l)(2)(A). Also, the deduction is not allowed for amounts during a month in which the taxpayer is eligible to participate in any subsidized health plan maintained by an employer of the taxpayer or of the spouse of the taxpayer. Section 162(l)(2)(B).

A 2-percent shareholder-employee in an S corporation, who otherwise meets the requirements of section 162(l), is eligible for the deduction under section 162(l) if the

plan providing medical care coverage for the 2-percent shareholder-employee is established by the S corporation. Rev. Rul. 91-26, 1991-1 C.B. 184. A plan providing medical care coverage for the 2-percent shareholder-employee in an S corporation is established by the S corporation if: (1) the S corporation makes the premium payments for the accident and health insurance policy covering the 2-percent shareholder-employee (and his or her spouse or dependents, if applicable) in the current taxable year; or (2) the 2-percent shareholder makes the premium payments and furnishes proof of premium payment to the S corporation and then the S corporation reimburses the 2-percent shareholder-employee for the premium payments in the current taxable year. If the accident and health insurance premiums are not paid or reimbursed by the S corporation and included in the 2-percent shareholder-employee's gross income, a plan providing medical care coverage for the 2-percent shareholder-employee is not established by the S corporation and the 2-percent shareholder-employee in an S corporation is not allowed the deduction under § 162(l).

In order for the 2-percent shareholder-employee to deduct the amount of the accident and health insurance premiums, the S corporation must report the accident and health insurance premiums paid or reimbursed as wages on the 2-percent shareholder-employee's Form W-2 in that same year. In addition, the shareholder must report the premium payments or reimbursements from the S corporation as gross income on his or her Form 1040, U.S. Individual Income Tax Return.

EXAMPLES

The following examples illustrate these rules. The following examples assume that each shareholder is a 2-percent shareholder-employee in an S corporation, whose

earned income from the S corporation exceeds the amount of the premiums for the accident and health insurance policies covering the shareholder, his or her spouse and dependents. None of the shareholders in the following examples are eligible to participate in any subsidized health plan maintained by an employer of the shareholder or the shareholder's spouse.

Example 1. (i) For 2008, shareholder A obtains an accident and health insurance policy in the name of shareholder A and makes the premium payments on the policy. The S corporation makes no payments or reimbursements with respect to the premiums.

(ii) A plan providing medical care for shareholder A is not established by the S corporation and shareholder A is not entitled to the deduction under § 162(l).

Example 2. (i) For 2008, the S corporation obtains an accident and health insurance plan in the name of the S corporation. The health plan provides coverage for shareholder B, B's spouse and dependents. The S corporation makes all the premium payments to the insurance company. The S corporation reports the amount of the premiums as wages on shareholder B's Form W-2 for 2008 and shareholder B reports that amount as gross income on Form 1040 for 2008.

(ii) A plan providing medical care for shareholder B has been established by the S corporation and shareholder B is allowed the deduction under § 162(l) for 2008.

Example 3. (i) For 2008, shareholder C obtains an accident and health insurance policy in the name of shareholder C. The S corporation makes all the premium payments to the insurance company. The S corporation reports the amount of the premiums as wages on shareholder C's Form W-2 for 2008 and shareholder C reports that amount as gross income on Form 1040 for 2008.

(ii) A plan providing medical care for shareholder C has been established by the S corporation and shareholder C is allowed the deduction under § 162(l) for 2008.

Example 4. (i) For 2008, shareholder D obtains an accident and health insurance policy in the name of shareholder D. Shareholder D makes the premium payments to the insurance company and furnishes proof of premium payment to the S corporation. The S corporation then reimburses shareholder D for the premium payments. The S corporation reports the amount of the premium reimbursements as wages on shareholder D's Form W-2 for 2008 and shareholder D reports that amount as gross income on Form 1040 for 2008.

(ii) A plan providing medical care for shareholder D has been established by the S corporation and shareholder D is allowed the deduction under § 162(l) for 2008.

AMENDED RETURNS FOR PRIOR TAXABLE YEARS

Taxpayers who did not claim deductions for fringe benefits described in this Notice may file timely amended tax returns to claim the deduction under § 162(l) if the taxpayers satisfy the requirements of this Notice. The statement “Filed Pursuant to Notice 2008-1” should be written on the top of any amended return.

The Service does not consider payments of accident and health insurance premiums by an S corporation on behalf of 2-percent shareholder-employees to be distributions for purposes of the single class of stock requirement of §1361(b)(1)(D).

DRAFTING INFORMATION

The principal authors of this notice are Mireille Khoury of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and Charles D. Wien of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice as it relates to accident and health insurance costs of self-employed individuals generally, contact Mireille Khoury at (202) 622-6080 (not a toll free call). For further information relating to accident and health insurance costs of 2-percent shareholder-employees of S corporations, contact Charles D. Wien at (202) 622-3070 (not a toll free call).

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Health Insurance Covering S Corporation Shareholders

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In many solely owned businesses, the owner of the business will purchase **health insurance** in his or her own name versus the name of the business. The type of entity may greatly affect where this **insurance** premium expense may be deducted on the individual's personal income tax return.

In Chief Counsel Advice (CCA) 200524001, it was held that a self-employed individual who is a sole proprietor and who purchases **health insurance** in his or her own name may treat that as **health insurance** purchased in the name of the sole proprietor business. As such, the **insurance** would qualify under the provisions of IRC §162(l). Assuming the self-employed individual meets the other provisions of IRC §162(l), the individual may claim a deduction for the **insurance** premiums in arriving at his or her adjusted gross income; also referred to as an above-the-line deduction.

In contrast, if the business is operating as an **S corporation**, there is a different tax consequence if the individual who is the sole shareholder and sole employee, purchases the **health insurance** in his or her own name.

For certain fringe benefits paid by the **S corporation**, including **health insurance** premiums, the Internal Revenue Code (IRC) holds that the **S corporation** will be treated as a partnership and any shareholder who owns more than 2% (a 2% shareholder) of the **S corporation** stock will be treated as a partner of such partnership (IRC §1372(a)). Revenue Ruling 91-26 holds that accident and **health insurance** premiums paid by a partnership on behalf of a partner are guaranteed payments under §707(c) of the Code if the premiums are paid for services rendered in the capacity of a partner and to the extent the premiums are determined without regard to partnership income. As guaranteed payments, the premiums are deductible by the partnership under §162 (subject to the capitalization rules of §263) and includible in the recipient-partner's gross income under §61.

As such, the **health insurance** premiums paid by the **S corporation** would not be deductible by the **S corporation** as a fringe benefit but would be deductible by the **S corporation** as compensation to the 2% shareholder. The **health insurance** premiums paid by the **S corporation** for the 2% shareholder should be included in the 2% shareholder's W-2.

IRC §162(l)(5) holds that a 2% shareholder that is treated as a partner under IRC §1372 will be treated as a self-employed person and, assuming all of the other provisions of IRC §162(l) are met, may deduct the **health insurance** premiums paid by the **S corporation** as an above-the-line deduction. It should be remembered that there are some limitations under IRC §162(l)(2). The one that often affects a 2% shareholder deals with other coverage. An above-the-line deduction is not allowed for any calendar month for which the shareholder is eligible to participate in any subsidized **health** plan maintained by any other employer of the shareholder or of the spouse of the shareholder.

Assuming there are no other subsidized **health** plans, the problem arises if the sole shareholder/employee purchases the **health insurance** in his or her own name instead of that of the **S**

corporation. In that case, the **S corporation** has not established a plan to provide medical care coverage, there is no fringe benefit paid to the 2% shareholder and the provisions of IRC §1372 do not come into play. Since the provisions of §1372 do not come into play, the **S corporation** is not treated as a partnership and the shareholder is not treated as a partner. Since the shareholder is not treated as a partner, the shareholder is not treated as self-employed and is not eligible for the above-the-line deduction treatment under IRC §162(l). The shareholder is still able to deduct the **health insurance** as an itemized deduction which is subject to the 7.5% AGI limitation.

Some states do not allow a **corporation** to purchase a group **health** plan with only one participant. This prevents the **S corporation** from acquiring a **health** plan and it requires the shareholder to purchase the plan in his or her own name. That 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 §162(l) benefits.

In summary, contrary to the holding in CCA 200524001 dealing with a sole proprietorship, a shareholder/employee is not allowed to purchase **health insurance** in the shareholder's own name and still obtain the above-the-line deduction benefits of IRC §162(l).

Note: This page contains one or more references to the Internal Revenue Code (IRC), Treasury Regulations, court cases, or other official tax guidance. References to these legal authorities are included for the convenience of those who would like to read the technical reference material. To access the applicable IRC sections, Treasury Regulations, or other official tax guidance, visit the [Tax Code, Regulations, and Official Guidance](#) page. To access any Tax Court case opinions issued after September 24, 1995, visit the [Opinions Search](#) page of the United States Tax Court.