

December 17, 2007
- by Roger McEowen

Overview

IRS has issued as a Notice a proposed revenue ruling drafted by the American Institute of Certified Public Accountants (AICPAs) that allows a 2-percent S corporation shareholder-employee to take an above-the-line deduction for accident and health insurance premiums paid (or reimbursed) by the S corporation (and included in the shareholder's gross income) on a policy in the shareholder's name rather than in the name of the corporation.¹ The Notice clarifies an issue that arose in 2006 when IRS stated that an S corporation 2-percent shareholder could not deduct medical insurance premiums except as premiums paid by a self-employed person, and then only if the policy was in the corporation's name.² Now, IRS says that if the corporation pays the premium directly to the insurance company, or pays the shareholder the amount of the premium as a reimbursement, then the shareholder can deduct the premium as a self-employed person.³ The IRS' change of position has implications for practitioners in terms of filling-out IRS Form W-2 and filing amended returns for open years to reflect the new rule.

S Corporations and Fringe Benefits

I.R.C. §1372 treats an S corporation as a partnership when determining how to tax employee fringe benefits.⁴ Under that provision, any 2-percent shareholder of the S corporation is treated as a partner.⁵ In general, accident and health insurance premiums paid by an S corporation to its 2-percent shareholders are treated as partnership guaranteed payments under I.R.C. §707(c)⁶ if the premiums are paid

for services rendered as a partner and to the extent the premiums are determined without regard to partnership income.⁷ Thus, the premium amount is not deductible by the corporation, and the 2-percent shareholder must include the premium amounts in gross income (in most situations). The premiums are not excludable under I.R.C. §106 (the exclusion for employer-provided coverage, because a 2-percent shareholder is not considered an employee for purposes of I.R.C. §106.

However, I.R.C. §162(l) does allow employees, as defined in I.R.C. §401(c)(1), to take a deduction for medical care insurance premiums if some requirements are met.⁸ Also, I.R.C. §162(l) permits a self-employed person, a partner, and an S corporation shareholder/employee to claim a deduction for 100 percent of the health insurance premiums for the taxpayer, spouse and dependents, limited by the income from the business that has the plan (thus, the business must have a health insurance plan).⁹

The health insurance premiums for a 2-percent shareholder/employee must be included in the shareholder's W-2 as income in Box 1.¹⁰ The amount is not subject to FICA as long as the plan is an employee plan as opposed to an owner plan.¹¹

Notice 2008-1¹²

In 2006, IRS issued a Headliner¹³ denying the deduction for a 2-percent shareholder when the policy is in the shareholder's name and the shareholder pays the premium.¹⁴ But, the Notice clarifies that a shareholder is entitled to the 100

percent deduction if the S corporation is paying the premiums directly or if the S corporation is reimbursing the 2-percent shareholder. That is the case if the corporation establishes a plan providing medical care coverage.¹⁵ In addition, the S corporation must report the premiums paid or reimbursed as wages on the 2-percent shareholder's Form W-2 for the year, and the shareholder must report the premium payments or reimbursements as gross income. The Notice sets forth four examples that cover the various types of arrangements that are possible:¹⁶

Example 1: For 2008, a shareholder obtains an accident and health insurance policy in the shareholder's name and pays the premiums on the policy. The S corporation makes no premium payments. The S corporation does not establish a plan providing medical care for the shareholder. The Notice states that the shareholder is not entitled to a deduction under I.R.C. §162(l). The S corporation failed to "establish" a plan.

Example 2: For 2008, the S corporation obtains an accident and health insurance plan in the S corporation's name. The plan provides coverage for a shareholder as well as the shareholder's spouse and dependents. The corporation pays the premiums to the insurance company. The corporation reports the premium amounts as wages on the shareholder's Form W-2 for 2008 and the shareholder reports that amount as gross income on Form 1040 for 2008. The Notice states that the shareholder can take a deduction under I.R.C. §162(l) for 2008.

Example 3: For 2008, a shareholder obtains an accident and health insurance policy in the shareholder's name. The S corporation makes all of the

premium payments to the insurance company and reports the amount of the premiums as wages on the shareholder's Form W-2 for 2008. The shareholder reports that amount as gross income on Form 1040 for 2008. The Notice states that the shareholder can take a deduction under I.R.C. §162(l) for 2008.

Example 4: For 2008, a shareholder obtains an accident and health insurance policy in the shareholder's name, and pays the premiums directly to the insurance company. The S corporation reimburses the shareholder for the amount of the payments. The S corporation reports the amount of the premium as wages on the shareholder's Form W-2, and the shareholder reports a like amount as gross income on Form 1040 for 2008. The Notice states that the shareholder can take a deduction under I.R.C. §162(l) for 2008.

Impact of the Notice

The Notice expands the deduction that can be taken on line 29 of Form 1040 to premiums paid by a 2-percent shareholder that are reimbursed by an S corporation. S corporation shareholders will need to make sure that any premium amounts are included on the 2007 Form W-2. That is one item that is now worth checking. In the past, tax practitioners have typically added the premium amounts to the "other income" line on Form 1040, and then deducted it on line 29. That won't work any longer.

It is also important to notify payroll departments of the amount of any accident and health insurance premiums so that the amount can be added to the W-2s during year-end processing. For S corporation shareholders that have been paying their own premiums, the premium amounts should be turned in for reimbursement before December 31, 2007, so that the amounts are included on the shareholder's Form W-2.

The Notice is a liberalization of past rules, and taxpayers can file amended returns for open tax years to claim the deduction under I.R.C. §162(l) if the requirements of the Notice are satisfied for those particular years.¹⁷ But, failure to follow the Notice could result in the premiums being taxable and non-deductible.¹⁸

¹ IRS Notice 2008-1, 2008-2, IRB 1. The AICPA's proposed revenue ruling was drafted by Sydney Traum and approved by the AICPA's Tax Executive Committee, the California Society of CPAs, the Florida Institute of CPAs and the American Association of Attorney-CPAs prior to its submission to IRS on December 27, 2006.

² IRS Headliner, Vol. 163 (May 15, 2006).

³ Notice 2008-1, 2008-2, IRB 1.

⁴ I.R.C. §1372(a).

⁵ I.R.C. §1372(a)(2). A "2-percent shareholder" is defined as any person who owns (or is considered as owning within the meaning of I.R.C. §318) on any day during the S corporation's tax year, more than 2 percent of the outstanding stock of the corporation, or stock possessing more than 2 percent of the total combined voting power of all of the corporate stock.

⁶ See also Rev. Rul. 91-26, 1991-1 C.B. 184.

⁷ As guaranteed payments, the premiums are deductible by the partnership under I.R.C. §162 (subject to the capitalization rules of I.R.C. §263) and includable in the recipient-partner's gross income under I.R.C. §61.

⁸ Under prior law, 2-percent shareholders did not receive any tax break for health insurance costs. Under current law, 2-percent shareholders must include the premium amount in income (but the amount does not count as wages for FICA or Medicare tax), but can take an offsetting deduction.

⁹ There are other restrictions such as not being eligible to participate in a subsidized plan by an employer of the spouse's employer.

¹⁰ Rev. Rul. 91-26, 1991-1 C.B. 184.

¹¹ IRS Announcement 92-16, 1992-5 I.R.B. 53.

¹² IRS Notice 2008-1, 2008-2, IRB 1.

¹³ IRS Headliner, Vol. 163 (May 15, 2006).

¹⁴ The Headliner is silent regarding reimbursement of the premiums by the S corporation.

¹⁵ For a plan to be considered "established by the S corporation," the S corporation must make the premium payments in the current tax year, or the shareholder may make the premium payments and furnish proof of payment to the S corporation, which then must reimburse the shareholder in the current tax year. The Notice does not require that the S corporation actually adopt a written plan.

¹⁶ The Notice assumes, for purposes of the Examples, that each shareholder is a 2-percent shareholder with earned income from the S corporation in excess of the amount of the premiums for the accident and health insurance policies covering the shareholder, spouse and dependents, and that none of the shareholders are eligible to participate in any subsidized health plan maintained by an employer of the shareholder or the shareholder's spouse.

¹⁷ The statement, "Filed Pursuant to Notice 2008-1" should be written on the top of the amended return.

¹⁸ IRS also stated in the Notice that they do 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 I.R.C. §1361(b)(1)(D).