Question: What are the main employee benefits and tax issues to be aware of for more-than-2% shareholders of an S corporation?

Compliance Team Response:

Section 125 Cafeteria Plan

More-than-2% shareholders in an S Corp cannot participate in any aspect of a Section 125 cafeteria plan.

The Internal Revenue Code treats such shareholders in the same manner as partners in a partnership for benefits purposes. The result is that more-than-2% shareholders in an S Corp are considered self-employed and expressly excluded under the cafeteria plan regulations. Only workers who are considered employees for purposes of Section 125 may participate in a cafeteria plan.

The primary effect of the exclusion for more-than-2% S Corp shareholders is:

1. **They cannot pay premiums for any health and welfare benefits on a pre-tax basis;**
2. **They cannot make HSA contributions through payroll on a pre-tax basis (but they can take an above-the-line deduction for after-tax contributions);**
3. **The cannot participate in the health FSA; and**
4. **They cannot participate in the dependent care FSA (DCAP).**

To be clear, an S Corp can still sponsor a cafeteria plan for its common law employees. The only limitation is that the more-than-2% shareholders (as well as the shareholders' children, parents, and grandparents) cannot participate in the plan.

Although a more-than-2% shareholder cannot participate in a cafeteria plan (and therefore cannot make pre-tax premium payments), he or she may be able to deduct up to 100% of the health premiums paid under IRC §162(1), and they can take an above-the-line deduction for any HSA contributions.

General Tax Overview

- **Employer Contributions Taxable:** 2%+ shareholders are not treated as employees for purposes of the §106 exclusion from income for employer-paid health premiums or HSA contributions. Any such employer contributions are treated as standard taxable compensation to the shareholder.
- **Shareholder Contributions Taxable:** 2%+ shareholders are not treated as employees for purposes of the §125 cafeteria plan, which is used by employees to make pre-tax contributions to health and welfare plans, make pre-tax HSA contributions, and participate in the health and dependent care FSA. Any such shareholder contributions to the health and welfare plans must be made post-tax, and any such HSA contributions must be made post-tax. Such shareholders cannot participate in the health FSA or dependent care FSA.

- **Individual Tax Return Deductions:** 2%+ shareholders may deduct premium amounts paid by the company under §162(1). Under IRS Notice 2008-1, an individual is eligible for the deduction if "the S corporation makes the premium payments for the accident and health insurance policy covered the 2-percent shareholder-employee…."
- **Above-the-Line HSA Deduction:** 2%+ shareholders may take an above-the-line deduction under §223 for the full amount of the taxable HSA contributions.

Regulations:

Prop. Treas. Reg. §1.125-1(g) (2):

(2) Self-employed individual not an employee.

(i) In general. *The term employee does not include a self-employed individual or a 2-percent shareholder of an S corporation,* as defined in paragraph (g) (2) (ii) of this subsection. For example, a sole proprietor, a partner in a partnership, or a director solely serving on a corporation's board of directors (and not otherwise providing services to the corporation as an employee) *is not an employee for purposes of section 125, and thus is not permitted to participate in a cafeteria plan*. However, a sole proprietor may sponsor a cafeteria plan covering the sole proprietor's employees (but not the sole proprietor). Similarly, a partnership or S corporation may sponsor a cafeteria plan covering employees (but not a partner or 2-percent shareholder of an S corporation).

(ii) Two percent shareholder of an S corporation. A 2-percent shareholder of an S corporation has the meaning set forth in section 1372(b).

IRC §162(1):

(I) Special rules for health insurance costs of self-employed individuals.

(1) Allowance of deduction.

In the case of a taxpayer who is an employee within the meaning of section 401(c)(1), there shall be allowed as a deduction under this section an amount equal to the amount paid during the taxable year for insurance which constitutes medical care for-

(A) The taxpayer,

(B) The taxpayer's spouse

(C) The taxpayer's dependents, and

(D) Any child (as defined in section 152(f) (1)) of the taxpayer who as of the end of the taxable y: ear has not attained age 27.

(2) Limitations.

{A) Dollar amount. No deduction shall be allowed under paragraph **(1)** to the extent that the amount of such deduction exceeds the taxpayer's earned income (within the meaning of section 401(c)) derived by the taxpayer from the trade or business with respect to which the plan providing the medical care coverage is established.

(B) Other coverage. Paragraph (1) shall not apply to any taxpayer for any calendar month for which the taxpayer is eligible to participate in any subsidized health plan maintained by any employer of the taxpayer or of the spouse of, or any dependent, or individual described in sub paragraph (D) of paragraph (1) with respect to, the taxpayer. The preceding sentence shall be applied separately with respect to-

(i) Plans which include coverage for qualified long-term care services (as defined in section 7702B(c)) or are qualified long-term care insurance contracts (as defined in section 7702B (b)), and

(ii) Plans which do not include such coverage and are not such contracts.

(C) Long-term care premiums. In the case of a qualified long-term care insurance contract (as defined in section 7702B(b)), only eligible long-term care premiums (as defined in section 213(d)(10)) shall be taken into account under paragraph (1).

(3) Coordination with medical deduction.

Any amount paid by a taxpayer for insurance to which paragraph **(1)** applies shall not be taken into account in computing the amount allowable to the taxpayer as a deduction under section 213(a).

(4) Deduction not allowed for self-employment tax purposes

The deduction allowable by reason of this subsection shall not be taken into account in determining an individual's net earnings from self-employment (within the meaning of section 1402(a)) for purposes of chapter 2 for taxable years beginning before January 1, 2010, or after December 31, 2010.

(5) ***Treatment of certain S corporation shareholders.***

This subsection shall apply in the case of any individual treated as a partner under section 1372(a), except that-

(A) For purposes of this subsection, such individual's wages (as defined in section 3121) from the S corporation shall be treated as such individual's earned income (within the meaning of section 401(c) (1)), and

(B) There shall be such adjustments in the application of this subsection as the Secretary may by regulations prescribe.

IRC §62(a) (19):

(a) **General rule.**

For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

(19) Health savings accounts.

The deduction allowed by section 223.

IRC §223(a):

(a) Deduction allowed.

In the case of an individual who is an eligible individual for any month during the taxable year, *there shall be allowed as a deduction for the taxable year an amount equal to the aggregate amount paid in cash during such taxable year by or on behalf of such individual to a health savings account of such individual.*

IRS Notice 2008-1:

https://www.irs.gov/pub/irs-drop/n-08-01.pdf

A 2-percent shareholder-employee in an S corporation, who otherwise meets the requirements of section 162(1), is eligible for the deduction under section 162(1) 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(1).

In order for the 2-percent shareholder-employee to deduct the a mount of the accident and health insurance premiums, the 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.

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(1).

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(1) for 2008.

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