S Corporation Compensation and Medical Insurance Issues

When computing compensation for employees and shareholders, S corporations may run into a variety of issues. The information below may help to clarify some of these concerns.

Reasonable Compensation

S corporations must pay reasonable compensation to a shareholder-employee in return for services that the employee provides to the corporation before non-wage distributions may be made to the shareholder-employee. The amount of reasonable compensation will never exceed the amount received by the shareholder either directly or indirectly.

The instructions to the Form 1120S, U.S. Income Tax Return for an S Corporation, state "Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation."

Several court cases support the authority of the IRS to reclassify other forms of payments to a shareholder-employee as a wage expense which are subject to employment taxes.

Authority to Reclassify	*Joly vs. Commissioner*, 211 F.3d 1269 (6th Cir., 2000)
Reinforced Employment Status of Shareholders	*Veterinary Surgical Consultants, P.C. vs. Commissioner*, 117 T.C. 141 (2001) *Joseph M. Grey Public Accountant, P.C. vs. Commissioner*, 119 T.C. 121 (2002)
Reasonable Reimbursement for Services Performed	*David E. Watson, PC vs. U.S., 668 F.3d 1008 (8th Cir. 2012)*

The key to establishing reasonable compensation is determining what the shareholder-employee did for the S corporation. As such, we need to look to the source of the S corporation's gross receipts.

The three major sources are:

1. Services of shareholder,
2. Services of non-shareholder employees, or

3. Capital and equipment.

If the gross receipts and profits come from items 2 and 3, then that should not be associated with the shareholder-employee's personal services and it is reasonable that the shareholder would receive distributions along with compensations.

On the other hand, if most of the gross receipts and profits are associated with the shareholder's personal services, then most of the profit distribution should be allocated as compensation.

In addition to the shareholder-employee direct generation of gross receipts, the shareholder-employee should also be compensated for administrative work performed for the other income producing employees or assets. For example, a manager may not directly produce gross receipts, but he assists the other employees or assets which are producing the day-to-day gross receipts.

Some factors in determining reasonable compensation:

- Training and experience
- Duties and responsibilities
- Time and effort devoted to the business
- Dividend history
- Payments to non-shareholder employees
- Timing and manner of paying bonuses to key people
- What comparable businesses pay for similar services
- Compensation agreements
- The use of a formula to determine compensation

Treating Medical Insurance Premiums as Wages

Health and accident insurance premiums paid on behalf of a greater than 2-percent S corporation shareholder-employee are deductible by the S corporation and reportable as wages on the shareholder-employee’s Form W-2, subject to income tax withholding.

However, these additional wages are not subject to Social Security, or Medicare (FICA), or Unemployment (FUTA) taxes if the payments of premiums are made to or on behalf of an employee under a plan or system that makes provision for all or a class of employees (or employees and their dependents). Therefore, the additional compensation is included in the shareholder-employee’s Box 1 (Wages) of Form W-2, Wage and Tax Statement, but is not included in Boxes 3 and 5 of Form W-2.

A 2-percent shareholder-employee is eligible for an above-the-line deduction in arriving at Adjusted Gross Income (AGI) for amounts paid during the year for medical care premiums if the medical care coverage was established by the S corporation and the shareholder met the other self-employed medical insurance deduction requirements. If, however, the shareholder or the shareholder’s spouse was eligible to participate in any subsidized health care plan, then the shareholder is not entitled to the above-the-line deduction. IRC § 162(l).

Health Insurance Purchased in Name of Shareholder

The insurance laws in some states do not allow a corporation to purchase group health insurance when the corporation only has one employee. Therefore, if the shareholder was the sole corporate employee, the shareholder had to purchase his health insurance in his own name.

The IRS issued Notice 2008-1, which ruled that under certain situations the shareholder would be allowed an above-the-line deduction even if the health insurance policy was purchased in the name of the shareholder. Notice 2008-1 provided four examples, including three examples in which the shareholder purchased the health insurance and one in which the S corporation purchased the health insurance.

Notice 2008-1 states that if the shareholder purchased the health insurance in his own name and paid for it with his own funds, the shareholder would not be allowed an above-the-line deduction. On the other hand, if the shareholder purchased the health insurance in his own name but the S corporation either directly paid for the health insurance or reimbursed the shareholder for the health insurance and also included the premium payment in the shareholder's W-2, the shareholder would be allowed an above-the-line deduction.

The bottom line is that in order for a shareholder to claim an above-the-line deduction, the health insurance premiums must ultimately be paid by the S corporation and must be reported as taxable compensation in the shareholder's W-2.

ACA Impact

The Affordable Care Act (ACA) did not change the above rules regarding the federal tax treatment of health and accident premiums paid for a 2% shareholder.

However, for tax years after 2013, the ACA imposes penalties on the S corporation if the S corporation offers a health plan that fails to comply with certain market reform provisions, which may include plans under which the S corporation reimburses employees for the cost of individual health insurance premiums. The potential excise tax is $100 per day, per employee, per violation.

Among the ACA market reform provisions is a requirement that a group health plan must not impose annual limits on essential health benefits. In Notice 2013-54, the IRS indicated that a health plan under which an employer reimburses employees for the cost of individual health insurance premiums (referred to as an "employer payment plan") will generally be treated as failing this requirement because the employer payment plan is treated as imposing a limit up to the cost of the individual policy premium.

The excise tax for failure to satisfy the ACA market reforms generally will not be imposed on an S corporation in the following two situations:

1. The S corporation provides medical benefits under a health plan that satisfies the ACA market reform requirements(for example, a group health plan that does not provide for reimbursement of individual policy premiums); or
2. No more than one active employee participates in the employer payment plan under which the S corporation reimburses the cost of individual policy premiums.

The ACA market reform provisions do not apply to plans that cover fewer than two participants who are active employees. IRC § 9831(a)(2).

Notice 2015-17 Transition Relief

On February 18, 2015, the IRS issued Notice 2015-17, which provides transition relief for S corporations that sponsor employer payment plans covering 2-percent shareholders.

Notice 2015-17 provides that, unless and until additional guidance provides otherwise, S corporations and shareholders may continue to rely on Notice 2008-1 with regard to the tax treatment of 2-percent shareholder-employee and their healthcare arrangements for all federal income and employment tax purposes. The

Department of Labor and the IRS are contemplating publication of additional guidance on the application of the market reforms to a 2-percent shareholder-employee healthcare arrangement.

Until such guidance is issued, the excise tax under IRC § 4980D will not be asserted for any failure to satisfy the market reforms by a 2-percent shareholder-employee healthcare arrangement.

Further, unless and until additional guidance provides otherwise, an S corporation with a 2-percent shareholder-employee healthcare arrangement will not be required to file IRS Form 8928 (regarding failures to satisfy requirements for group health plans under chapter 100 of the Code, including the market reforms) solely as a result of having a 2-percent shareholder-employee healthcare arrangement.

Note: To the extent that a 2-percent shareholder is allowed both the above-the-line deduction and the premium tax credit, Rev. Proc. 2014-41 provides guidance on computing the deduction and the credit.

Fewer Than Two Participants Who Are Current Employees Exception

As discussed above, market reforms do not apply to plans that cover fewer than two active employees. Notice 2015-17 explains that if the S corporation employs more than one employee, where the additional employee is a spouse or child of the shareholder and all employees are covered under a reimbursement arrangement with family coverage under the same plan, the arrangement would be considered to only cover one employee and would not be subject to the market reforms. As such, an S corporation with only family employees covered by the same plan may continue to reimburse for a family plan and fall under the “fewer than two participants who are current employees” exception to the market reforms.

With respect to coverage of employees who are not 2-percent shareholders, Notice 2015-17 explains that if an S corporation maintains more than one reimbursement arrangement covering both 2-percent shareholder-employees and non-2-percent shareholder-employees, the arrangements would be considered a group health plan and would not be exempted under the “fewer than two participants who are current employees” exception to the market reforms. Such a plan would generally fail to satisfy the ACA market reform requirements and thus may trigger the excise tax under IRC § 4980D with respect to the non-2-percent shareholder employees. However, Q&A-1 of Notice 2015-17 provides that no penalties under § 4980D will be assessed under such an arrangement until at least June 30, 2015.

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