Providing Fringe Benefits to S Corporation Employees

CASE STUDY
Published December 01, 2011

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In a C corporation, employee fringe benefits generally are deductible at the corporate level, and the employee excludes the value from income. In an S corporation, employee fringe benefits paid on behalf of a 2% shareholder are subject to special rules.

Sec. 1372(a) states that for fringe benefit purposes, an S corporation “shall be treated as a partnership” and a 2% shareholder “shall be treated as a partner of such partnership.” A 2% shareholder is one that owns more than 2% of the corporation’s outstanding stock on any day during the S corporation’s tax year, considering direct and constructive ownership (Secs. 1372(a) and (b)).

S corporation employees and owners may be uncertain regarding which fringe benefits are subject to the 2% shareholder rules as well as the mechanics of implementing the restrictions. However, the cost of the fringe benefits subject to the 2% shareholder rules generally is included as compensation on the recipient shareholder’s W-2 and is deducted by the S corporation as wages. Fringe benefits subject to the 2% shareholder rules include:

1. The cost of group term life insurance coverage up to $50,000 (Sec. 79);
2. Amounts received from accident and health plans (Sec. 105);
3. Contributions by an employer to accident and health plans (Sec. 106);
4. Meals and lodging furnished for the convenience of the employer (Sec. 119);
5. Employee achievement awards (Sec. 74(c); IRS Publication 15-B, Employer’s Tax Guide to Fringe Benefits);
6. Cafeteria plans (Sec. 125; Prop. Regs. Sec. 1.125-1(g)(2));
7. Qualified transportation fringe benefits (Sec. 132(f));
8. Adoption assistance programs (Sec. 137(c)(2));
9. Contributions by the corporation to health savings accounts (Sec. 223); and
10. Qualified moving expense reimbursements (Sec. 132(g)).

Some fringe benefits are not subject to the 2% shareholder rules. The corporation can deduct the cost of these fringe benefits, up to the limits specified by the relevant Code section, regardless of the percentage of stock that the recipient shareholder owns. Further, they are excluded from the employee’s income. These fringe benefits include:

1. Pension and profit-sharing plans (Sec. 401(c)(1));
2. Compensation for injury or sickness (Sec. 104(a)(3));
3. Educational assistance programs (Sec. 127);
4. Dependent care assistance (Sec. 129); and
5. No-additional-cost services, qualified employee discounts, working condition fringes, de minimis fringes, qualified retirement planning services, and on-premises athletic facilities (Sec. 132).

Providing Work-Related (Statutory) Fringe Benefits

The term “work-related fringe benefits” refers collectively to the benefits excluded from the employee’s income under Sec. 132. (These tax-free benefits are also commonly referred to as Sec. 132 fringe benefits or statutory fringe benefits.) These include qualified employee discounts, no-additional-cost services, working condition fringe benefits, de minimis fringe benefits, on-premises athletic facilities, qualified transportation fringe benefits, qualified moving expense reimbursements, and qualified retirement planning services. All Sec. 132 fringe benefits except for qualified transportation fringe benefits and qualified moving expense reimbursements are available on a tax-favored basis to 2% shareholders.

No-additional-cost services and qualified employee discounts must be available on a nondiscriminatory basis, and the exclusion from income for qualified employee discounts is limited to discounts on services or products provided within the company’s line of business in which the employee works. Thus, if an S corporation operates a retail department store and manufactures electrical components, a department store employee is not eligible for tax-free discounts on electrical components.

Applying the Family Stock Attribution Rules

Under the family stock attribution rules, a person is considered to own the stock owned by that person’s spouse, children, grandchildren, and parents (Sec. 318(a)(1), via Sec. 1372(b)). Stock constructively owned by one family member cannot be reattributed to a second family member when applying the family stock attribution rules to that second family member (Sec. 318(a)(5)).

Example: W owns 100% of the stock of S, Inc., an S corporation. W retired a few years ago and promoted his son P to president and CEO of S. The corporation covers all its employees, including P, with group medical insurance. The
current-year cost of the premiums for $P$ is $3,000.

Since $P$'s father owns 100% of the stock of $S$, $P$ is deemed to own all the stock for purposes of the 2% test. According to Rev. Rul. 91-26, the corporation treats the insurance provided to $P$ as compensation. $P$'s taxable income is increased by $3,000, while the corporate deduction passes through to $W$, who owns 100% of the stock. However, $P$ may be able to claim an above-the-line deduction (for income tax purposes, but not for self-employment tax after 2010) for the medical insurance premiums under Sec. 162(l).

Treat Taxable Fringe Benefits as Compensation

Rev. Rul. 91-26 and IRS Announcement 92-16 partially clarify fringe benefit treatment but directly address only health and accident insurance premiums. Rev. Rul. 91-26 concludes that health and accident premiums paid on behalf of a 2% shareholder are reported as compensation to the shareholder. (This means that the premiums paid on behalf of a 2% shareholder are not deducted on Form 1120S, U.S. Income Tax Return for an S Corporation, as a fringe benefit but as compensation paid to the shareholder.) Announcement 92-16 adds that the deemed wages are not subject to Social Security, Medicare taxes, and FUTA taxes if they are paid pursuant to a plan under Sec. 3121(a).

**Observation:** A plan or system normally exists if (1) the plan is in writing or is otherwise made known to employees, (2) there is reference to the plan in the employment contract, (3) employees contribute to the plan, (4) there is a separate fund for payments apart from the employer's salary account, or (5) the employer is required to make the payments (Rev. Rul. 80-303).

In the authors' opinion, treating the cost of health and accident insurance premiums as compensation under Rev. Rul. 91-26 also applies to other fringe benefits subject to the 2% shareholder rules, because it seems to be required under the rules relating to wages (Sec. 3401(a)). The value (normally, cost) of the fringe benefit is added to the wages of the shareholder on whose behalf the fringe benefit was paid and is allowable to the corporation as wage expense (under Sec. 162) rather than as a fringe benefit cost.

A 2% shareholder is not considered an employee for fringe benefit purposes and so cannot exclude the cost of the premiums from gross income as employer-provided coverage under an accident or health plan. However, a 2% shareholder may be able to claim the self-employed health insurance deduction under Sec. 162(l).


**EditorNotes**

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