

Tax Treatment of Health Insurance Paid by an S Corporation

- For certain fringe benefits paid by the S corporation, including health insurance premiums, Sec.1372(a) 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.
- Revenue Ruling 91-26 holds that accident and health insurance premiums paid by a partnership on behalf of a partner are guaranteed payments under Sec.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 Sec.162 (subject to the capitalization rules of Sec.263) and includible in the recipient-partner's gross income under Sec.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 Sec.162(1)(5) holds that a 2% shareholder that is treated as a partner under IRC Sec.1372 will be treated as a self-employed person and, assuming all of the other provisions of IRC Sec.162(1) are met, may deduct the health insurance premiums paid by the S corporation as an above-the-line deduction.

CAUTION – 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.

Tax Treatment of Health Insurance Purchased in the Shareholder's Name

- 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 Sec.1372 do not come into play.
- Since the provisions of Sec.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 Sec.162 (1).
- The shareholder is still able to deduct the health insurance as an itemized deduction which is subject to the 7.5% AGI limitation.

NOTE – 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 Sec.162 (1) benefits.