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Paying Accident and Health Insurance Premiums in Partnerships and S Corporations: Applicability to Limited Partners

— by Neil E. Harl*

In 1991, the Internal Revenue Service provided guidance on how to handle payment of accident and health insurance premiums in partnerships and S corporations. A matter of continuing concern is the extent to which those rules apply to limited partners.

General rules for partnerships

If accident and health insurance premiums are paid for services rendered in the capacity of a partner, to the extent the premiums are determined without regard to partnership income, the amounts are considered to be guaranteed payments. Generally, guaranteed payments are treated as a partner’s distributive share of ordinary income. As guaranteed payments, the premiums are deductible by the partnership and includible in the recipient partner’s gross income. The premiums are not excludible from the recipient partner’s gross income as a contribution by an employer to an accident and health plan. If the requirements are met, the partner may deduct the cost of premiums to the extent permitted for self-employed individuals. That percentage is 60 percent for 1999 through 2001, 70 percent for 2002 and 100 percent for 2003 and later years.

A partnership must report the cost of accident and health insurance premiums that are guaranteed payments on the Form 1065 and Schedule K-1s but is not required to file a Form 1099 or W-2 for health and accident insurance premiums that are guaranteed payments.

Thus, the premium payment amounts are reportable into income with a partial deduction claimable until 2003 with full deductibility thereafter.

It is noted that, in the 1991 ruling, all partners were apparently general partners and the ruling was premised on the fact that the premiums were “paid for services rendered in the capacity of partner.”

General rules for S corporations

The rules for S corporations are similar but not identical to those for partnerships. Accident and health insurance premiums paid by an S corporation on behalf of a two-percent shareholder-employee as consideration for services rendered are treated as guaranteed payments. Accident and health insurance premiums on behalf of a two-percent shareholder are deductible by the corporation on Form 1120-S and are includible in the recipient shareholder-employee’s gross income. The premiums are

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not excludable from the recipient-shareholder’s gross income as a contribution by an employer to an accident and health plan.\textsuperscript{19} If the requirements are met, the shareholder-employee may deduct the cost of premiums to the extent permitted for self-employed individuals.\textsuperscript{20} Again, that percentage is 60 percent for 1999 through 2001, 70 percent for 2002 and 100 percent for 2003 and later years.\textsuperscript{21}

If the requirements are met,\textsuperscript{22} amounts paid by an S corporation for accident and health insurance covering a two-per cent shareholder-employee are not wages for social security and Medicare purposes even though subject to income tax withholding.\textsuperscript{23} If the requirements are not met,\textsuperscript{24} the amounts are subject to social security and Medicare as well as income tax withholding.\textsuperscript{25}

An S corporation is required to file a Form W-2 for each two-per cent shareholder-employee showing the cost of accident and health insurance premiums paid on behalf of the shareholder-employee.\textsuperscript{26}

It is noted that, in the 1991 ruling,\textsuperscript{27} all S corporation shareholders were employees.

**Status of limited partners**

An important issue is how limited partners who are not being paid “for services rendered in the capacity of partner”\textsuperscript{28} are treated for purposes of health and accident insurance premium payment.

For purposes of health and accident insurance premium payment, a “self employed individual” is defined as an individual who has “earned income” for the taxable year.\textsuperscript{29} “Earned income” is defined as net earnings from self-employment as defined in I.R.C. § 1402(a).\textsuperscript{30} Under Section 1402, the term “net earnings from self-employment” is defined to include, with exceptions, a partner’s distributive share of income or less from a trade or business carried on by a partnership in which the individual is a partner.\textsuperscript{31} Proposed regulations state that a limited partner’s distributive share of income or loss is not included in net earnings from self-employment except for guaranteed payments for services.\textsuperscript{32} In general, under the regulations, an individual is considered to be a limited partner unless the individual—(1) has personal liability for the debts or claims of the entity; (2) has authority to contract for or on behalf of the partnership; or (3) participates in the partnership’s trade or business for more than 500 hours during the partnership’s taxable year.\textsuperscript{33} However, the Taxpayer Relief Act of 1997 prohibited the Internal Revenue Service from issuing temporary or final regulations defining a limited partner for self-employment tax purposes, before July 1, 1998.\textsuperscript{34} Although that date has passed, the proposed regulations remain in a state of limbo.

However, a passive limited partner would not have earned income and would not have net earnings from self-employment.

Assuming that a limited partner is not receiving guaranteed payments for services,\textsuperscript{35} the rules for general partners in the 1991 ruling would seem not to apply to inactive limited partners. Thus, the premium payments would not be deductible by the partnership. Because such an inactive limited partner would not be considered an employee for purposes of deductibility of health and accident insurance premiums for self-employed individuals,\textsuperscript{36} the inactive limited partner would be unable to deduct any part of the premiums.\textsuperscript{37}

**FOOTNOTES**

4. I.R.C. § 162.
10. See note 8 supra.
12. Id.
13. Id.
14. See I.R.C. § 1372(b): “The term ‘2-percent shareholder’ means any person who owns (or is considered as owning within the meaning of section 318) on any day during the taxable year of the S corporation more than 2 percent of the outstanding stock of such corporation or stock possessing more than 2 percent of the total combined voting power of all stock of such corporation.” Rev. Rul. 91-26, 1991-1 C.B. 184.
15. See note 14 supra.
21. I.R.C. § 3121(a)(2)(b) (specifying that some payments under a plan are excluded from wages).
26. Id.
27. Id.
29. I.R.C. § 401(c)(2).
30. I.R.C. § 1402(a).
32. Id.
34. See I.R.C. § 707(c).
36. Id