Health and Accident Insurance for "2%" S Corporation Shareholders

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Health and Accident Insurance for “2%” S Corporation Shareholders

-by Neil E. Harl*

Recent developments\(^1\) have called into question the availability of the “above-the-line” deduction for federal income tax purposes for “2 percent” shareholders of S corporations under certain circumstances.\(^2\) The problem is particularly acute for sole shareholders of S corporations.\(^3\)

**Requirements for deductibility**

The statute\(^4\) allows an individual who is an employee to claim a deduction for insurance which pays for medical care for the taxpayer, spouse and dependents. Similarly, a self-employed individual with earned income can be treated as an employee for this purpose.\(^5\) Moreover, the amount of the deduction cannot exceed the taxpayer’s earned income derived from the trade or business with respect to which the plan providing medical care coverage is established.\(^6\) The deduction is limited further by the fact that a deduction is not allowed during any month during which the taxpayer is eligible to participate in any subsidized health plan maintained by any employer of the taxpayer or of the spouse of the taxpayer.\(^7\)

**The 2005 ruling**

In a private letter ruling issued in mid-2005,\(^8\) the question was posed whether a sole proprietor could claim the above-the-line deduction where the individual had purchased health insurance in the sole proprietor’s own name, not in the name of the sole proprietorship, and to treat the sole proprietorship income as the trade or business for which the plan was established.\(^9\) The ruling states that a sole proprietor could purchase health insurance in the sole proprietor’s name and claim an above-the-line deduction for the costs in providing coverage for the sole proprietor, the spouse and dependents.\(^10\)

**The situation for S corporation shareholders**

For enumerated fringe benefits, including amounts paid under accident and health plans, an S corporation is treated as a partnership and any shareholder who owns more than two percent of the S corporation stock is treated as a partner.\(^11\) In 1991, the Internal Revenue Service ruled that accident and health insurance premiums paid by a partnership (or S corporation) on behalf of a partner are considered guaranteed payments if the premiums are paid for services rendered in that capacity and to the extent the premiums are determined without regard to partnership income.\(^12\) With the status of guaranteed payments, the premiums are

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The obvious solution is to have the S corporation purchase the health insurance in its own name. But the problem with that is that some states do not allow a corporation to purchase a health insurance plan with only one participant. This precludes the S corporation from acquiring a health insurance plan and means that the only practical solution is to have the sole shareholder purchase the plan in his or her own name. The Internal Revenue Service has made it clear that the 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(l) benefits.”

The solution

In a perfect world, a Congress sensitive to inequities in the tax system would respond with an amendment to make it clear that a shareholder-employee purchase of health insurance would be deemed a plan providing medical coverage on the part of the S corporation. However, this is viewed as a minor issue, especially in an era when even major tax issues are commanding little Congressional attention.

Footnotes


3 See note 1, supra.


5 I.R.C. §§ 401(c)(1), 162(l)(1).


11 I.R.C. § 1372(a).

12 See I.R.C. § 707(c).


14 I.R.C. § 162.

15 I.R.C. § 61.

16 I.R.C. § 162(l).

17 I.R.C. § 106.


19 I.R.C. § 1372.


