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Memorandum**

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subject: Health Insurance Costs of Employee Family Members of 2-Percent Shareholders

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ISSUE

Whether an individual who is a 2-percent shareholder of an S corporation pursuant to the attribution of ownership rules under § 318 of the Internal Revenue Code is entitled to the deduction under § 162(l) for amounts that are paid by the S corporation under a group health plan for all employees and included in the individual's gross income, if the individual otherwise meets the requirements of § 162(l).

CONCLUSION

An individual who is a 2-percent shareholder of an S corporation pursuant to the attribution of ownership rules under § 318 is entitled to the deduction under § 162(l) for amounts that are paid by the S corporation under a group health plan for all employees and included in the individual's gross income, if the individual otherwise meets the requirements of § 162(l).

FACTS

An individual owns 100% of an S corporation, which employs the individual's family member. The family member is considered to be a 2-percent shareholder pursuant to the attribution of ownership rules under § 318. The S corporation provides a group health plan for all employees, and the amounts paid by the S corporation under such group health plan are included in the family member's gross income.

LAW AND ANALYSIS

Section 1372(a) provides that, for purposes of applying the income tax provisions of the Code relating to employee fringe benefits, an S corporation shall be treated as a partnership, and any 2-percent shareholder of the S corporation shall be treated as a partner of such partnership. For purposes of § 1372, the term "2-percent shareholder" is any person who owns (or is considered as owning within the meaning of § 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. Section 1372(b). Section 318(a)(1) provides that an individual shall be considered as owning the stock owned, directly or indirectly, by or for (i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and (ii) his children, grandchildren, and parents.

Accident and health insurance premiums paid or furnished by an S corporation on behalf of its 2-percent shareholders in consideration for services rendered are treated for income tax purposes like partnership guaranteed payments under § 707(c) of the Code. Rev. Rul. 91-26, 1991-1 C.B. 184. An S corporation is entitled to deduct the cost of such employee fringe benefits under § 162(a) if the requirements of that section are satisfied (taking into account the rules of § 263). The premium payments are included in wages for income tax withholding purposes on the shareholder-employee's Form W-2, Wage and Tax Statement, but are not wages subject to Social Security and Medicare taxes if the requirements for exclusion under § 3121(a)(2)(B) are satisfied. See § 3121(a)(2)(B); Ann. 92-16, 1992-5 I.R.B. 53. The 2-percent shareholder is required to include the amount of the accident and health insurance premiums in gross income under § 61(a). Notice 2008-1, 2008-2 I.R.B. 251.

Section 106 provides an exclusion from the gross income of an employee for employer-provided coverage under an accident and health plan. A 2-percent shareholder is not an employee for purposes of § 106. Treas. Reg. § 1.106-1; section 1372(a). Accordingly, the premiums are not excludible from the 2-percent shareholder-employee's gross income under § 106. Notice 2008-1.

Section 162(l)(1)(A) allows an individual who is an employee within the meaning of § 401(c)(1) to take a deduction in computing adjusted gross income for amounts paid during the taxable year for insurance that constitutes medical care for the taxpayer, his

or her spouse, and dependents. The deduction is not allowed to the extent that the amount of the deduction exceeds the earned income (within the meaning of § 401(c)(2)) derived by the taxpayer from the trade or business with respect to which the plan providing the medical care coverage is established. Section 162(l)(2)(A). Also, the deduction is not allowed for amounts during a month in which the taxpayer is eligible to participate in any subsidized health plan maintained by an employer of the taxpayer or of the spouse of the taxpayer. Section 162(l)(2)(B).

A 2-percent shareholder-employee in an S corporation, who otherwise meets the requirements of § 162(l), is eligible for the deduction under § 162(l) if the plan providing medical care coverage for the 2-percent shareholder-employee is established by the S corporation. Rev. Rul. 91-26, 1991-1 C.B. 184. A plan providing medical care coverage for the 2-percent shareholder-employee in an S corporation is established by the S corporation if: (1) the S corporation makes the premium payments for the accident and health insurance policy covering the 2-percent shareholder-employee (and his or her spouse or dependents, if applicable) in the current taxable year; or (2) the 2-percent shareholder makes the premium payments and furnishes proof of premium payment to the S corporation and then the S corporation reimburses the 2-percent shareholder-employee for the premium payments in the current taxable year. If the accident and health insurance premiums are not paid or reimbursed by the S corporation and included in the 2-percent shareholder-employee's gross income, a plan providing medical care coverage for the 2-percent shareholder-employee is not established by the S corporation and the 2-percent shareholder-employee in an S corporation is not allowed the deduction under § 162(l). Notice 2008-1.

In order for the 2-percent shareholder-employee to deduct the amount of the accident and health insurance premiums, the S corporation must report the accident and health insurance premiums paid or reimbursed as wages on the 2-percent shareholder-employee's Form W-2 in that same year. In addition, the shareholder must report the premium payments or reimbursements from the S corporation as gross income on his or her Form 1040, U.S. Individual Tax Return. Notice 2008-1.

Pursuant to the rules described above, an individual who is a 2-percent shareholder of an S corporation pursuant to the attribution of ownership rules under § 318 is entitled to the deduction under § 162(l) for amounts that are paid by the S corporation under a group health plan for all employees and included in the individual's gross income, if the individual otherwise meets the requirements of section 162(l).

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