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Notice 2008-1

Special Rules for Health Insurance Costs of 2-Percent Shareholder-Employees

December 13, 2007

PURPOSE

This notice provides rules under which a 2-percent shareholder-employee in an S corporation is entitled to the deduction under §162 (l) of the Internal Revenue Code for accident and health insurance premiums that are paid or reimbursed by the S corporation and included in the 2-percent shareholder-employee'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).

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 section 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).

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.

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 section 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 section 162 (l), is eligible for the deduction under section 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).

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 Income Tax Return.

EXAMPLES

The following examples illustrate these rules. The following examples assume that each shareholder is a 2-percent shareholder-employee in an S corporation, whose earned income from the S corporation exceeds the amount of the premiums for the accident and health insurance policies covering the shareholder, his or her spouse and dependents. None of the shareholders in the following examples are eligible to participate in any subsidized health plan maintained by an employer of the shareholder or the shareholder's spouse.

Example 1. (i) For 2008, shareholder A obtains an accident and health insurance policy in the name of shareholder A and makes the premium payments on the policy. The S corporation makes no payments or reimbursements with respect to the premiums.

(ii) A plan providing medical care for shareholder A is not established by the S corporation and shareholder A is not entitled to the deduction under § 162 (l).

Example 2. (i) For 2008, the S corporation obtains an accident and health insurance plan in the name of the S corporation. The health plan provides coverage for shareholder B, B's spouse and dependents. The S corporation makes all the premium payments to the insurance company. The S corporation reports the amount of the premiums as wages on shareholder B's Form W-2 for 2008 and shareholder B reports that amount as gross income on Form 1040 for 2008.

(ii) A plan providing medical care for shareholder B has been established by the S corporation and shareholder B is allowed the deduction under § 162 (l) for 2008.

Example 3. (i) For 2008, shareholder C obtains an accident and health insurance policy in the name of shareholder C. The S corporation makes all the premium payments to the insurance company. The S corporation reports the amount of the premiums as wages on shareholder C's Form W-2 for 2008 and shareholder C reports that amount as gross income on Form 1040 for 2008.

(ii) A plan providing medical care for shareholder C has been established by the S corporation and shareholder C is allowed the deduction under § 162 (l) for 2008.

Example 4. (i) For 2008, shareholder D obtains an accident and health insurance policy in the name of shareholder D. Shareholder D makes the premium payments to the insurance company and furnishes proof of premium payment to the S corporation. The S corporation then reimburses shareholder D for the premium payments. The S corporation reports the amount of the premium reimbursements as wages on shareholder D's Form W-2 for 2008 and shareholder D reports that amount as gross income on Form 1040 for 2008.

(ii) A plan providing medical care for shareholder D has been established by the S corporation and shareholder D is allowed the deduction under § 162 (l) for 2008.

AMENDED RETURNS FOR PRIOR TAXABLE YEARS

Taxpayers who did not claim deductions for fringe benefits described in this Notice may file timely amended tax returns to claim the deduction under § 162 (l) if the taxpayers satisfy the requirements of this Notice. The statement "Filed Pursuant to Notice 2008-1" should be written on the top of any amended return.

The Service does not consider payments of accident and health insurance premiums by an S corporation on behalf of 2-percent shareholder-employees to be distributions for purposes of the single class of stock requirement of §1361 (b) (1) (D).

DRAFTING INFORMATION

The principal authors of this notice are Mireille Khoury of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and Charles D. Wien of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further

information regarding this notice as it relates to accident and health insurance costs of self-employed individuals generally, contact Mireille Khoury at (202) 622-6080 (not a toll free call). For further information relating to accident and health insurance costs of 2-percent shareholder-employees of S corporations, contact Charles D. Wien at (202) 622-3070 (not a toll free call).