



JENNINGS LAW FIRM

memorandum

November 5, 2008

HEALTH PREMIUMS PAID BY S CORPORATIONS

Many businesses pay some portion of the premiums for their employees' health insurance. In the case of S corporations who pay these premiums for their "2% shareholders," these premiums are includible in the shareholders' gross income but excludible from their FICA/Medicare wages. In our view, these premiums are considered "compensation" for purposes of the S corporation's retirement plan.

Legal Principles

Section 1372(a) of the Internal Revenue Code of 1986 (the "Code") provides that for purposes of applying the income tax provisions of the Code relating to employee fringe benefits, an S corporation is treated as a partnership, and any 2% shareholder (as defined under Section 1372(b) of the Code) is treated as a partner in a partnership. Section 1372(b) defines a 2% shareholder as any person who owns (or is considered owning) more than 2% of the corporation's outstanding stock.

Section 106 of the Code provides that an employee's gross income does not include employer-provided coverage under an accident or health plan that compensates the employee for personal injuries or sickness of the employee (or his dependents). A 2% shareholder in an S corporation is not considered an employee for purposes of Section 106 due to the application of Section 1372(a). See Notice 2008-1, 2008-2 IRB 251 (12/13/2007).

Section 1372(a) of the Code, however, does not address the treatment of health premiums paid by an S corporation on behalf of its 2% shareholders for purposes of Social Security and Medicare taxes. Specifically, Section 3121(a)(2)(B) of the Code excludes from wages subject to Social Security and Medicare taxes certain amounts paid by an employer on behalf of an employee (including insurance premiums) for medical and hospitalization expenses incurred in connection with sickness and accident disability.

In Announcement 92-16, 1992-5 IRB 53, the IRS indicated that the exclusion under Section 3121(a)(2)(B) applies to each employee of an S corporation, including an employee who is a 2% shareholder. In Notice 2008-1 (cited above), the IRS reaffirmed Announcement 92-16 and expressly stated that:

1. Section 1372(a) treats an employee who is a 2% shareholder in an S corporation as a partner in a partnership but only for income tax purposes.
2. Section 3121(a)(2)(B) treats 2% shareholders as any other employee for purposes of Social Security and Medicare taxes and, if the requirements under that section are satisfied, health premiums paid by an S corporation on behalf of its 2% shareholders are not wages for purposes of Social Security and Medicare taxes.

Section 162(l)(5) of the Code permits partners to deduct health insurance premiums paid on their behalf by the partnership. Section 162(l)(5)(A) permits 2% shareholders in an S corporation to deduct health

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insurance premiums paid by the corporation on their behalf. Section 162(l)(5)(A) provides that a 2% shareholder's wages are defined under Section 3121 of the Code.

Section 414(s) of the Code sets out definitions of "compensation" that can be used for purposes of a qualified retirement plan under Section 401(a) of the Code. Section 414(s) provides alternative definitions that can be used:

1. Compensation as defined under Section 415(c)(3) of the Code (415 Compensation).
2. 415 Compensation but excluding salary reduction contributions under Section 125, 132(f)(4), 402(e)(3), 402(h) or 403(b) of the Code to the extent such contributions are excludible from the employee's gross income.
3. An alternative definition of compensation that does not discriminate in favor of "highly compensated employees" (as defined under Section 414(q) of the Code).

Treas. Reg. 1.415(c)-2 provides that for purposes of Section 415(c)(3), compensation means all items of compensation described under Treas. Reg. 1.415(c)-2(b), and excludes those items of remuneration described under Treas. Reg. 1.415(c)-2(c).

Treas. Reg. 1.415(c)-2(b) describes various items of remuneration and is limited to those items that are includible in gross income. Treas. Reg. 1.415(c)-2(c) lists various items of compensation that are not considered 415 Compensation and none of them refer to Section 106 of the Code.

Analysis

Health premiums paid by an S corporation on behalf of an employee who is a 2% shareholder is includible in the employee's gross income. Notice 2008-1 acknowledges that "wages" or "compensation" have different meanings for different purposes under the Code. Specifically, wages paid to a 2% shareholder by an S corporation are considered wages for income tax withholding purposes but are not considered wages for Social Security and Medicare tax purposes.

Section 162(l)(5)(A) permits 2% shareholders to deduct health premiums paid on their behalf by their S corporations but does not change the fact that such premiums are initially includible in the employees' gross income.

Treas. Reg. 1.415(c)-2(b)(3) describes various items of remuneration that are considered 415 Compensation and those items are generally remuneration that is includible in the employee's gross income. Certain salary deferrals are includible in an employee's 415 Compensation but only to the extent such amounts are not includible in an employee's gross income. Health premiums paid by an S corporation on behalf of an employee who is a 2% shareholder are includible in the employee's gross income. Employees who are 2% shareholders may not exclude from their gross income salary reduction contributions to pay health premiums.

415 Compensation focuses on remuneration that is includible in gross income, and does not refer to compensation that may or may not be considered "wages" for purposes of Social Security and Medicare taxes under Section 3121(a) of the Code. Thus, to the extent health premiums paid by an S corporation on behalf of employees who are 2% shareholders are includible in such employees' gross income, such amounts are considered compensation for retirement plan purposes.

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Services We Can Provide

The rules governing qualified retirement plans are very complex. Many employers have concluded it is not enough to engage just a pension consultant for advice on these matters. We offer advice to clients of our affiliate, Dana Consulting Group, and also to employers who use other consulting firms or whose plan is managed in a fully bundled administration program.

If you have any questions or comments, please feel free to contact us.

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