



# S Corporation Compensation and Medical Insurance Issues

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When computing compensation for employees and shareholders, S corporations may run into a variety of issues. The information below may help to clarify some of these concerns.

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## Reasonable Compensation

S corporations must pay reasonable compensation to a shareholder-employee in return for services that the employee provides to the corporation before non-wage distributions may be made to the shareholder-employee. The amount of reasonable compensation will never exceed the amount received by the shareholder either directly or indirectly.

The instructions to the Form 1120S, U.S. Income Tax Return for an S Corporation, state "Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation."

Under section 7436 of the Internal Revenue Code, the IRS has the authority to reclassify payments made to shareholders from non-wage distributions (which are not subject to employment taxes) to wages (which are subject to employment taxes). Several court cases support the authority of the IRS to reclassify other forms of payments to a shareholder-employee as a wage expense which are subject to [employment taxes](#).

Authority to Reclassify

Joly v. Commissioner, T.C. Memo. 1998-361, aff'd by unpub. op.,  
211 F.3d 1269 (6th Cir. 2000)

<p><b>Reinforced Employment Status of Shareholders</b></p>	<p><i>Veterinary Surgical Consultants, P.C. vs. Commissioner</i>, 117 T.C. 141 (2001)</p> <p><i>Joseph M. Grey Public Accountant, P.C. vs. Commissioner</i>, 119 T.C. 121 (2002)</p>
<p><b>Reasonable Reimbursement for Services Performed</b></p>	<p><i>David E. Watson, PC vs. U.S.</i>, 668 F.3d 1008 (8<sup>th</sup> Cir. 2012)</p>

The key to establishing reasonable compensation is determining what the shareholder-employee did for the S corporation by looking to the source of the S corporation's gross receipts.

The three major sources are:

1. Services of shareholder
2. Services of non-shareholder employees or
3. Capital and equipment

To the extent gross receipts are generated by services of non-shareholder employees and capital and equipment, payments to the shareholder would properly be treated as non-wage distributions that are not subject to employment taxes.

But to the extent gross receipts are generated by the shareholder's personal services, then payments to the shareholder-employee should be classified as wages that are subject to employment taxes.

In addition to gross receipts generated directly by the shareholder-employee, the shareholder-employee should also be subject to wage treatment for administrative work performed by him for the other income-producing employees or assets. For example, a manager may not directly produce gross receipts, but he assists the other employees or assets which are producing the day-to-day gross receipts.

Some factors in determining reasonable compensation:

- Training and experience
- Duties and responsibilities
- Time and effort devoted to the business
- Dividend history
- Payments to non-shareholder employees
- Timing and manner of paying bonuses to key people
- What comparable businesses pay for similar services
- Compensation agreements
- The use of a formula to determine compensation

## Treating Medical Insurance Premiums as Wages

Health and accident insurance premiums paid on behalf of a greater than 2-percent S corporation shareholder-employee are deductible by the S corporation and reportable as wages on the shareholder-employee's Form W-2, subject to income tax withholding. (A 2-percent shareholder is someone who owns more than 2 percent of the outstanding stock of the corporation or stock possessing more than 2 percent of the total combined voting power of all stock of the corporation.)

However, these additional wages are not subject to Social Security, or Medicare (FICA), or Unemployment (FUTA) taxes if the payments of premiums are made to or on behalf of an employee under a plan or system that makes provision for all or a class of employees (or employees and their dependents). Therefore, the additional compensation is included in the shareholder-employee's Box 1 (Wages) of Form W-2, Wage and Tax Statement, but is not included in Boxes 3 and 5 of Form W-2.

A 2-percent shareholder-employee is eligible for an above-the-line deduction in arriving at Adjusted Gross Income (AGI) for amounts paid during the year for medical care premiums if the medical care coverage was established by the S corporation and the shareholder met the other self-employed medical insurance deduction requirements. If, however, the shareholder or the shareholder's spouse was eligible to participate in any subsidized health care plan, then the shareholder is not entitled to the above-the-line deduction. IRC § 162(l).

## Health Insurance Purchased in Name of Shareholder

Insurance laws in some states do not allow a corporation to buy group health insurance when the corporation only has one employee. Therefore, if the shareholder was the sole employee of the corporation, then the shareholder has to purchase health insurance in his own name.

[Notice 2008-1](#) provided rules by which a 2-percent shareholder would be allowed an above-the-line deduction even if the health insurance policy was purchased in the name of the shareholder. Notice 2008-1 provided four examples, including three examples in which the shareholder purchased the health insurance and one in which the S corporation purchased the health insurance.

Notice 2008-1 states that if the shareholder purchased the health insurance in his own name and paid for it with his own funds, the shareholder would not be allowed an above-the-line deduction. On the other hand, if the corporation obtains and pays for health insurance in its name, covers the shareholder under the policy, and reports the premiums as W-2 wages to the shareholder, then the shareholder is allowed an above-the-line deduction. Similarly, if the shareholder purchased the health insurance in his own name but the S corporation either directly paid for the health insurance or reimbursed the shareholder for the health insurance and also included the premium payment in the shareholder's W-2, the shareholder would be allowed an above-the-line deduction.

The bottom line is that in order for a shareholder to claim an above-the-line deduction, the health insurance premiums must ultimately be paid by the S corporation and must be reported as taxable compensation in the shareholder's W-2.

## ACA Impact

The Affordable Care Act (ACA) did not change the rules described above regarding the federal tax treatment of health and accident premiums paid for a 2-percent shareholder.

However, for tax years after 2013, the ACA imposes penalties on an S corporation that offers a health plan failing to comply with certain market reform provisions, which may include plans under which the S corporation reimburses employees for the cost of individual health insurance premiums.

The potential excise tax is \$100 per day, per employee, per violation.

Among the ACA market reform provisions is a requirement that a group health plan must not impose annual limits on essential health benefits. In [Notice 2013-54](#), the IRS indicated that a health plan under which an employer reimburses employees for the cost of individual health insurance premiums on the individual coverage market (referred to as an "employer payment plan") will generally be treated as failing this requirement because the employer payment plan is treated as imposing a limit up to the cost of the individual policy premium.

The excise tax for failure to satisfy the ACA market reforms generally will not be imposed on an S corporation in the following two situations:

1. The S corporation provides medical benefits under a health plan that satisfies the ACA market reform requirements (for example, a group health plan that does not provide for reimbursement of individual policy premiums) or
2. No more than one current employee participates in the employer payment plan under which the S corporation reimburses the cost of individual policy premiums.

The ACA market reform provisions do not apply to plans that cover fewer than two participants who are current employees. IRC § 9831(a)(2).

## **Notice 2015-17 Transition Relief**

[Notice 2015-17](#) provides transition relief for S corporations that sponsor employer payment plans covering 2-percent shareholders.

Notice 2015-17 provides that, unless and until additional guidance provides otherwise, S corporations and shareholders may continue to rely on Notice 2008-1 with regard to the tax treatment of 2-percent shareholder-employee and their healthcare arrangements for all federal income and employment tax purposes. The Department of Labor and the IRS are contemplating publication of additional guidance on the application of the market reforms to a 2-percent shareholder-employee healthcare arrangement.

Until such guidance is issued, the excise tax under IRC § 4980D will not be asserted for any failure to satisfy the market reforms by a 2-percent shareholder-employee healthcare arrangement.

Further, unless and until additional guidance provides otherwise, an S corporation with a 2-percent shareholder-employee healthcare arrangement will not be required to file IRS Form 8928 (regarding failures to satisfy requirements for group health plans under chapter 100 of the Code, including the market reforms) solely as a result of having a 2-percent shareholder-employee healthcare arrangement.

**Note:** To the extent that a 2-percent shareholder-employee is allowed both the above-the-line deduction under IRC § 162(l) and the premium tax credit under IRC § 36B, [Rev. Proc. 2014-41](#) provides guidance on computing the deduction and the credit.

## **Fewer Than Two Participants Who Are Current Employees Exception**

As discussed above, market reforms do not apply to plans that cover fewer than two current employees. Notice 2015-17 explains that if the S corporation employs more than one employee, where the additional employee is a spouse or child of the shareholder and all employees are covered under a reimbursement arrangement with family coverage under the same plan, the arrangement would be considered to only cover one employee and would not be subject to the market reforms. Thus, an S corporation with only family employees covered by the same plan may continue to reimburse for a family plan and fall under the “fewer than two participants who are current employees” exception to the market reforms.

With respect to coverage of employees who are not 2-percent shareholders, Notice 2015-17 explains that if an S corporation maintains more than one reimbursement arrangement covering both 2-percent shareholder-employees and non-2-percent shareholder-employees, the arrangements would be considered a group health plan and would not be exempted under the “fewer than two participants who are current employees” exception to the market reforms. Such a plan would generally fail to satisfy the ACA market reform requirements and thus may trigger the excise tax under IRC § 4980D with respect to the non-2-percent shareholder employees. While

Q&A-1 of Notice 2015-17 provides that no penalties under IRC § 4980D will be assessed under such an arrangement until at least June 30, 2015, section 18001(a)(7)(B) extends the relief under Notice 2015-17 to any plan year beginning on or before December 31, 2016.

## Qualified Small Employer Health Reimbursement Arrangements for Eligible Small Employers

Under prior guidance, the IRS indicated that employers could not pay for the cost of individual health insurance for employees, or reimburse the premium cost for such individual policies, without violating ACA market reforms and triggering an excise tax of \$100 per day per affected individual. With the passage of the 21st Century Cures Act in 2016, small employers can, beginning in 2017, establish Qualified Small Employer Health Reimbursement Arrangements (“QSEHRA”). Described in IRC § 9831(d), a QSEHRA is an arrangement that a small business uses to reimburse its employees’ qualified medical expenses. The reimbursement is made after the employee incurs a medical expense and submits documentation. A QSEHRA cannot work in conjunction with a group health insurance plan. A QSEHRA will not violate the ACA coverage mandates if certain key requirements are met.

To establish a QSEHRA, the employer must:

- Be a small employer (fewer than 50 full-time employees and full-time employee equivalents)
- Not be subject to the Affordable Care Act’s employer shared responsibility provisions (also referred to as the “pay or play mandate”)
- Not provide a group health plan to its employees and
- Be funded solely by the employer (no employee contributions are permitted)

All full-time employees must be eligible for the QSEHRA after a waiting period of no more than 90 days of service. There are certain permitted exclusions, such as for employees under age 25 and union employees. A QSEHRA may be funded only by the employer, not by employee salary reductions.

Under a QSEHRA, there is a maximum annual employer reimbursement, which is adjusted for inflation.

Year	Self Only Employees	Employees with a Family
2017	\$4,950	\$10,000
2018	\$5,050	\$10,250

The maximum annual benefit is prorated for employees not covered by the QSEHRA for the entire year (e.g., new hires).

A QSEHRA can reimburse any medical expenses as defined in IRC § 213(d) incurred by an employee or the employee’s family (as determined under the terms of the QSEHRA). Reimbursement is tax-free to the employee provided the employee is enrolled in minimum essential health coverage.

A QSEHRA must be offered on the same terms and conditions to all eligible employees, but may vary in price based on the age of covered individuals or the number of individuals covered. Furthermore, the arrangement must be operated on a uniform and consistent basis for all eligible employees.

## QSEHRA Notice Requirements

Small employers must provide eligible employees with an annual notice about the QSEHRA at least 90 days before the beginning of the year. The notice must include the following information:

- A statement of the amount of the permitted benefit for the year.
- A statement that the eligible employee should disclose the amount of the benefit to the health insurance exchange when applying for advance payment of the premium tax credit.
- A statement that if the employee is not covered under minimum essential coverage, the employee may be subject to the mandatory penalty and the QSEHRA reimbursements could be taxable. [Note: the mandatory penalty for failure to be covered under minimum essential coverage expires after December 31, 2018.]

## **Failure to Satisfy the Requirements to be a QSEHRA**

If an arrangement fails to be a QSEHRA because one or more of the requirements is not satisfied, the arrangement is a group health plan subject to Chapter 100 of the IRC. Any violation of Chapter 100 is subject to the excise tax under IRC § 4980D (\$100 per affected person per day), unless the IRS waives all or part of the excise tax upon a showing of reasonable cause and no willful neglect.

Examples of non-compliance with IRC § 9831(d) include the following:

- The plan is not provided by an eligible employer (such as an employer that offers another group health plan to its employees).
- The plan is not provided on the same terms to all eligible employees.
- The plan reimburses medical expenses without first requiring proof of minimum essential coverage (MEC).
- The plan provides a permitted benefit in excess of the statutory dollar limits.

An arrangement's failure to be a QSEHRA will not cause any reimbursement of a properly substantiated medical expense that is otherwise excludable from income to be included in the employee's income or wages.

An arrangement designed to reimburse expenses other than medical expenses (whether or not also reimbursing medical expenses) is neither a QSEHRA nor a group health plan. All payments under such an arrangement are includible in the employee's income as wages.

An employer's failure to timely provide a compliant written notice does not cause an arrangement to fail to be a QSEHRA, but instead results in the \$50 per employee/per incident penalty under IRC § 6652(o) (up to a maximum of \$2,500).

## **Interaction with HSA Requirements**

Under IRC § 223, certain individuals are eligible to take a deduction for amounts paid in cash by or on behalf of such individual to a health savings account (HSA), which is subject to rules similar to individual retirement arrangements. Individuals who have high deductible health plan (HDHP) coverage and no other disqualifying health coverage may contribute to an HSA. Individuals who are covered by permitted insurance (defined under IRC § 223(c)(3)) or certain disregarded coverage (defined under IRC § 223(c)(1)(B)), in addition to HDHP coverage, may remain eligible to contribute to an HSA. For 2018, the HSA contribution is limited to \$3,450 for single employees and \$6,900 for employees with a family. An employee 55 years or older may contribute an additional \$1,000 per year.

An individual who is provided a QSEHRA that, by its terms, is eligible to reimburse any medical expense, including cost sharing, is not eligible for an HSA under IRC § 223.

On the other hand, if the QSEHRA is properly limited, the employee would still be eligible to have an HSA along with a QSEHRA. In the year an employee makes a contribution to an HSA, the QSEHRA can only reimburse the employee for the following:

- High deductible health insurance premiums
- Wellness or preventive care (e.g., checkups, weight loss, smoking cessation, mammograms)
- Dental expenses
- Vision expenses and
- Long-term care premiums

These QSEHRA limits are only necessary for employees who make or receive contributions to their or their spouse's HSA during the year. Other employees can be reimbursed for all qualified medical expenses.

## **Notice 2017-67**

Notice 2017-67 provides extensive guidance on the requirements for providing a QSEHRA, the tax consequences of the arrangement, and the requirements for providing written notice of the arrangement to eligible employees. Notice 2017-67 applies for plan years beginning on and after November 20, 2017. Through a series of 79 questions and answers, Notice 2017-67 covers the following rules:

- Eligible employer
- Eligible employee
- Same terms requirement
- Statutory dollar limits
- Written notice requirement
- Minimum essential coverage (MEC) requirement
- Proof of MEC requirement
- Substantiation requirement
- Reimbursement of medical expenses
- Reporting requirement
- Coordination with premium tax credit
- Failure to satisfy the requirements to be a QSEHRA and
- Interaction with health savings account requirements

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