

Compensation and Medical Insurance Issues for S Corporations

By Richard M. Ornstein, CPA

If you are operating an S Corporation, you already may be aware of the various issues that develop when calculating compensation to the corporation's employees. We have assembled some issues that you should consider when calculating compensation for your employees. Should you have any questions about any of the topics in this article, please be sure to speak with an accounting professional.

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.

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 the service rendered to the corporation.

Below are some factors you may want to consider 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 the greater than two percent S corporation shareholder-employees are deductible and reportable by the S corporation as wages for income tax withholding purposes on the shareholder-employee's Form W-2.

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



SHAREHOLDERS

Martin R. Glickstein, CPA
mglickstein@glccpa.com

Rodney S. Laval, CPA
rlaval@glccpa.com

W. Neal Carris, CPA
ncarris@glccpa.com

James M. Loomis, CPA
jloomis@glccpa.com

Mary C. Dantuma, CPA
mdantuma@glccpa.com

Bethany K. Lusby, CPA
blusby@glccpa.com

Richard M. Ornstein, CPA
ronstein@glccpa.com

Paula M. Taylor, CPA
ptaylor@glccpa.com

J. Russell Hamlin, CPA
rhamlin@glccpa.com

PRINCIPAL

T. Shepard Burr, CPA
sburr@glccpa.com



A medical plan can be considered established by the S corporation if the S corporation paid or reimbursed the shareholder-employee for premiums and reported:

- ◆ The premium payment
- ◆ Reimbursement as wages on the shareholder-employee's W-2
- ◆ Health insurance purchased in name of shareholder

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

The IRS released a notice that ruled that under certain situations the shareholder would be allowed an above-the-line deduction even if the health insurance policy was purchased in the name of the shareholder. They also provided four examples: Three of the examples had the shareholder purchasing the health insurance. The other example had the S corporation purchasing the health insurance.

The notice held 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 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 had to be paid by the S corporation and had to be included in the shareholder's W-2.

You should be aware that there are a number of changes that may occur due to healthcare reform bills under discussion in Congress, and the passage of those bills could change significantly the way in which S corporations purchase health insurance.

If you would like more information about reasonable compensation and health insurance premium deductions for S corporations, please contact a financial professional today.