

## **Hot Issues for S Corporations**

During the recent tax season we noted two predominant areas for S Corporations that have been improperly treated and should be addressed.

### **Proper Treatment of Shareholder Health Insurance Premiums**

S Corporation shareholders who own 2% or more of the corporation are considered “self-employed” for purposes of deducting health insurance, and the S Corporation must follow these procedures in order to maximize the deduction for shareholder health insurance premiums.

- Pay the health insurance premiums of the shareholder, or reimburse payments made by the shareholder, **and**
- Include payments in the shareholder’s W-2 wages

Health insurance premium wages are subject to income tax withholding; however, they are **not** subject to Social Security or Medicare taxes. To ensure that health insurance premiums are being properly treated and reported you should work with your bookkeeper and/or payroll provider to properly implement the special rules as outlined in the attached document.

For a complete explanation of these special rules please see the second page of this document.

### **Proper Treatment of Shareholder Loans and Advances**

Shareholder advances or loans to shareholders that are on the books at year-end are subject to recharacterization by the IRS as dividend distributions. As such, there should be no shareholder advances or loans from the S Corporation on the year-end balance sheet.

You can avoid having loans or advances recharacterized by taking one of the three following actions before the end of the year:

- Repay loans or advances to the S Corporation
- Include loans or advances as wages in the shareholder’s W-2
- Show loans or advances as shareholder distributions on the balance sheet

Please contact us if you would like to discuss these or any other issues further.

## **Special Rules for Health Insurance Costs of 2% S Corporation Shareholders**

S Corporation shareholders who own 2% or more of the business are considered “self-employed” for purposes of deducting health insurance premiums as an adjustment to income (rather than an itemized deduction subject to the medical expense limitations) on their individual tax returns.

In order for a 2% shareholder to have an allowable “adjustment to income” for health insurance premiums, the S Corporation must establish a plan providing medical care coverage. The S Corporation is considered to have established a plan if the either of the two following conditions are met:

- The S Corporation makes the health insurance premium payments for the policy covering 2% shareholders and their dependents, if applicable, or
- The 2% shareholder makes the premium payments and is reimbursed by the S Corporation for those payments

In either case, the premium payments are considered wages and must be included in the shareholder’s W-2 wages. These wages are subject to withholding tax, but are **not** subject to Social Security or Medicare taxes. You will need to work with your bookkeeper and/or payroll service to do this correctly. You will also need to be able to separately identify both regular wages and health insurance premium wages.

Once health insurance premium wages have been properly included in W-2 wages they are eligible for the “self-employed health insurance” deduction on the shareholder’s individual tax return.

If you do not treat the health insurance premiums as wages and follow these procedures, the premiums will be included with other unreimbursed medical expenses as an itemized deduction. With this treatment, only the expenses that exceed 7.5% of AGI are allowable deductions. As such, there is substantial motivation to properly treat these expenses and maximize the deduction available to S Corporation shareholders.