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Employee Benefits

A Littler Mendelson Newsletter

New Rules Permit 2% Shareholder-Employee To Deduct Employer-Paid Accident and Health Premiums and Reimbursements

By Steven J. Friedman and Andrea Jackson

On December 13, 2007, the Internal Revenue Service issued Notice 2008-1 providing rules under which a 2% shareholder-employee in an S corporation is entitled to an income tax deduction for accident and health insurance premiums that are paid or reimbursed by the S corporation and included in the 2% shareholder-employee's gross income.

While many employees are eligible to exclude contributions made by an employer for accident and health insurance premium payments or reimbursements from gross income, 2% percent shareholder-employees of S corporations are not considered employees for this purpose. Because of this classification, the Internal Revenue Code has required the *inclusion* of such contributions or reimbursements made by an S corporation in the gross income of a 2% shareholder-employee.

Special rules promulgated under Notice 2008-1, however, provide that if certain requirements are met, a deduction may now be taken. The requirements include the following:

- The 2% shareholder-employee's earned income from the S corporation must exceed the amount of the premiums for the accident and health insurance policies covering the shareholder-employee;
- The 2% shareholder-employee may not be eligible to participate in any subsidized health plan maintained

by the S corporation or the employer of his or her spouse;

- The shareholder-employee must report the premium payments or reimbursements received from the S corporation as gross income on the Form 1040, U.S. Individual Tax Return;
- The S corporation must establish a plan. A plan providing medical care is considered "established" by the S corporation if the S corporation makes insurance premium payments on behalf of the 2% shareholder-employee or reimburses the 2% shareholder-employee for insurance premium payments in the current taxable year; and
- The S corporation must report the accident and health insurance premium payments or reimbursements as wages on the 2% shareholder-employee's Form W-2 in that same year.

For the purposes of the special rules outlined in Notice 2008-1, a 2% shareholder-employee is defined as any person who either owns (or is considered as owning) on any day during the taxable year more than 2% of the outstanding stock of the S corporation or more than 2% of the total combined voting power of all stock of the S corporation.

An Internal Revenue Service representative has confirmed to us that the special rules are effective immediately. Two

percent shareholder-employees of S corporations should review the Notice carefully to determine whether they satisfy the requirements and are therefore qualified to claim the deduction under section 162(l) of the Internal Revenue Code.

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