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S Corporation Compensation and Medical Insurance Issues

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.

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."

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	<i>Joly vs. Commissioner</i> , 211 F.3d 1269 (6th Cir., 2000)
Reinforced Employment Status of Shareholders	<i>Veterinary Surgical Consultants, P.C. vs. Commissioner</i> , 117 T.C. 141 (2001) <i>Joseph M. Grey Public Accountant, P.C. vs. Commissioner</i> , 119 T.C. 121 (2002)
Reasonable Reimbursement for Services Performed	<i>David E. Watson, PC vs. U.S.</i> , 668 F.3d 1008 (8 th Cir. 2012)

The key to establishing reasonable compensation is determining what the shareholder-employee did for the S corporation. As such, we need to look 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.

If the gross receipts and profits come from items 2 and 3, then that should not be associated with the shareholder-employee's personal services and it is reasonable that the shareholder would receive distributions along with compensations.

On the other hand, if most of the gross receipts and profits are associated with the shareholder's personal services, then most of the profit distribution should be allocated as compensation.

In addition to the shareholder-employee direct generation of gross receipts, the shareholder-employee should also be compensated for administrative work performed 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 the greater than two percent S corporation shareholder-employee are deductible and reportable by the S corporation as wages for income tax withholding purposes on the shareholder-employee's Form W-2.

These benefits are not subject to Social Security or Medicare (FICA) or Unemployment (FUTA) taxes. The additional compensation is included in Box 1 (Wages) of the Form W-2, Wage and Tax Statement, issued to the shareholder-employee, but would not be included in Boxes 3 and 5 of Form W-2.

A 2-percent shareholder-employee is eligible for a deduction in arriving at Adjusted Gross Income (AGI) 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. A deduction used to arrive at AGI is referred to as an above-the-line deduction. 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 above-the-line deduction.

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 only has 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 issued Notice 2008-1 which 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. Notice 2008-1 provided four examples, three of the examples had the shareholder purchasing the health insurance and 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.