

## **CLIENT REPORT:**

### **IRS Provides Compensation and Insurance Information for S Corp Shareholder-Employees**

Dear Client:

S corporations are one of the most popular choices of business entity. As a shareholder-employee of an S corporation, I am writing to remind you of some important rules governing compensation, health and accident insurance, and Schedule K-1 issues. The IRS recently highlighted these key issues on its web site.

When S corporation shareholders perform more than minor services for the corporation, and receive or are entitled to receive compensation in exchange, they are employees for federal employment tax purposes. Their compensation must be reported as wages for those purposes. Additionally, compensation to a shareholder-employee must be reasonable.

The IRS looks at the following factors when 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; and
- \* What comparable businesses pay for similar services.

If your S corporation also pays health and accident insurance premiums on behalf of greater-than-two percent shareholder-employees, the S corporation may deduct the cost of health and accident insurance premiums paid on their behalf. A "greater-than-two-percent" shareholder employee for this purpose is a person who owns, or is considered as owning under constructive ownership rules, more than two-percent of the outstanding stock of the S corporation or stock possessing more than two percent of the total combined voting power of all the corporation's stock. The S corporation reports the premium amounts as wages for income tax withholding purposes on the shareholder-employee's Form W-2. However, these amounts are not subject to Social Security, Medicare or FUTA.

Finally, the IRS reminds S corporation shareholder-employees that the Schedule K-1 issued by the S corporation does not state the taxable amount of their distribution. The Schedule K-1 reflects the S corporation's income, loss and deductions, which are allocated to the shareholder for the year.

If you have questions about the tax obligations of being an S corporation shareholder-employee, or any—and other— issues discussed in this letter, please contact our office.

Sincerely yours,

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