

December 3, 2009

S Corporation Shareholders Beware!

Proper reporting of S Corporation shareholder-employee's health insurance and HSA contributions is very important. When prepared properly, the company can take a tax deduction and the shareholder-employee can possibly receive offsetting deductions on their personal income tax return. **A 2-percent shareholder-employee of an S corporation is not eligible for these fringe benefits because they are not treated as an employee.**

Please read the following detailed descriptions and further explanations relating to the tax reporting for S corporation shareholder-employees and HSA reporting for your employees. Please go to our website at www.phbcpa.com, click on PHB News (PHB News online) and click on the links to reference IRS Publication 15 (Circular E) Employer's Tax Guide for use in 2009 and IRS Publication 15-B - Employer's Tax Guide to Fringe Benefits for more detailed information.

If you prepare your own payroll tax returns and W-2s, be sure to report the 2-percent shareholder-employee benefits properly. Please let us know if you would like us to review your information before you prepare the final payroll tax returns and W-2s. **If we prepare your payroll tax returns and W-2s, you will need to provide us with the following** when you bring in your year end payroll information so we can properly report the information on the payroll tax returns and W-2s:

- **the cost of health insurance provided for the 2-percent shareholder-employees**
- **employer contributions to the 2-percent shareholder-employee's HSA**
- **employer contributions to all other employee's HSAs**

We hope this information is beneficial to you. Please contact Connie Dahl, Payroll Manager @ (320) 234-4430 with any questions as soon as possible to avoid delay in providing W-2s to your employee's as well as eliminate amending payroll tax returns and preparing W-2cs which can be time consuming and costly.

Piehl, Hanson, Beckman, P.A

S Corporation 2-Percent Shareholder-Employee

A 2-percent shareholder is someone who directly or indirectly owns (at any time during the year) more than 2-percent of the corporation's stock or stock with more than 2-percent of the voting power.

Cafeteria Plan

Some employers offer cafeteria plans, also known as flexible spending plans or a section 125 plan, which give employees the option of participating in a range of tax-saving benefit programs. A cafeteria plan is a written plan and all participants in the plan must be employees. **An "employee" for the purposes of the cafeteria plan rules does not include a 2-percent shareholder of an S corporation.** The plan may be funded with employer contributions, employee contributions (usually through salary reduction agreements) or a combination of both.

Beginning July 1, 2009, **Minnesota law requires employers** that have 11 or more full-time equivalent employees and do not offer health insurance benefits to their employees to establish and maintain a cafeteria or premium only Section 125 Plan to allow their employees to purchase individual market or employer-based health coverage with pretax dollars. **Employers may opt out of this requirement** by certifying to the Commissioner of Commerce that they have received education and information on the advantages of Section 125 Plans and have chosen not to establish such a plan. The application must be submitted online. Please go to PHB News online and click on the link to the Minnesota Department of Commerce for further details.

If an employer offers a plan and the employee chooses to participate in the plan, they determine the percentage of their pretax income to be withheld from their paycheck (up to the limit the plan allows) by estimating the amount they are going to contribute before the tax year begins. For example, money can be set aside to pay for medical expenses that are not covered by insurance, for child care, or for additional life insurance coverage. As the employee incurs these expenses, they are reimbursed from the amount they have contributed to the plan. Money set aside in the employee's flexible spending plan and not spent or used by the employee is forfeited.

These benefits are excluded from an employee's taxable wages and are not subject to federal income tax withholding and state income tax withholding and in most cases are not subject to social security, Medicare, or federal unemployment (FUTA) tax and are not reported on Form W-2. They are subject to MN unemployment tax. **2-percent shareholder-employees are not treated as employees and are not eligible for these benefits.** Please go to PHB News online and click on the IRS links to Publication 15-B – Employer's Tax Guide to Fringe Benefits for use in 2009 and the 2009 Instructions for Forms W-2 and W-3 for further detailed instructions.

Accident & Health Benefits

The exclusion applies to contributions an employer makes to an accident or health plan for an employee including:

- Contributions to the cost of accident or health insurance including qualified long-term care insurance and dental insurance
- Contributions to a separate trust or fund that directly or through insurance provides accident or health benefits
- Contributions to Archer MSAs or health savings accounts
- Payments you directly or indirectly make to an employee under an accident or health plan for reimbursement of medical expenses and payments for specific injuries or illnesses (such as the loss of the use of an arm or leg). The payments must be figured without regard to any period of absence from work.

Please go to PHB News online and click on the link to Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans for further information.

Because you cannot treat 2-percent shareholder-employees of an S corporation as employees, you must include the value of accident or health benefits you provide in the wages subject to federal income tax withholding and state income tax withholding. However, you can exclude the value of these benefits from the wages subject to social security, Medicare and FUTA wages, and because the 2-percent shareholder-employee can not choose cash as an option, the accident or health benefit provided to them is not subject to MN unemployment tax.

Health Savings Accounts

A Health Savings Account (HSA) is an account owned by a qualified individual who is generally your employee or former employee. Any contribution an employer makes to an HSA becomes the employee's property and cannot be withdrawn by the employer. Contributions to the account are used to pay current and future medical expenses of the account owner, his or her spouse, and any qualified dependent. The medical expenses must not be reimbursable by insurance or other sources and their payment from HSA funds (distributions) can not be used as a medical expense deduction on the individual's federal income tax return.

Exception – An individual is not a qualified individual if he or she can be claimed as a dependent on another person's tax return. Also, an employee's participation in a flexible spending arrangement (FSA) or health reimbursement arrangement (HRA) generally disqualifies the individual (and employer) from making contributions to his or her HSA.

The 2-percent shareholder-employee can make contributions to an HSA, but are not entitled to exclude the contributions from gross income. **2-percent shareholder-employees are not treated as employees and are not eligible for these benefits.** The company can make contributions to a 2-percent shareholder's HSA. The contributions

are deductible by the S corporation when included in the 2-percent shareholder-employee's gross income. The shareholder-employee can deduct the HSA contribution up to preset maximums on their personal income tax return. Report the HSA company contributions as wages subject to federal income tax withholding and state income tax withholding. Exclude the contributions from the wages subject to social security, Medicare and FUTA wages, as well as MN unemployment tax. **You must report all employer contributions to an HSA in box 12 of Form W-2 with Code W.**

All Other Employee's HSA Contributions

Employer contributions made to an employee's HSA and employee contributions through a cafeteria plan are all treated as employer contributions. The contributions made by the employee through the cafeteria plan are not subject to federal income tax withholding, social security, Medicare, FUTA tax and state income tax withholding (if it is reasonable to believe at the time of the payment that the contribution will be excludable from the employee's income). **You must report all employer contributions to an HSA in box 12 of Form W-2 with Code W.**

The trustee or custodian of the HSA, generally a bank or insurance company, reports distributions from the HSA using Form 1099-SA.

If an employee's contributions to an HSA are not made through a cafeteria plan, the contributions are includible in income as wages and are subject to federal income tax withholding, social security, Medicare taxes, federal unemployment tax, state income tax withholding and MN unemployment tax. The employee contributions are deductible, within limits, on the employee's Form 1040.