Directive 99-4: Deductibility of S Corporation Qualified Retirement Plan Contributions by Shareholder-Employees

Issue

In computing Massachusetts adjusted gross income, a deduction is generally allowed for employer contributions to or under a stock bonus, pension, profit-sharing or annuity plan, or a deferred compensation plan (herein, a qualified retirement plan) deductible under § 404 of the Internal Revenue Code (Code). G.L. c. 62, § 2(d)(1). However, under G.L. c. 62, § 2(d)(1)(D), the deduction is specifically disallowed for contributions on behalf of an individual who is an employee within the meaning of § 401(c)(1) of the Code. The issue is whether the disallowance of a deduction for contributions made to a qualified retirement plan on behalf of a shareholder-employee of an S corporation is required under G.L. c. 62, § 2(d)(1)(D).

Directive

General Laws chapter 62, section 2(d)(1)(D) does not disallow a deduction for employer contributions to a qualified retirement plan on behalf of a shareholder-employee of an S corporation because shareholder-employees of an S corporation are not self-employed individuals treated as employees under § 401(c)(1) of the Code.

Discussion

Under G.L. c. 62, § 2(d)(1) there is a deduction for "deductions allowable under [I.R.C.] §§ 62 and 404 without regard to § 265 . . . ." Id. Section 404 of the Code governs deductions for employer contributions to qualified retirement plans. However, under G.L. c. 62, § 2(d)(1)(D), this deduction is disallowed "in the case of an individual who is an employee within the meaning of [I.R.C.] § 401(c)(1) . . . to the extent attributable to [pension] contributions made on behalf of such individual . . . ." Id.

Internal Revenue Code § 401(c)(1) treats self-employed individuals as "employees" under certain conditions. As a result, if a shareholder-employee of an S corporation is considered self-employed, he may be an "employee" within the meaning of that subsection.

An examination of § 401(c) provides two reasons why shareholder-employees are not employees by virtue of the subsection. First, the definitional subsection relating to § 401(c)(1) specifically identifies as § 401(c)(1) employees sole proprietors and partners, but not shareholder-employees of an S corporation. I.R.C. § 401(c)(3)(A), (B); see, Durando v. United States, 70 F.3d 548 (9th Cir. 1995).

Second, an individual cannot be considered self-employed, and therefore cannot be an I.R.C. § 401(c)(1) employee, unless that individual has "earned income as defined in [I.R.C.] § 1402(a)." I.R.C. §§ 401(c)(1)(B) and 401(c)(2). "Earned income" means "net earnings from self-employment," I.R.C. § 401(c)(2)(A), and "net earnings from self-employment" is, in turn, defined as the gross income derived by an individual from any trade or business carried on by such individual . . . plus his distributive share . . . from any trade or business carried on by a partnership of which he is a member. I.R.C. § 1402(a).

The provisions cited thus make income received by partners and sole proprietors "net income from self-employment," but "no language exists indicating that S corporation pass-through income also

constitutes net earnings from self-employment." Durando at 551. This is consistent with the fact that income earned by a corporation through its trade or business is not treated as if it were earned directly by its shareholders, even when the shareholders' services help to produce that income. "An S corporation's income passes through to its shareholders not because they helped to create that income, but because they are shareholders." Id. at 552, citing I.R.C. § 1366(a).

We conclude that I.R.C. § 401(c)(1) does not cover S corporation shareholder-employees because they are not "self-employed individuals" having "earned income" within the meaning of that section. Therefore, deductions allowable under I.R.C. § 404 for employer contributions made to qualified retirement plans on their behalf are not disallowed by G.L. c. 62, § 2(d)(1)(D).

The S corporation regulation, 830 CMR 62.17A.1, contains a paragraph explaining differences between a corporation's treatment of certain items of income, loss, or deduction under G.L. c. 63, and an individual's treatment of those items under G.L. c. 62. The paragraph contains the following:

> [a] corporation can deduct all of its qualified retirement plan contributions under Code s. 404; but a sole-proprietor cannot deduct under M.G.L. c. 62,§ 2(d)(7) [now § 2(d)(1)(D)] contributions to qualified plans made on the proprietor's own behalf. Therefore, contributions to qualified retirement plans under Code s. 404 and 405(c) on behalf of Massachusetts shareholder-employees are not deductible in computing the shareholders' S corporation income.

Id., §(5)(b)(2). The underlined statement is incorrect in that it conflicts with the above analysis.

Applications for Abatement

Shareholder-employees of S corporations who adjusted their Massachusetts S corporation income to add back federally deductible contributions made to qualified retirement plans on their behalf may apply for an abatement for the open tax years. Abatement applications should include the CA-6, the original and amended SK-1 and a corrected copy of the corporation's Schedule S.

For the treatment of Code § 1372 fringe benefits and the deductibility of health insurance premiums paid on behalf of S corporation shareholders, see DOR Directive 99-5.

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April 1, 1999

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