

Health Insurance Costs for S Corporations

This article is to advise you of the tax benefits available to certain S corporation shareholders for health insurance premium costs. However, please be aware that "greater than 2% shareholders" must include health insurance premium payments on their W-2 as taxable compensation, (subject to income tax withholding). The IRS is auditing this area heavily and disallowing health insurance deductions when not reflected properly on the W-2. Please review the reporting requirements section below.

Health Insurance Tax Savings

Certain shareholders of S corporations can deduct 100% of their health insurance costs as an above-the-line deduction in arriving at adjusted gross income (AGI); this tax savings can reduce your after-tax cost of health coverage.

These rules apply for any calendar month in which S corporation shareholders are not otherwise eligible to participate in any subsidized health plan maintained by any other employer of the shareholder or their spouse. In addition, no deduction is allowed to the extent that the deduction exceeds earned income from the S corporation trade or business with respect to which the plan providing the medical care coverage was established.

Example: Jane is a more than 2% shareholder in an S corporation. The S corporation pays \$6,000 in health insurance premiums for Jane and she has no other medical expenses. The \$6,000 is taxable income to Jane and appears on her W-2. Jane's AGI is \$100,000, since 10% of \$100,000 equals \$10,000, Jane would not be able to claim any itemized deduction for her health insurance premiums. However, since she is a more than 2% shareholder in an S corporation, she can deduct the entire \$6,000 as an adjustment to her AGI.

Health Insurance Purchased in the Name of Sole Shareholder - Employee

The insurance laws in California 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/her health insurance in their own name.

The IRS ruled that S Corporation Shareholders are allowed to take an above-the-line deduction even if the health insurance policy was purchased in the name of the shareholder as long as 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 bottom line is that in order for a shareholder to claim an above-the-line deduction, the health insurance premiums must ultimately be paid by the S corporation and must be reported as taxable compensation in the shareholder's W-2.

Reporting Requirements

Health insurance costs paid by the S corporation for its greater than 2% shareholders are included in the recipient's W-2 as taxable wage income and the S corporation takes a compensation deduction. The S corporation cannot take the deduction as a direct health insurance expense for the greater than 2% shareholders.

As this income must be reported on the W-2, the income inclusion must be calculated and reported by January 31st. This deadline generally gives the employer a month between year-end and the date for filing the W-2s to identify the costs to be charged back. However, the IRS provides a special accounting rule for fringe benefits provided during November and December. Under this rule, employers may choose to treat fringe benefits furnished during these months (or any shorter period) as paid in the next year. This can ease the administrative burden on the employer. Further, if the health insurance payments are made under a "plan" for the S corporation employees and their dependents, the amount is only subject to income tax withholding and not subject to federal or California employment taxes.

Form K-1 (1120S and 100S) and Form 1099 should not be used as an alternative to Form W-2 to report this additional compensation. Please contact us if you wish to discuss how these rules apply to your particular situation or if you have any questions.