Health Care Expenses, Premiums, HRAs, HSAs – Section 105

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An LLC or S-Corp allows you set up a plan to reimburse shareholders (and employees) for medical premiums and expenses plus make contributions to a Health Savings Account (HSA). And this can actually save a significant amount of Social Security and Medicare taxes. Read on.

Health Insurance Premiums
In IRS Notice 2008-1 premiums paid under individual medical and health insurance plans may be deductible on your personal tax return (the usual Form 1040) if the following conditions are met:

- The S-Corp must establish an **Accountable Plan** for the payment of health insurance premiums on behalf of the shareholder.
- The S-Corp must either directly pay the premiums for the plan or reimburse the shareholder for the premiums paid. Proper recordkeeping habits must be followed.
- Here's the kicker- premiums paid or reimbursed must be included in Box 1 of the shareholder's W-2. The health insurance premiums are not included in Box 3 Social Security Wages and Box 5 Medicare Wages (thus they are exempt from employment taxes). This might take some payroll coordination, but it certainly is worthwhile.

By including the cost of health insurance as wages in Box 1 on your W-2, the S-Corp gets a "wage expense" deduction, which in turn reduces the K-1 income for all shareholders (but each shareholder gets comparable a bump in W-2 income as a part of his or her reasonable salary). On your personal tax return, you will get a dollar for dollar deduction for health insurance premiums paid. This directly reduces your adjusted gross income, and is not a Schedule A itemized deduction (which is good). If this procedure is not followed, the premiums can only be deducted on Schedule A subject to the 7.5% or 10.0% income thresholds for medical expenses (which is not good).

The policy can be in the name of the shareholder yet the S-Corp can make the premium payments directly. Or the shareholder can pay the premiums and be reimbursed- we suggest keeping the paper trail to a minimum and having the company pay directly.

Health Reimbursement Arrangement (HRA)
Update- it appears that the Affordable Care Act (Obamacare) has made health reimbursement arrangements obsolete. However, the following information remains in our article in case things change-

An S-Corp can also adopt a Section 105 Health Reimbursement Arrangement (HRA). Two providers seem to have the best handle on it- BASE and ZaneBenefits. Here is the summary from BASE-

wcginc.com/BASE-HRA.pdf

By adopting an HRA you can maintain your current reasonable salary yet reclassify a portion of it (and perhaps a large portion of it) as reimbursement for health care expenses. For example, let's say your salary is $36,000 and your health care premiums plus other expenses are $500 per month or $6,000 a year. As a result, only $30,000 will be subjected to Social Security and Medicare taxes, while $36,000 is being reported as wages. A win-win scenario since higher reported wages and lower taxes is good. As in real good.

Health Savings Account (HSA) Unlike an HRA whose fate might be sealed with ACA, the S-Corp can also make HSA contributions associated with your high-deductible health insurance plan. As mentioned in other areas of this article, even with a Health Reimbursement Arrange (HRA), an HSA is a great way to save taxes today on money you need when you retire. It is a foregone conclusion that when you get older you'll need more medical attention. When you need a new hip at age 72, you'll be drawing money from somewhere- either your 401k or your HSA. So in some regards, your HSA becomes a retirement vehicle.

And, most HSAs have investment choices within them such as choice of funds and other options. Talk to your HSA provider.

Flexible Spending Accounts (FSA)
If you do not use a high deductible insurance plan (e.g., CDHP), you might be ineligible or not have access to a Health Savings Account (HSA). Your only choice is the Flexible Spending Account (FSA). FSAs act very similarly to an HSA from an instant tax savings perspective. But, and this is a whammy, it might be a use it or lose it program. So, if you have $1,000 in medical expenses yet deducted $2,500 in pre-tax dollars for your FSA, you better round up another $1,500 in qualified medical expenses such as contact solution to not lose the money.

All FSA payments for the prior tax year must be made by February 15, such as medical procedure performed on December 31 yet billed in January of the following year. And the reimbursement request must be submitted by March 15 (this is a generalization depending on your plan provisions).

However, there is an interesting caveat to the use or lose it system- if you lose the money because you didn't have enough qualified medical expenses, the money is returned to the company. And if you administer your own FSA plan, this money becomes a weird slush fund of sorts (at this time we do not have a good handle on how to treat or label this returned FSA money- it certainly warrants looking into).

Starting in 2014, FSA programs can either extend reimbursements until March 15 or allow you to rollover $500 to the next year.

How Health Expenses Reduces Self-Employment Taxes
As mentioned earlier, self-employment taxes and Social Security / Medicare taxes are the same thing. When you pay health insurance and / or make health savings account contributions, this must be reported in Box 1 of your W-2. This income is subject to income taxes, but not Social Security and Medicare taxes. And you get a $1 for $1 deduction as well on your personal tax return, so the income is a wash.

But extra savings kick in with the reasonable salary testing. As mentioned, 50% of net income is a jumping off point for a reasonable salary. But what if a big chunk of the 50% is actually health insurance premiums and HSA contributions? Example-

	With Health Insurance	**Without Health Insurance**
Net Income	$100,000	$100,000
Reasonable Salary at 50%	$50,000	$50,000
Health Insurance Premiums	$12,000	$0
HSA Contribution	$5,000	$0
W-2, Box 1 Income	$50,000	$50,000
W-2, Box 3 Social Security Income	$33,000	$50,000
W-2, Box 5 Medicare Income	$33,000	$50,000
Social Security, Medicare Taxes	**$5,049**	**$7,650**

So, by having the company pay for your health insurance premiums and / or make HSA contributions on your behalf, you could save thousands of dollars in Social Security and Medicare taxes. In this example the savings are over $2,600, and frankly the health related figures above might be low.