

Partnership and S Corporation Health Insurance Premiums

In prior years, this topic wasn't such a big deal... until now. The IRS is cracking down on "double-dipping" of health insurance deductions by partners and S Corporation shareholders. IRS found that frequently the entity deducted the premiums then the owners deducted them on their personal return. This frequently happened when the person preparing the personal return did not prepare the business entity's tax return. They actually changed the rules in 2008, but implementation has been slow.

We will use an example of a \$10,000 medical insurance premium to illustrate this issue. Here's what *was* happening:

<u>Income (Expense)</u>	<u>Passthrough Business Entity</u>	<u>Owner's K-1</u>	<u>Owner's Personal Return</u>	<u>Net Taxable Income</u>
Medical premiums paid	\$(10,000)			
Ordinary income reduced		\$(10,000)		\$(10,000)
Self-employed medical insurance deducted			\$(10,000)	<u>\$(10,000)</u>
Total effective deduction on owner's return				<u>\$(20,000)</u>

Here is how it should be handled:

PARTNERSHIPS

The actual deduction occurs at the partnership level and is passed to the partner via lower income on the K-1.

If the partnership pays for the health insurance premiums for its partners, it deducts the expense as guaranteed payments and reports the amount to each partner on their respective K-1s as guaranteed payments.

The partner then picks up the guaranteed payment as income and reports "self employed health insurance" deduction. The guaranteed payment offsets the self employed health insurance deduction for a net zero effect on taxable income, thus the single deduction described above on the K-1.

When a partner pays his (her) own medical insurance premiums, the self-employed medical insurance deduction is allowed if there is self-employment income.

Correct reporting for partnership:

<u>Income (Expense)</u>	<u>Partnership</u>	<u>Owner's K-1</u>	<u>Owner's Personal Return</u>	<u>Net Taxable Income</u>
Medical insurance premiums paid and deducted	\$(10,000)	\$(10,000)	\$(10,000)	\$(10,000)
Guaranteed payment to partner		10,000	10,000	10,000
Self-employed medical insurance deduction		(10,000)	(10,000)	<u>(10,000)</u>
Total effective deduction on owner's return				\$ <u>(10,000)</u>

S CORPORATIONS

This one is little more complex. These rules only apply to shareholders who own more than 2% of the company. Owners below 2% are not eligible for the self employed medical insurance deduction.

The corporation deducts the expense as compensation and includes the amount on the shareholder's W-2. The amount is subject to income taxes, but not employment taxes. The amount should also show up in box 14 of the W-2 so that the tax preparer knows to take the deduction. Most companies use payroll processing companies to handle payroll. Our experience so far has been mixed. Some understand it and properly account for it. Others seem to have some difficulty reporting it properly.

The shareholder reports the compensation from his/her W-2, then deducts the health insurance amount from box 14 on the W-2 as a "self employed health insurance" deduction for a net zero impact to taxable income. The actual deduction is achieved at the corporation level and passed to the shareholder in the form of lower income reported on the K-1.

Correct reporting by S Corporation for 2% or greater shareholders:

<u>Income (Expense)</u>	<u>S Corporation</u>	<u>Shareholder's K-1</u>	<u>Owner's Personal Return</u>	<u>Net Taxable Income</u>
Medical insurance premiums paid and <u>deducted as owner wages</u> lowers ordinary income	\$(10,000)	\$(10,000)	\$(10,000)	\$(10,000)
Owner's W-2			10,000	10,000
Greater than 2% shareholder medical insurance premium (Noted in Box 14 of W-2)		(10,000)	(10,000)	<u>(10,000)</u>
Net taxable income reported by shareholder				<u>\$(10,000)</u>

What if the shareholder pays his(her) own premiums?

If the shareholder pays the premiums personally, the shareholder must be reimbursed by the company and follow the rules described above. The shareholder cannot directly pay for the premiums without reimbursement and take the "self employed health insurance" deduction. However, this method makes it possible to pay the premiums for the shareholder and get a deduction without violating ERISA. Thus, the reimbursement method is preferable when not offering health insurance to all employees.