

Reporting Medical Benefits Provided by S Corporations
(as of January 2017)

This article provides limited information about complying with IRS payroll reporting requirements for S Corporations who provide medical benefits for their employee(s). It also discusses important changes effective for tax years beginning after 2013 resulting from the implementation of certain provisions of the Affordable Care Act (ACA) which was passed by Congress in March of 2010. These laws were revised somewhat by the passage of the “21st Century Cares Act” on December 13, 2016.

These ACA compliance requirements referred to as the “market reform” rules apply to small employers with more than one but less than 50 employees starting with their 2014 plan year. Together the payroll reporting and the ACA requirements present significant compliance issues which affect employers, including small S Corporations, who provide any type of medical benefits to their employees, in particular reimbursing employees for the cost of their medical insurance premiums, unless certain exceptions apply.

In addition to the ACA market reform rules, compliance with payroll reporting requirements continues to be necessary in order to avoid payroll tax issues and to protect significant income tax benefits for the S Corporation shareholders and employees. This article is not intended to provide personal income tax planning and each shareholder should consult with a tax advisor who understands the related payroll reporting requirements and the deductions for self-employed medical, dental, vision, long term care insurance, and HSA contributions that may be available on the shareholder’s personal income tax returns.

To get a general idea of how the ACA market reform rules apply to employers, it is necessary to understand that both the employer plan itself and the coverages offered under the plan have separate criteria for complying with ACA requirements. In its simplest form, any medical benefits offered to an employee constitute an employer plan, which may be subject to substantial penalties, discussed below, for noncompliance with the ACA market reform rules. In addition, the policies offered under an employer plan, unless grandfathered, must comply with ACA minimum essential coverages. It must be noted that these are two separate issues and have separate penalties for noncompliance.

Every S Corporation who provides any type of medical benefits to their employees should perform a thorough review of their benefit plan to assure compliance with the new ACA market reform rules or they could be subject to the new \$100 per employee, per day penalty for noncompliance, which is a maximum of \$36,500 per employee, per year. This new penalty is punitive and definitely requires your attention. Since employers with less than 50 full time employees are not required to provide any medical benefits, they should also review whether the cost of an ACA compliant plan is worth it.

Small employers who continue with qualified group plans that were in place on March 23, 2010 and considered “Grandfathered” plans are exempt from the new market reform rules. Single shareholder S Corporations with the shareholder as the only employee are also not affected by

the new market reform rules. In any case, all S Corporations must continue to follow the related payroll reporting requirements.

This article does not provide guidance about the criteria for establishing a benefit plan, so employers need to consult with their plan administrator and insurance professional for details on designing and implementing such plans and their related costs. As mentioned above, providing a benefit plan, or separate health benefits, which is not compliant with the new ACA rules can result in the employer being subject to substantial penalties even though the payroll reporting is done correctly.

If an S Corporation decides to provide medical benefits to its employees, it must have a written benefit plan document outlining the extent of the benefits to be provided and approval of the plan must be documented in the meeting minutes of the Board of Directors. S Corporations with an existing medical benefits plan must consider whether their plan meets the market reform and minimum coverage requirements of the Affordable Care Act. These ACA requirements are outlined in IRS Notice 2013-54 and updated by Notice 2015-17, and include such changes as no annual dollar limit on certain health benefit reimbursements and providing preventive health services at no cost to the employee. Long-term care, vision care, and dental care are not subject to the ACA rules and can be provided under a separate plan but continue to be subject to payroll reporting requirements.

A premium only reimbursement plan which has been common with small S Corporations is covered under Section 105 of the Internal Revenue Code and subject to the market reform provisions of the ACA unless the S Corporation has only one employee. Before passage of the 21st Century Cares Act in December 2016, the market reform provisions eliminated the opportunity for S Corporations with more than one employee to use a stand-alone medical reimbursements plan, including reimbursement of employee paid medical insurance premiums, unless these plans meet other exceptions, such as integration with a fully compliant medical benefits plan, which most small employers may find too expensive. Fortunately, the 21st Century Cares Act provides a limited exception to the market reform penalties for small employer Health Reimbursement Arrangement (HRA) plans. This act makes the new provisions retroactive to 2015 and avoids the market reform penalty for qualifying employers with this type of plan.

If an S Corporation decides to adopt an ACA compliant group medical plan the insurance premiums must be paid directly by the S Corporation. The amounts paid to cover the non-shareholder employees are tax free fringe benefits to these employees and are treated as employee benefits deductible as an operating expense on the S Corporation's income tax returns. However, the amounts paid for benefits on behalf of the shareholder/employee who owns directly or indirectly more than 2% of the S Corporation stock must be treated as taxable wages when paid. The shareholder fringe benefit amounts must be reported on the company's quarterly payroll tax returns and included in the shareholder/employee annual W-2's (see IRS Rev. Rule. 91-26). The gross wages (including the medical premiums) are then fully deducted on the S Corporation's income tax returns. Prior law continues to exempt these fringe benefit wages from FICA and FUTA. S Corporations need to work closely with their payroll service to make sure the benefits paid on behalf of the shareholder/employee are reported correctly.

Previously, the IRS Notice 2015-17 (effective July 1, 2015) required S Corporations with more than one employee that had a medical reimbursement plan that was not compliant with the ACA market reform provisions to amend their plans to be fully compliant or terminate their plans all together. The 21st Century Cares Act supersedes this IRS notice and does allow qualified employers to establish a HRA plan in order to reimburse insurance premiums paid personally by employees. This article does not explain all the details for administration of HRA plans, such as notices to employees, funding limits, etc., so employers, or their advisors, should reference this act and the related analysis for guidance on the criteria and administration of such an HRA plan.

Assuming the S Corporation decides to provide an ACA compliant plan, including an HRA plan, it should be noted that the definition of a “more than 2% shareholder” is far reaching and that attribution rules apply to all employees who are related to the actual shareholders, even though the employee does not own any shares. These rules have not changed and must be understood before the S Corporation and the shareholders can correctly comply with the payroll reporting requirements. For example, employees subject to the 2% shareholder definition are not allowed to have any pretax withholdings, even if the plan is ACA compliant and allows for pretax benefits for the other employees.

Another reason for complying with the documentation and payroll reporting requirements is to avoid potential penalties for noncompliance and the costs to amend all four quarters of their payroll tax returns and W-2's. If the payroll reporting requirements are not met the IRS has the option of treating amounts paid for any shareholder medical benefits, including dental, vision, and long term care insurance, and HSA contributions, as taxable compensation subject to payroll taxes. Moreover, noncompliance with the payroll reporting requirements prohibits the shareholder from taking the “above the line” deduction for self-employed medical insurance which is discussed later in this article.

In cases where the S Corporation has not complied with the payroll reporting requirements, some tax preparers who get the tax information after year end may decide to show the amounts paid for shareholder's premiums as separate non-deductible items on the S Corporation's income tax return and related shareholder K-1's. This approach is not prudent as it may alert the IRS to the noncompliance issue and subject the S Corporation to the ACA market reform penalty and it does not comply with long standing payroll reporting requirements.

If a tax preparer treats medical insurance premiums paid on behalf of the more than 2% shareholders which are not included in W-2 wages as a deductible operating expense on the S Corporation's income tax returns, in addition to the ACA compliance issues, the payroll reporting and the income tax returns will be wrong. Shareholder medical insurance cannot be deducted as an operating expense on the S Corporation income tax returns, unless it is treated as W-2 wages. To correct this error would require that the S Corporation amend their payroll tax returns and shareholders' W-2's, in addition to amending the corporation's income tax returns and each shareholder's K-1. If the shareholders have already filed their personal income tax returns, changing the W-2's and K-1's will require each affected shareholder to amend their personal returns as well. Accordingly, S Corporations should not provide medical benefits to shareholders and employees unless they deduct the shareholder benefits as W-2 wages on the S Corporation's income tax returns and have in place an ACA compliant plan.

Another reason to comply with ACA and the payroll reporting requirements is that the S Corporation must include the insurance premiums in the W-2 wages of the shareholders in order for the shareholders to get the “above the line” deduction for self employed medical insurance on their personal income tax return, see IRS Pub. 535. If the S Corporation terminates the medical reimbursement plan in order to avoid the ACA market reform penalty, there would be no premiums paid by the S Corporation for any employees. If this is the case, it does not matter that the shareholders meet all the other requirements for the self-employed medical insurance deduction, unless the law changes in the future, the shareholders are not allowed to deduct the premiums “above the line” as an adjustment to gross income unless these premiums are paid under an employer plan. However, the shareholders may treat the amounts they pay personally for medical, dental, and vision insurance premiums and the allowable long term care insurance premiums as part of their total medical expense deduction taken as an itemized deduction. However, only the portion of the total medical expenses that exceeds 10% of the shareholder's adjusted gross income (AGI) will be deductible as an itemized deduction.

If an S Corporation adopts a fully compliant group medical plan the related premiums must be paid directly by the S Corporation. Additional premiums for dental, vision, or long term care provided under a separate “integrated” plan must also be paid by the S corporation, or reimbursed if paid directly by the employee or shareholder. Payroll reporting also applies.

As an alternative to a group plan, the 21st Century Cares Act allows an S Corporation to have an HRA plan, but not both. The HRA account funding must be paid directly by the S Corporation, employees may not contribute to the HRA. The actual insurance premiums paid by the employee or shareholder should be reimbursed from the HRA account each year. The funding of the HRA account, subject to certain limits, is reported as a tax free fringe benefit for the non-shareholder employees and reported as W-2 wages for the “more than 2% “ shareholder(s). Only the amount of premiums actually reimbursed to the shareholders from the HRA account are allowed for the shareholders’ self-employed medical deduction on their personal tax return. For any shareholders who are over age 65 and paying Medicare insurance, these premiums can also be reimbursed by the HRA account. These reimbursements must be done each year in order for the premiums paid by a shareholder to qualify for the “above the line” deduction on the shareholder’s personal income tax return. Otherwise, these premiums can only be deducted as medical expenses subject to the AGI limitation, as discussed above.

Separately an S Corporations may adopt a plan that provides for Health Savings Accounts (HSA) contributions to be paid by the company, or amounts paid directly by the shareholder for HSA contributions can be reimbursed by the S Corporation up to the Company’s benefit plan limits and included in the shareholders’ W-2 wages. Additional HSA contributions, up to the IRS HSA limits, made directly by the shareholder that are not reimbursed by the S Corporation but are also deductible by the shareholder on their personal tax returns. HSA plan compliance is separate from any HRA plan and is outside the scope of this article.

In addition to the payroll reporting requirements placed on S Corporation employers, in order to qualify for the “above the line” self employed medical insurance deduction on their personal income tax returns each shareholder must meet certain requirements, such as not having another employer plan available to them, or to their spouse if filing a joint return. The amount of the “above the line” deduction is also limited to the shareholder’s Medicare wages, subject to FICA.

The requirements for partnerships and sole proprietors are not addressed in this article. More information can be found on the IRS website at www.IRS.gov, and in IRS Pub 535. Since the ACA requirements and the related tax laws continue to change, small businesses, especially S Corporations and their shareholders, should check to see how these changes apply to their situation prior to the beginning of each benefit plan year.

In summary, establishing an employee benefit plan may help to retain employees and provide them with additional tax free compensation. However, the small employers may find the cost of providing ACA compliant plans to be prohibitive. Additional effort is necessary to administer these plans while complying with payroll reporting requirements.

Being a business owner involves more than running a profitable business, tax planning, and asset protection. Attention must also be given to employee benefits, payroll reporting, and the new ACA requirements. Complying with these various rules is onerous, so get help from a plan administrator, insurance professional, an attorney, and a Certified Public Accountant (CPA) who are familiar with these requirements. Call us to see how we may ***“help you keep more of what you make”***.

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