

September 2019

Q&A: No FICA on Health Insurance for the More-Than-2% Shareholder-Employee

Question

I am a partner in a CPA firm that has many S corporation clients.

Most of our S corporation clients have fewer than 50 employees, making them exempt from the Affordable Care Act.

My question concerns S corporations that pay for health insurance on the more-than-2-percent shareholder-employees but do not provide any health insurance to their rank-and-file employees.

We properly add the premiums to the more-than-2-percent shareholder-employee's wages, making those wages subject to income taxation. But we do not make those wages subject to Social Security and Medicare taxes.

Some of my partners disagree with this treatment and believe that the wages are subject to Social Security and Medicare taxes.

What's your take on this?

Answer

We agree with you. We don't believe that the health insurance premiums included in the more-than-2-percent shareholder-employee's W-2 wages are subject to Social Security or Medicare taxes.

That said, we admit that the law is not crystal clear.

Background on S Corporation Health Insurance

Step 1. For the S corporation more-than-2-percent shareholder-employee to have a chance to deduct his or her cost of health insurance, the S corporation has to either pay the premiums to the insurance company or reimburse the more-than-2-percent shareholder-employee for the cost of his or her individually purchased insurance.¹

Which means that for you, your step 1 is to get the insurance cost on the corporate books.

Step 2. Now that you have the insurance cost on the S corporation's books, you take the premiums and add them to the more-than-2-percent shareholder-employee's W-2.

Both Notice 2008-1 and Announcement 92-16 state that for the more-than-2-percent shareholder employee, you include the health insurance premiums as W-2 wages for federal income tax withholding purposes, but the premiums are *not* wages subject to Social Security and Medicare taxes if the S corporation employer satisfies the requirements for exclusion under Section 3121(a)(2)(B).²

Complaint. The IRS's stated purpose in Announcement 92-16 is "to clarify the Social Security and Medicare tax treatment of accident and health insurance premiums paid by an S corporation on behalf of 2-percent-shareholder-employees." That did not happen in this announcement, which is as clear as tree bark.

This bring us back to IRC Section 3121(a)(2)(B), which excludes from wages health insurance paid by an employer for or on behalf of an employee if the payments must be made under a plan or system for employees and their dependents generally or for a class (or classes) of employees and their dependents.³

Some Clarity

The law is clear that if the more-than-2-percent shareholder-employee is insured along with all the rest of the company employees on the S corporation's plan, the more-than-2-percent shareholder-employee's health insurance income is free from Social Security, Medicare, and FUTA payroll taxes.

It's similarly clear that if the S corporation employs *only* the owner-employee, his or her health insurance income is also free from payroll taxes.

Clarify This

What's not crystal clear is the W-2 treatment of the more-than-2-percent owner-employee who has self-only (or self plus his or her dependents) coverage that the S corporation pays or reimburses (but gives no health insurance benefits to its rank-and-file employees).

With this situation, does the S corporation violate the Section 3121(a)(2)(B) rule for "employees generally," or does the S corporation consider the more-than-2-percent owner-employee to be in a separate "class" that meets the requirements of Section 3121(a)(2)(B)?

Normally, we'd go to the tax code and examine how "class or classes" is defined, but such a clarifying definition is unfortunately absent.

Informal IRS Guidance

IRS Publication 15-B (2019 version) states, on page 7, that because you can't treat a more-than-2-percent shareholder as an employee for purposes of deducting health insurance, you must include the value of the health insurance in the W-2 taxable income of the more-than-2-percent shareholder.

But the next sentence in the 2019 version invokes the "no clarity" rule by stating that the wages above are exempt from Social Security, Medicare, and FUTA taxes, if made under a plan set up to benefit all employees or certain groups of employees.⁴

The 2014 version of Publication 15-B did not contain the "plan set up to benefit all employees or certain groups of employees" phrase.⁵ We could find no new guidance from the IRS in its rulings or notices to account for its change in the wording.

Similarly, the May 10, 2019, version of the IRS online guide to S Corporation Compensation and Medical Insurance Issues states that the health and accident premiums paid on behalf of a greater-than-2-percent S corporation shareholder-employee are⁶

- W-2 wages subject to income tax withholding
- but "are not subject to Social Security, or Medicare (FICA), or Unemployment (FUTA) taxes
- if the payments of premiums are made to or on behalf of an employee under a plan or system that makes provision for all or a class of employees (or employees and their dependents)."

The sentence following the above states: “Therefore, the additional compensation is included in the shareholder-employee’s Box 1 (Wages) of Form W-2, Wage and Tax Statement, but is not included in Boxes 3 and 5 of Form W-2.”

Audit Guides

The IRS Audit Techniques Guides (ATGs) help IRS examiners during audits by providing insight into issues and accounting methods unique to specific industries. While ATGs are designed to provide guidance for IRS employees, they’re also useful to small-business owners and tax professionals who prepare returns.

We examined the guides for clues and found this in the Fishing ATG:⁷

1. *Premiums for health insurance paid by an S corporation on behalf of a more than 2 percent shareholder are deductible on the corporate return, and the shareholder must include the amount of the premiums in income on his/her Form 1040.*
2. *The income should be included on the shareholder’s Form W-2 as taxable wages.*
3. *Those wages are not subject to FICA or FUTA as are regular wages.*

In the audit guide that IRS examiners refer to when auditing an independent used car dealer, we found that health insurance premiums paid by the S corporation for a greater-than-2-percent shareholder-employee are not considered wages for Social Security or Medicare tax purposes.⁸

What about the ACA’s Antidiscrimination Provisions?

The Affordable Care Act (ACA) prohibits business owners from discriminating on the basis of salary when it comes to the provision of health insurance.⁹

But this is not a worry: Back in 2011, the IRS announced that it would not enforce this nondiscrimination provision until additional guidance was released.¹⁰ That has not yet happened—and, given the change of administration and continued uncertainty surrounding the ACA generally, may *never* happen. If and when it does, you will have time to prepare.

For more on how the ACA impacts the health insurance for the more-than-2-percent owner of an S corporation, see Update: 2018 Health Insurance for S Corporation Owners. Note. The rules in this 2018 update continue to apply today.

Takeaways

Certainly, S corporations that pay or reimburse health insurance for their more-than-2-percent shareholder-employees must include the payments or reimbursements in their W-2 wages as income subject to federal income taxes.

Such shareholder-employees may or may not qualify for the self-employed health insurance deduction on their Form 1040s.

Rank-and-file employees do not have any such worries. In fact, the health insurance premiums paid to cover the rank and file are generally tax-free to the employees and tax-deductible by the S corporation as benefits for the employees.

The difference certainly appears to put the more-than-2-percent shareholder-employees in a different class from the tax-favored rank-and-file group. To us, this means that the amounts for health insurance included on the W-2 are not subject to Social Security, Medicare, and FUTA taxes.

For those less certain than us, don't deny yourself the tax benefit. Instead, claim the exemption and disclose your treatment as we explain in *Uncertain of a New TCJA rule? Do This to Avoid Penalties*.

1 Notice 2008-1.

2 Notice 2008-1; Announcement 92-16.

3 IRC Section 3121(a)(2)(B).

4 IRS Publication 15-B, Employer's Tax Guide to Fringe Benefits (2019), p. 7.

5 IRS Publication 15-B, Employer's Tax Guide to Fringe Benefits (2014), dated December 4, 2013, p. 6.

6 IRS Online Guide to S Corporation Compensation and Medical Insurance Issues.

7 IRS Audit Technique Guide—Fishing, Revision Date, August 2011, p. 87.

8 MSSP Training Guide, Independent Used Car Dealers, Chapter 6, Expense Issues, ps. 6-11.

9 Public Health Service (PHS) Act Section 2716.

10 Notice 2011-1.

