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Avoid This S Corporation Health Insurance Deduction Mistake

If you have family members working for you in your S corporation, stop and read this article now.

Think of this: You own 100 percent of your S corporation. Your 30-year-old daughter works for your S corporation. She owns no stock. Your S corporation covers her with a group health policy.

Did your S corporation claim an insurance deduction for the cost of the premiums attributable to your daughter? If yes, that's wrong. The health insurance is not deductible by the S corporation as health insurance. The S corporation must treat it as W-2 wages as we explain.

And with the incorrect setup, your family is simply out the money it paid for the health insurance. This is bad. It means a zero deduction for the S corporation and a lost health insurance deduction for your daughter.

Let's fix this mess. Let's get a corporate tax deduction. And let's get a Form 1040 tax deduction for the daughter.

S Corporation Owner Insurance 101

If you own more than 2 percent of an S corporation, you need to follow three steps to deduct your health insurance premiums.¹

Step 1. Get the cost of the insurance on the S corporation's books.

To do this, the S corporation first establishes a health insurance plan for you in one of two ways:

1. The S corporation makes the premium payments for the accident and health insurance policy covering you (and your spouse or dependents, if applicable).

2. You make the premium payments to the insurance company and then furnish an expense report with proof of the premium payments to the S corporation, which in turn reimburses you for the premium payments.

Step 2. The S corporation includes the health insurance premiums on your W-2 as taxable income. But this income is not subject to payroll taxes (Social Security and Medicare). In other words, the S corporation includes the additional compensation in box 1 of the W-2 but not in boxes 3 or 5.

Step 3. You claim the health insurance deduction as an above-the-line self-employed health insurance deduction on Form 1040, provided you otherwise qualify for the deduction by overcoming the two hurdles below.

You have two qualification hurdles to claiming the self-employed health insurance deduction on your Form 1040:

1. You cannot take this insurance deduction if you or your spouse is eligible for employer-subsidized health insurance. Thus, if your spouse can get family health insurance as a tax-advantaged fringe benefit through his or her employer, you lose your eligibility for this deduction—even if your spouse does not actually accept the employer-sponsored insurance.²
2. Your deduction for the insurance premiums cannot exceed the amount of your salary from the S corporation.³

Family Member Surprise

The self-employed health insurance rules explained above apply to each shareholder-employee who owns more than 2 percent of the S corporation.

The surprise is that your family members who work for your S corporation are deemed by the attribution rules under tax code Section 318 to own the same percentage of stock as you own. And this means that the rules you face to deduct your health insurance also apply to certain family members.

Under the attribution rules for family members, the tax law deems you to own the stock owned by your⁴
spouse,

- children,
- grandchildren, and
- parents.

Example 1. Your parents collectively own 100 percent of an S corporation, and you work for that S corporation. The S corporation covers you under its group health insurance policy.

The tax law considers you (even though you do not own a single share of stock) to own 100 percent of the S corporation, under the Section 318 attribution rules.

Because of the attribution rules and your status as a shareholder-employee who owns more than 2 percent of the company, the S corporation must include the value of your health insurance as W-2 income to you so that the S corporation can deduct the health insurance expense on its tax return as a wage expense.

Example 2. Your spouse owns 5 percent of an S corporation, and you work for that S corporation. The S corporation covers you under its group health insurance policy.

The tax law considers you a more than 2 percent S corporation shareholder under the Section 318 attribution rules. (You are deemed to own 5 percent.)

Let's say the S corporation doesn't include the value of your health insurance as wages on your W-2 because it didn't realize it had to do so. Because of this mistake, the S corporation can't deduct the value of your health insurance on its tax return.

Attribution Deduction

In recent guidance, the IRS concluded that you can take the self-employed health insurance deduction if you own the stock solely by attribution, provided you meet all the other requirements.⁵

Example 3. You own 100 percent of your S corporation business.

You employ your daughter as a manager in the business and pay her \$70,000 per year. You also provide her health insurance as part of your group plan, at a cost to your S corporation of \$6,000 per year.

Since the tax law attributes your S corporation stock ownership to your daughter, she is a more than 2 percent S corporation shareholder. As such, your S corporation must

- include \$6,000 as income on your daughter's W-2 as box 1 wages, and
- deduct the \$6,000 as a wage expense.

If your S corporation did this, good for you. You secured the S corporation's tax deduction for the insurance.

Also, good for your daughter. She can claim the self-employed health insurance deduction on her Form 1040, offsetting the \$6,000 of W-2 income (provided she meets the other requirements for the self-employed health insurance deduction).

Did you get this correct? If not, check out how to fix it below.

How to Fix It

This isn't new law. The IRS is interpreting existing law.

But we're guessing that as you read this article, you might see a boo-boo in your handling of this issue.

But don't worry—you can fix the errors.

Fix Error 1: No Attribution

You need to do three things to correct an attribution failure:

1. Amend the S corporation tax return to claim the insurance expense as a wage expense.
2. Amend the family member's W-2s to include the insurance amounts as box 1 wages.

3. Amend the family member's Form 1040 to correct wages and claim the self-employed health insurance deduction (if he or she qualifies).

Fix Error 2: Attribution, but No 1040 Deduction

This fix is simple: amend the family member's Form 1040 to claim the self-employed health insurance deduction (if he or she qualifies).

Warning. If the amended Form 1040 shows a refund, you have a limited time to file it and timely claim a refund. You must file the amended return by the later of⁶

- three years from the filing date of the tax return, or
- two years from the date you paid the tax.

For most of you, as of today, this means you can file a claim for refund for tax years 2016, 2017, and 2018 (and perhaps 2015, if you filed an extension for that tax year).

Takeaways

If you own more than 2 percent of an S corporation, you have to do three things to claim a deduction for your health insurance:

1. You must get the cost of the insurance on the S corporation's books.
2. Your S corporation must include the health insurance premiums on your W-2 form.
3. You must (if eligible) claim the health insurance deduction as an above-the-line deduction on Form 1040.

The three-step procedure also applies to your spouse, children, grandchildren, and parents if they work for your S corporation and get health insurance coverage, even if they don't own a single share of S corporation stock directly.

Note. Your spouse and your child under age 27 could be included in a family plan, and thus the premium cost for them would be added to your W-2.⁷

You need to get this right. Without the W-2 treatment, the S corporation does not get a tax deduction.

With the correct W-2 treatment, the more than 2 percent shareholder who finds the health insurance premiums on his or her W-2 can claim the self-employed health insurance deduction on Form 1040, provided he or she is not eligible for employer-subsidized health insurance through another job or a spouse's job.

If your S corporation did not handle this correctly in the past, get busy amending those returns.

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1 Notice 2008-1.

2 IRC Section 162(l)(2)(B).

3 IRC Section 162(l)(5).

4 IRC Section 318(a)(1).

5 Chief Counsel Advice 201912001.

6 IRC Section 6511.

7 IRC Section 105(b); Note: The under-age-27 rule is for tax-deduction purposes; for excise tax purposes, the magic age is 26. See Reg. Section 54-4980H-1(a)(12) for the under-age-26 rule.
