



Extra, Extra, Read All About Medical Plans
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Medical Expenses and the S Corporation

The IRS issued a “headliner” on their website on May 15 for tax professionals that was picked up by most tax services, and has created concern for practitioners who have clients with S corporation clients that are pure one person operations. The coverage has suggested that unless the insurance policy is issued in the name of the S corporation, there will be no deduction under §162(l) for the self-employed health insurance deduction. In today’s podcast we’ll consider the impact of Revenue Ruling 61-146 on the analysis found in this headliner.

The provision that we take a look at in this podcast is Section 162(l), which provides

- (l) Special rules for health insurance costs of self-employed individuals
 - (1) Allowance of deduction
 - (A) In general

In the case of an individual who is an employee within the meaning of section 401(c)(1), there shall be allowed as a deduction under this section an amount equal to the applicable percentage of the amount paid during the taxable year for insurance which constitutes medical care for the taxpayer, his spouse, and dependents.

(B) Applicable percentage

For purposes of subparagraph (A), the applicable percentage shall be determined under the following table:

For taxable years beginning in calendar year --	The applicable percentage is --
1999 through 2001	60
2002	70
2003 and thereafter	100.

(2) Limitations

(A) Dollar amount

No deduction shall be allowed under paragraph (1) to the extent that the amount of such deduction exceeds the taxpayer's earned income (within the meaning of section 401(c)) derived by the taxpayer from the trade or business with respect to which the plan providing the medical care coverage is established.

(B) Other coverage

Paragraph (1) shall not apply to any taxpayer for any calendar month for which the taxpayer is eligible to participate in any subsidized health plan maintained by any employer of the taxpayer or of the spouse of the taxpayer. The preceding sentence shall be applied separately with respect to--

(i) plans which include coverage for qualified long-term care services (as defined in section 7702B(c)) or are qualified long-term care insurance contracts (as defined in section 7702B(b)), and

(ii) plans which do not include such coverage and are not such contracts.

(C) Long-term care premiums

In the case of a qualified long-term care insurance contract (as defined in section 7702B(b)), only eligible long-term care premiums (as defined in section 213(d)(10)) shall be taken into account under paragraph (1).

(3) Coordination with medical deduction

Any amount paid by a taxpayer for insurance to which paragraph (1) applies shall not be taken into account in computing the amount allowable to the taxpayer as a deduction under section 213(a).

(4) Deduction not allowed for self-employment tax purposes

The deduction allowable by reason of this subsection shall not be taken into account in determining an individual's net earnings from self-employment (within the meaning of section 1402(a)) for purposes of chapter 2.

(5) Treatment of certain S corporation shareholders

This subsection shall apply in the case of any individual treated as a partner under section 1372(a), except that --

(A) for purposes of this subsection, such individual's wages (as defined in section 3121) from the S corporation shall be treated as such individual's earned income (within the meaning of section 401(c)(1)), and

(B) there shall be such adjustments in the application of this subsection as the Secretary may by regulations prescribe.

As well, the headliner references §1372, which provides the following:

(a) General rule

For purposes of applying the provisions of this subtitle which relate to employee fringe benefits--

(1) the S corporation shall be treated as a partnership, and

(2) any 2-percent shareholder of the S corporation shall be treated as a partner of such partnership.

(b) 2-percent shareholder defined

For purposes of this section, the term "2-percent shareholder" means any person who owns (or is considered as owning within the meaning of section 318) on any day during the taxable year of the S corporation more than 2 percent of the outstanding stock of such corporation or stock possessing more than 2 percent of the total combined voting power of all stock of such corporation.

The Headliner

The document the IRS posted reads as follows:

Headliner Volume 163

May 15, 2006

In many solely owned businesses, the owner of the business will purchase health insurance in his or her own name versus the name of the business. The type of entity may greatly affect where this insurance premium expense may be deducted on the individual's personal income tax return.

In Chief Counsel Advice (CCA) 200524001, it was held that a self-employed individual who is a sole proprietor and who purchases health insurance in his or her own name may treat that as health insurance purchased in the name of the sole proprietor business. As such, the insurance would qualify under the provisions of IRC §162(l). Assuming the self-employed individual meets the other provisions of IRC §162(l), the individual may claim a deduction for the insurance premiums in arriving at his or her adjusted gross income; also referred to as an above-the-line deduction.

In contrast, if the business is operating as an S corporation, there is a different tax consequence if the individual who is the sole shareholder and sole employee, purchases the health insurance in his or her own name.

For certain fringe benefits paid by the S corporation, including health insurance premiums, the Internal Revenue Code (IRC) holds that the S corporation will be treated as a partnership and any shareholder who owns more than 2% (a 2% shareholder) of the S corporation stock will be treated as a partner of such partnership (IRC §1372(a)). Revenue Ruling 91-26 holds that accident and health insurance premiums paid by a partnership on behalf of a partner are guaranteed payments under §707(c) of the Code if the premiums are paid for services rendered in the capacity of a partner and to the extent the premiums are determined without regard to partnership income. As guaranteed payments, the premiums are deductible by the partnership under §162 (subject to the capitalization rules of §263) and includible in the recipient-partner's gross income under §61.

As such, the health insurance premiums paid by the S corporation would not be deductible by the S corporation as a fringe benefit but would be deductible by the S corporation as compensation to the 2% shareholder. The health insurance premiums paid by the S corporation for the 2% shareholder should be included in the 2% shareholder's W-2.

IRC §162(l)(5) holds that a 2% shareholder that is treated as a partner under IRC §1372 will be treated as a self-employed person and, assuming all of the other provisions of IRC §162(l) are met, may deduct the health insurance premiums paid by the S corporation as an above-the-line deduction. It should be remembered that there are some limitations under

IRC §162(l)(2). The one that often affects a 2% shareholder deals with other coverage. An above-the-line deduction is not allowed for any calendar month for which the shareholder is eligible to participate in any subsidized health plan maintained by any other employer of the shareholder or of the spouse of the shareholder.

Assuming there are no other subsidized health plans, the problem arises if the sole shareholder/ employee purchases the health insurance in his or her own name instead of that of the S corporation. In that case, the S corporation has not established a plan to provide medical care coverage, there is no fringe benefit paid to the 2% shareholder and the provisions of IRC §1372 do not come into play. Since the provisions of §1372 do not come into play, the S corporation is not treated as a partnership and the shareholder is not treated as a partner. Since the shareholder is not treated as a partner, the shareholder is not treated as self-employed and is not eligible for the above-the-line deduction treatment under IRC §162(l). The shareholder is still able to deduct the health insurance as an itemized deduction which is subject to the 7.5% AGI limitation.

Some states do not allow a corporation to purchase a group health plan with only one participant. This prevents the S corporation from acquiring a health plan and it requires the shareholder to purchase the plan in his or her own name. That state law limitation does not override the requirements that the S corporation must provide fringe benefits to its employees in order to have the 2% shareholder qualify for the IRC §162(l) benefits.

In summary, contrary to the holding in CCA 200524001 dealing with a sole proprietorship, a shareholder/employee is not allowed to purchase health insurance in the shareholder's own name and still obtain the above-the-line deduction benefits of IRC §162(l).

The key text in the above is found in the following phrase, which offers the justification for the lack of qualification under §162(l):

Assuming there are no other subsidized health plans, the problem arises if the sole shareholder/ employee purchases the health insurance in his or her own name instead of that of the S corporation. In that case, the S corporation has not established a plan to provide medical care coverage, there is no fringe benefit paid to the 2% shareholder and the provisions of IRC §1372 do not come into play.

Note that the conclusion is tied to the position that a plan did not exist because the policy was purchased in the name of the shareholder employee, rather than the S corporation.

The requirement that a plan be in place is found almost in passing in §162(l)(2)(A), which

provides:

(2) Limitations

(A) Dollar amount

No deduction shall be allowed under paragraph (1) to the extent that the amount of such deduction exceeds the taxpayer's earned income (within the meaning of section 401(c)) derived by the taxpayer from the trade or business with respect to which the plan providing the medical care coverage is established.

The reference at the end of that sentence is the plan in §162(l) that we find a plan requirement. While not the best drafting technique, clearly we do need a plan established to test against.

Other Medical Plan Provisions

So what is a plan? If we look elsewhere in the IRC, we find medical plans referenced in §106—in fact, the treatment there is what triggered the eventual passage of §162(l), since unincorporated taxpayers could not get the same tax free medical benefits as their incorporated brethren in the same field.

IRC §106(a) provides:

(a) General rule

Except as otherwise provided in this section, gross income of an employee does not include employer-provided coverage under an accident or health plan.

So does such a plan only mean that offered through group health insurance for an insured plan—or can some other form of plan work for these purposes?

In 1961 the IRS outlined in Revenue Ruling 61-146 the following information about what happens when an employer reimburses an employee or directly pays the premiums for an employee on an individually written plan:

Rev. Rul. 61-146

Advice has been requested whether amounts paid by an employer, under the circumstances below, as his share of premiums for hospital and medical insurance for his employees are excludable from the gross income of the employees under section 106 of the Internal Revenue Code of 1954.

In the instant case, the employer pays a share of the premiums for hospital and medical insurance for his employees. For those employees who are covered by a group policy through their employment, the employer pays his share of the premium directly to the insurance company. For those

employees who are not covered by the employer's group policy but have other types of hospital and medical insurance for which they pay the premiums directly to the insurers, the employer pays a part of such premiums upon proof that the insurance is in force and is being paid for by the employees.

To facilitate payment of his share of the premiums paid directly by the employees to the insurers, the employer uses the following methods:

(1) reimburses each employee directly once or twice a year for the employer's share of the insurance premiums upon proof of prior payments of the premiums by the employee;

(2) issues to each employee a check payable to the particular employee's insurance company, the employee being obligated to turn over the check to the insurance company; or

(3) issues a check as in method (2) except the check is made payable jointly to the insurance company and the employee.

Section 106 of the Code provides that gross income does not include contributions by the employer to accident or health plans for compensation (through insurance or otherwise) to his employees for personal injuries or sickness.

Section 1.106-1 of the Income Tax Regulations provides that the employer may contribute to an accident or health plan either by paying the premium (or a portion of the premium) on a policy of accident or health insurance covering one or more of his employees, or by contributing to a separate trust or fund, which provides accident or health benefits directly or through insurance to one or more of his employees.

In this case it is clear that in method (2) the employer is actually paying accident or health insurance premiums directly to the insurer of the particular employee, utilizing the employee as his agent for the delivery of the checks to the insurer. Method (3) is not substantially different, inasmuch as the employee there is obligated to turn the checks over to the insurer and can in no event divert the payments to other uses. Although method (1) involves direct payment to the employee, in practical effect it does not differ from methods (2) or (3), since proof is required by the employer that hospital and medical insurance is in force for the employee and that premiums for the period involved have been paid by the employee and because the employer's payment is stated to be in reimbursement for the employer's share of the insurance premiums.

Under the circumstances of this case, it is held that the amounts paid by the employer under methods (2) or (3) above constitute payments of

premium or portions of premiums on policies of accident or health insurance covering one or more employees within the meaning of section 1.106-1 of the regulations. Similarly, the payments under method (1) constitute employer payments of accident or health insurance premiums for employees if the payments are shown to be in reimbursement of premiums actually paid by the employees to the insurers. Accordingly, amounts paid as above are excludable from the gross income of the employees under section 106 of the Code.

Revenue Ruling 57-33, C.B. 1957-1, 303, holds that certain weekly payments made by employers direct to employees, pursuant to a union contract of employment, for the purpose of purchasing individual hospitalization and surgical insurance coverage, are 'wages' for Federal employment tax purposes and are includible in the gross income of the employees.

Under the facts in that case, the employers had no accident or health plan of their own in effect and, with respect to the payments which they made direct to the employees, did not require an accounting either by the employees or the employees' union that the funds were expended in the acquisition of insurance coverage. Revenue Ruling 57-33, accordingly, is distinguishable from the instant case.

The IRS has clarified the ruling on three occasions over the years to emphasize what has to be done to qualify. Rev. Rul. 75-241 emphasizes that the employer has to verify the payments are actually used for medical care—it's not enough to give an "allowance" that the employee can use to buy insurance if the employer doesn't verify that the employee actually did so.

Similarly, Rev. Rul. 85-44 held that a former employee who received an award, a portion of which was allocated to amounts the employer should have paid towards group health insurance, could not exclude those amounts from income under §106. Under the facts presented, the amount was determined based solely on what the employer would have paid, and there was no verification or requirement that the employee had actually paid for such insurance. Again, a strict accounting was required to obtain this benefit.

In Rev. Rul. 2002-3 the IRS refused to allow an exclusion from income for amounts an employer paid employers to "make them whole after taxes" for the reduction in their pay that had been applied (apparently across the board) to provide health care. Again, this "reimbursement" failed the tests.

Note that employees can't be given an option to reduce their pay and then get reimbursed under an informal plan, since such a plan would fail to meet the requirements of Section 125.

S Corporations

As the complaint about the individual policy was that the company did not have a plan, it would appear that if the company adopted (even if for a single individual) a plan in accordance with Revenue Ruling 61-146 then the objection is avoided. Thus, despite the implication many have drawn from the headliner's analysis, it would appear that even if the analysis is correct, it should be possible to avoid the result that the headliner arrived at.