Reporting S Corporation Shareholder Health Insurance on the W-2 is Critical to Maintaining Full Deductibility

Although in 2008 the IRS clarified and eased some of the requirements regarding deducting accident and health insurance premiums for S corporation shareholders, they have also made it clear that the only way to achieve the optimal “above-the-line” deduction treatment is to have the premium amounts for 2% or more shareholders reported correctly on their Form W-2 Wage and Tax Statement. The consequences with respect to the “above-the-line,” pre-adjusted gross income (AGI), non-itemized health insurance deduction are as follows:

- Shareholder premiums cannot be reported on Schedule K-1 and deducted
- Shareholder premiums cannot be reported on Form 1099-MISC and deducted
- Shareholder premiums cannot be unreported and deducted
- To be included on the W-2, the information must be gathered in December (or early January) and reported on the quarterly payroll returns
- Actual payment of premiums from the corporate account or reimbursement of shareholder for qualified policy from corporate account must be made by December 31st

Generally a business deducts non-ownership health insurance deductions as an employee fringe benefit, non-taxable to the employee and not reported on the W-2. However, for the shareholder the premium payments must be reported as wages subject to income tax on the W-2 and as a deduction item in the other information box of the form, eventually to be deducted on the shareholders tax return. These are the requirements; there are no alternatives; we are stuck with them. While the rules seem unduly complex and burdensome, taking a shortcut is likely to result in the loss of a deduction for the substantial/expensive health insurance premiums. The reason for this is because the deduction moves from page 1 of the tax return pre-AGI, to the limited medical deduction line of Schedule A. If taxpayers are eligible to itemize on Schedule A without income limitations, the first portion of the medical deduction suffers a phase out (7.5% of AGI).

The IRS released Notice 2008-1 clarifying the rules. The only way to be eligible for the deduction is to have a plan established by the S corporation that provides medical care coverage for the 2% shareholder-employer. A plan providing medical care coverage for the 2% shareholder is established by the S corporation if:

- the S corporation makes the premium payments covering the 2% shareholder-employee (and his or her spouse or dependents) for the accident and health insurance policy, in either the corporation’s name or the shareholder’s name, in the current taxable year; or
- the 2% shareholder makes the premium payments on a health insurance plan, either in the corporation’s name or the shareholder’s name, and furnishes proof of premium payment to the S corporation. The S corporation reimburses the 2% shareholder-employee for the premium payments in the current taxable year.
A plan established and paid for by an individual shareholder without corporate reimbursement does not qualify. Furthermore, shareholders must not be eligible to participate in any subsidized health plan maintained by another, different employer of the shareholder or the shareholder's spouse. You can deduct the lesser of 100% of the health insurance premiums or your earned income derived from the trade or business providing the health insurance coverage. Earned income here generally means your wages from the S corporation and you can't add wages or earnings from different businesses.