One Person Show or Husband-Wife Team, S Corporation

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Generally speaking, for S Corporations with a single owner and therefore only one employee, the rules haven’t changed. Business as usual. Remember, as a shareholder of an S Corp you are also considered an employee. If you hire your spouse or if your spouse is also a shareholder of the S Corp, this strategy blows up because you now have two employees.

Sole proprietors and single member LLCs will handle some of these issues differently, so we’ll first tackle the S Corporation owner and how health insurance premiums and all the above-mentioned programs interact.

Health Insurance Premiums*

In IRS Notice 2008-1 health insurance premiums including dental and vision, paid under individual medical and health insurance plans may be deducted as an “above the line” deduction (as opposed to Itemized Deductions on Schedule A) on your personal tax return if the following conditions are met:

- The S-Corp must establish an Accountable Plan for the payment of health insurance premiums on behalf of the shareholder.

- The S-Corp must either directly pay the premiums for the plan or reimburse the shareholder for the premiums paid. Proper recordkeeping habits must be followed. The Watson CPA Group strongly recommends that the company makes the premium payments directly.

- Here’s the kicker- premiums paid or reimbursed must be included in Box 1 of the shareholder’s W-2. The health insurance premiums are not included in Box 3 Social Security Wages and Box 5 Medicare Wages (thus they are exempt from employment taxes). This might take some payroll coordination, but it certainly is worthwhile.

* Sole proprietors, single member LLCs and partners are treated very similarly without the W-2 angle (see below).

By including the cost of health insurance as wages in Box 1 on your W-2, the S-Corp gets a “wage expense” deduction, which in turn reduces the K-1 income for all shareholders (but each shareholder gets comparable a bump in W-2 income as a part of his or her reasonable salary). On your personal tax return, you will get a dollar for dollar deduction for health insurance premiums paid.

You take this deduction on line 29 of Form 1040. This directly reduces your adjusted gross income, and is not a Schedule A itemized deduction (which is good). If this procedure is not followed, the premiums can only be deducted on Schedule A subject to the 10.0% income thresholds for medical expenses (which is not good). The quality and subsequent tax savings of this deduction is similar to the Cafeteria Plan example.

The policy can be in the name of the shareholder yet the S-Corp can make the premium payments directly. Or the shareholder can pay the premiums and be reimbursed- we suggest
keeping the paper trail to a minimum and having the company pay directly.

**Spouse Has Health Insurance**

If your spouse has health insurance from another employer, the additional cost to cover the family or to cover you might be deductible, but probably not. The probably not part comes from the observation that most companies are already deducting health insurance on a pre-tax basis, and to take a portion of that as self-employed health insurance would be double-dipping.

So, if your spouse is spending $500 per month and $200 of that is additional premium to cover you, the entire $500 is probably being deducted pre-tax, providing an instant tax savings already. It was worth the thought though. No fault in asking.

**Health Savings Accounts (HSAs)**

These are treated similarly to health insurance premiums for the self-employed. Therefore, your company can make the contributions directly into your account, and add the contribution amounts to your W-2, Box 1 only. This in turn is deducted on line 25 of your Form 1040 just like health insurance premiums.

**How Health Expenses Reduces Self-Employment Taxes**

As mentioned earlier, self-employment taxes and Social Security / Medicare taxes are the same thing. When you pay health insurance and / or make health savings account contributions, this must be reported in Box 1 of your W-2. This income is subject to income taxes, but not Social Security and Medicare taxes since the premiums are not included in Box 3 and 5. And you get a $1 for $1 deduction as well on your personal tax return, so the income is a wash.

But extra savings kick in with the reasonable salary testing. As mentioned, 50% of net income is a jumping off point for a reasonable salary. But what if a big chunk of the 50% is actually health insurance premiums and HSA contributions? Example-

<table>
<thead>
<tr>
<th></th>
<th>With Health Insurance</th>
<th>Without Health Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Reasonable Salary at 50%</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Health Insurance Premiums</td>
<td>12,000</td>
<td>0</td>
</tr>
<tr>
<td>HSA Contribution</td>
<td>5,000</td>
<td>0</td>
</tr>
<tr>
<td>W-2, Box 1 Income</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>W-2, Box 3 Social Security Income</td>
<td>33,000</td>
<td>50,000</td>
</tr>
<tr>
<td>W-2, Box 5 Medicare Income</td>
<td>33,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Social Security, Medicare Taxes</td>
<td>5,049</td>
<td>7,650</td>
</tr>
<tr>
<td>Total Savings</td>
<td>2,601</td>
<td></td>
</tr>
</tbody>
</table>

That’s real money. In your pocket. Per year!

**Section 105 Health Reimbursement Arrangements (HRA)**

If you adopt an HRA, the S Corp can reimburse you directly for out of pocket medical expenses including long-term care benefits. This in turn reduces your business income and therefore your K-1 income and therefore your income taxes. Otherwise, to spend $10 on contact solution requires you to pay yourself $13. Silly. Get an HRA. But be careful as illustrated earlier with a 25% marginal tax rate you need $1,600 in out of pocket medical expenses and long-term care premiums (not including medical, dental or vision premiums) for it to be cost effective.
Husband-Wife Team

Not much is different with a husband and wife team operating an S Corporation. However, only one person can be an owner, and that same person can be the only employee. Heads or tails. The owner can obtain family coverage for health care services such as medical, dental and vision including family HSAs, and use the entire amount for computing the tax deduction. There is not a proration or limitation for an S Corporation shareholder with a family plan.

So, while it is not required to make your spouse an employee, it is also not advised since you will unnecessarily put yourself into a multiple employee scenario requiring a Section 125 Cafeteria Plan for these deductions.

Taxpayer's Comprehensive Guide to LLCs and S Corps

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