

HRAs for Different Business Types

J.S., Kansas

"The website is fast and easy.

We have contacted 105

Concepts many times, and each

time they have been very

responsive and helpful."

J.P., Iowa

"105 Concepts has created a

unique system that should be

used by every agent in the group

health market."



SOLE PROPRIETORSHIPS

A sole proprietor may not set up an HRA for himself because the sole proprietor is the employer, not the employee. The internal revenue code states that a self-employed individual may not establish an HRA. The advantage comes into play when the sole proprietor is married and can employ his spouse as a legitimate employee of the business. The employer/owner can then set up an HRA for his employee/spouse. The employee/spouse can be reimbursed for all medical expenses for herself, her spouse, and her dependents. This allows the medical expenses to be deducted by the business (on Schedule C or F) as an employee benefit plan thus saving federal and state income taxes as well as employment taxes (social security, medicare, FUTA and, possibly, SUTA). The benefit is not included on the employee/spouse's W2 as it is exempt from these taxes for the employee's purposes also.

In effect, amounts paid for medical expenses that were previously subjected to employment taxes and limited to deductibility only in excess of 7.5% AGI, are now fully deductible for both employment tax and income tax purposes. The tax savings can be considerable.

Q: Sole proprietors are eligible to deduct health insurance premiums as "above the line" deductions so how does the HRA help them?

A: By running the expenses through an HRA, employment taxes are saved as well so there is an immediate tax savings of 15.3% just on the premiums. Out of pocket medical expenses including the deductibles, co-pays, prescriptions, etc. can be reimbursed through the HRA without any AGI limitations. These costs alone can create significant tax savings (the 15.3% payroll taxes plus federal and state income taxes).

PARTNERSHIPS

A partner is deemed to be self-employed thus cannot participate in an HRA. Employees of the partnership, who are not partners, may participate. The partnership can hire the partner's spouse as an employee of the partnership and set up an HRA for her benefit. As in the case with a sole proprietor, the employee/spouse can be reimbursed for her, her spouse's, and her dependents' medical expenses.

By establishing this employee benefit plan, the partnership can deduct the reimbursed amounts from partnership income. The amounts are also omitted from the employee's W2. The partnership realizes employment tax savings while the employee saves both payroll and income taxes.

CORPORATIONS

Corporations can establish HRA's for the benefit of their employees. The corporation, as the employer, can deduct the reimbursed amounts as a fringe benefit plan thus reducing its taxable income. The corporation will also realize payroll tax savings on the amounts paid since there is no reporting of these fringe benefit plan amounts on the employees' W2 forms. The employees receive both income tax and payroll tax savings.

S CORPORATIONS

S Corporations can establish HRA's for the benefit of their employees just as regular corporations can. Employees, who are not shareholders in the S Corp, are treated just as employees of regular corporations – the fringe benefits are deductible by the S Corp and are not included on the employees' W2 forms. The tax savings are the same as those for regular corporations.

The treatment is different for any employee who owns more than 2% of the stock in the S Corp. In this case, the reimbursement amount, because it is a fringe benefit, must be added back to the employee's wages. It is added back to Box 1 wages (wages subject to income taxes) but not boxes 3 or 5 wages (wages subject to social security and medicare taxes). Health insurance premiums (and long-term care insurance premiums) can then be deducted on the face of the 1040 as an above-the-line deduction. There are limitations on the amount of long-term care insurance premiums that may be deducted in this manner.

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Bob Jennings



"I recommend this product to all tax and accounting professionals in the United States."



Out of pocket medical expenses can also be reimbursed through an HRA of a greater than 2% shareholder but there is no tax advantage to do so. This is because the amount is deducted in the S Corp (Form 1120S), but it is added back into Box 1 wages (Form W2) of the shareholder. Unlike insurance premiums, the out of pocket expenses cannot be deducted on the face of the 1040 but must be deducted on Schedule A where it's subject to the 7.5% of AGI limitation making it difficult, if not impossible, to deduct.

There is an advantage to increasing Box 1 wages for a greater than 2% shareholder. There is a credit for production activities of a business that qualifies and the credit is determined in part by wages paid, as reported in Box 1 of the employee's W2 form. There are also retirement plans available where the amount contributed is limited to a percentage of Box 1 wages. By increasing Box 1 wages, you can possibly realize a greater tax credit and contribute more to a retirement plan.

LLC's

LLC's are a type of entity that can be treated in one of several ways for tax purposes. In order to know whether or not, and to what extent an HRA may be advantageous, you must first know the tax treatment election that was made by the LLC.

The manner in which the LLC is treated for tax purposes determines how the entity is treated for HRA purposes. An LLC that is a sole member entity can be treated as a Schedule C for income tax purposes. Just like a regular schedule C, this entity would have to show spousal employment in order to establish an HRA.

An LLC that is treated as a partnership for tax purposes can establish an HRA for the benefit of employees who are not partner/owners. They might also show spousal employment in order to establish an HRA that would benefit the partners through their spouses.

An LLC that is treated as an S Corporation can establish an HRA for its employees. This also holds true for an LLC that is treated as a corporation.

SERVICES AVAILABLE

- Unlimited Benefit Consulting
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