

In The Know, Volume XV, Issue 11

Tuesday, March 4, 2014

NEW TAX DEVELOPMENT

NO Pre-Tax Reimbursement of Certain Health Insurance Policies

While most churches thought that they were exempt from the major impacts of the Affordable Care Act (often called “ACA” or “ObamaCare”), a seemingly innocuous Internal Revenue Service notice, issued in September 2013, is now being interpreted to place many churches and businesses in the crossfire of the Affordable Care Act.

According to IRS Notice 2013-54, employers may no longer reimburse employees for, or directly pay, the cost of *individual* health insurance policy premiums and exclude such amounts from the employee’s gross income. Effective January 1, 2014, these “employer payment plans” must be paid with “after tax” dollars, rather than with “pre-tax” dollars. The employer is only allowed to use “pre-tax” dollars to pay for health insurance premiums if the employer offers a *group* health insurance plan.

Since an IRS revenue ruling in 1961, churches and businesses have been able to structure compensation plans where employees could obtain their own individual health care plan, provide documentation and substantiation of such to the employer, and the employer could reimburse the employee for, or directly pay, the cost of the individual health insurance policy premiums and such amounts were excluded from the employee’s gross income. Under IRS Notice 2013-54, the Affordable Care Act no longer allows such an arrangement to occur with pre-tax dollars. An employer can still withhold funds and transmit those to pay the premiums on the individual health insurance policy, but the amounts must come from after-tax funds.

Consider the following examples:

- 1.) A local church agrees to pay a pastor \$40,000 a year salary, plus pay another \$10,000 a year towards the pastor’s individual health insurance premium. According to IRS Notice 2013-54, the pastor would have taxable income of \$50,000 in the year in question. It should be noted that the amount designated for insurance must be taxed whether the pastor has secured the health insurance independently or through the government-operated Health Care Exchange.

- 2.) A pastor's wife has health insurance through a *group* plan at her employment and her company pays the entirety of her premium. Such amounts paid by her company are not taxable income to her since she is covered by a *group* plan that meets the requirements of the Affordable Care Act. In addition, her company offers full family coverage but the employee must pay the difference between the company provided employee group coverage and the family coverage premium. If the pastor's church offers to pay the additional \$500 per month to cover the pastor and the pastor's children, the \$500 per month is taxable income to the pastor.

As noted above, IRS Notice 2013-54 took effect January 1, 2014. Therefore, any premiums paid or reimbursed by a church to a pastor or staff member for that person's individual health insurance plan must be treated as taxable income. Treating such amounts as taxable income means that the amounts are subject to federal income taxes, state income taxes, and self-employment taxes (Social Security and Medicare taxes). Using example one above, and assuming a 20% federal income tax bracket, the pastor would be subject to federal income taxes of \$2,000, plus SECA taxes of \$1,530, as well as any state income taxes.

Because the Affordable Care Act has converted the policy premium payments from pre-tax to after-tax funds for individual health insurance plans, the self-employed minister stands to lose forty or so percent of this benefit that was previously considered a fringe benefit, assuming state taxes are due.

While these rules are currently in place and effective, the conversations with Congress, the U.S. Department of Treasury, and the Internal Revenue Service continue, simply because most believe that this is an unintended consequence of the Affordable Care Act. The hope is that corrective notices will be issued to revert back to the rules that have been formally in place since at least 1961. The Internal Revenue Service contends that the new policy is necessary to prevent "double dipping" from a person receiving insurance premiums paid with pre-tax dollars and additionally the new "premium tax credit" available under the Affordable Care Act.

Therefore, as of now, the bottom line is that churches may no longer reimburse employees for, or directly pay, the cost of *individual* health insurance policy premiums and exclude such amounts from the employee's gross income.

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