

# Catch a break on health care costs

By Frank Sommerville, JD, CPA

The tax code is frequently used by Congress to manage the U.S. economy. Since health care costs have increased dramatically, Congress has enacted several tax breaks to help health care consumers. All these tax breaks work the same way: If you pay health care costs with money that is not subject to tax, it costs less. For example, to pay a \$100 health care expense with wages after taxes were deducted, the individual would typically need to earn \$140. On the other hand, if the taxpayer could pay this expense with untaxed wages, the individual would only need \$100.

Since Congress wants employers to fund health care expenses, all these methods involve the employer working with the employee to minimize the employee's tax burden. This is why the church must take the steps to create health care benefits that allow health care expenses to be paid with untaxed wages.

## Health insurance

The church may provide health insurance to its employees with untaxed compensation. Further, federal law allows employers to discriminate in how they provide health insurance. This means that the church could pay the full premiums for the minister and his family, while agreeing to pay the premium that covers only the secretary. Please note that some state laws and insurance companies prohibit discrimination and require all employees to be enrolled. You should check with your tax advisor and

insurance agent to see if you are in one of those states.

## Health care reimbursement plans

Sections 105 and 106 of the Internal Revenue Code (IRS) allow employers to adopt a plan to reimburse employees their qualifying health care expenses. The reimbursement is tax-free to the employee. The plan must be in writing and must not discriminate in favor of the highly compensated employees. The church is free to select the health care expenses it will reimburse and set any limits that it desires.

This plan may include reimbursement for all medical expenses that would qualify for a tax deduction, including prescription medicines. Recently, the IRS approved a plan that included nonprescription medicines on the approved reimbursement list.

## Health care savings accounts

In December 2003, Congress passed the Medicare reforms that included allowing certain employees to set up a personal health care savings account. These accounts are patterned after the Individual Retirement Accounts (IRAs). To participate in the health savings account, the individual must be covered by a high-deductible health insurance policy. A high-deductible policy is one with a deductible in the amount of \$1,000, or up to \$5,000 under certain circumstances.

Employees may submit qualifying health care expenses to the account administrator for reimbursement. The reimbursement is tax-free.

### Cafeteria plans

All the above methods involve only church-funded benefits. For a variety of reasons, this may not always be possible. That is where cafeteria plans come in. A cafeteria plan provides a convenient way for employees to fund their own fringe benefits. The health insurance premiums and the Section 105/106 plans can be funded with employee salary reductions. In addition to these health care expenses, the cafeteria plan can reimburse other qualified expenses, such as child care expenses. The church saves money because the amounts paid into the cafeteria plan by lay employees are not subject to payroll taxes. However, some important things need to be considered before setting up a cafeteria plan.

First, the church must adopt a cafeteria plan that meets all the technical requirements. Second, the employees must sign a form authorizing the salary reduction. The amounts that go into the cafeteria plan are not taxed. This method achieves the same goal as providing the health expense benefits described in the prior paragraphs.

In 2002, the IRS made it even easier for churches to adopt a "premium-only cafeteria plan." The IRS removed all filing requirements for premium-only cafeteria plans. This means that the church can adopt a qualifying plan that reduces taxes without requiring a third-party administrator.

However, none of the tools can be implemented without expert advice. They all have technical requirements. Also, they have continuing requirements that must be met. A church cannot adopt any of these plans and simply forget it.



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## Offering Tax Compliance Services

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Many of our clients have requested a service that will address current and potential concerns associated with tax compliance. We call it a "Tax Compliance Review." A team consisting of an attorney and a CPA go to a church and conduct procedures similar to an Internal Revenue Service exam. Upon completion of the review our firm issues a report to the church board detailing the areas of noncompliance. The report issued is protected by attorney-client privilege and will not be a road map for the IRS (or anyone else) to follow in the event of an investigation. But it will allow you to identify policies, procedures, governance issues and financial transactions that do not comply with tax laws; as well as identify factors that may cause the church to lose its tax-exempt status.

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Express Request No. 28