

Tax Court Again Points Out That Care Must Be Taken When Establishing Medical Reimbursement Plans

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Overview

It is possible to generate income tax advantages through various fringe benefits that can be provided to a spouse as an employee of the family business.¹ One of those fringes for an employee/spouse that is a bona fide employee is employer-provided health insurance coverage that can also include other family members. The technique, if done properly, can also convert family health insurance premiums into deductible business expenses. Pursuant to I.R.C. §105, an employer can establish a medical reimbursement plan covering the employer's spouse. While it generates a deduction for the family business for the amount of the health insurance premiums that are paid, the spouse can also use the plan to deduct insurance co-pays, non-covered prescriptions, eye glasses, dental care, orthodontics, and other medical expenses that would otherwise be an itemized "Schedule A" deduction subject to the 7.5% floor. In addition, an employee spouse would be entitled to \$50,000 of group-term life insurance premiums and disability premiums as nontaxable fringe benefits. But, to get the desired tax benefits, the arrangement must be properly structured. Recent court cases illustrate that it is critical to pay close attention to details when establishing such a plan.

I.R.C. §105

Employees don't generally have to include in their income amounts received from either health insurance that the employer pays for or

amounts the employer pays for directly. In 1999, IRS approved the concept in the issuance of two Coordinated Issue Papers.² In those publications, IRS set forth six points outlining its position on the matter. Those six points are as follows:

- The employee-spouse must be a bona fide employee of the business and provide services to the business for which the compensation *and* fringe benefit package represents reasonable compensation;³
- The employer-spouse deducts 100 percent of the fringe benefits as a business expense, and the employee-spouse receives a tax-free fringe benefit;
- The employer-spouse may be covered by the medical benefits as a member of the employee's family;
- Payments for reimbursement of medical expenses incurred before the adoption of the fringe benefit arrangement are *not* permitted;⁴
- The performance of nominal or insignificant services that have no economic substance will be challenged; and
- The medical insurance policy should not be held in the name of the employer-spouse, but should be owned by the employee-spouse.⁵

Medical Reimbursement Plans and Family Farming Operations

Plans for sole proprietorship operations.

Medical reimbursement plans don't generally work for sole proprietors, but IRS issued a Revenue Ruling in 1971 providing a chance for sole proprietors to use medical reimbursement plans where the spouse of the sole proprietor works for the business.⁶ However, as noted above, the spouse must be a bona fide employee of the business and receive reasonable compensation (including the medical reimbursement) for the services actually rendered. In a 2006 case, the taxpayer prevailed against an IRS attack on the medical reimbursement plan the taxpayer had adopted that covered her spouse/employee.⁷ The Tax Court ruled in that case that the spouse was truly an employee of the enterprise and that a proper plan existed. The court was impressed with the quality of the records the taxpayers retained on the work the husband performed - that was the key to the case.

But, IRS has prevailed in two other cases due largely to the taxpayer's lack of substantiation. Both cases involved medical reimbursement plans administered by AgriPlan/BIZPLAN. In the one case, the taxpayer adopted a plan that provided reimbursement of all health insurance premiums and up to \$3,000 in other medical expenses to eligible employees for themselves and their immediate family.⁸ The taxpayer executed an employment agreement with her husband late in 2000 where she agreed to pay him \$480 in wages annually and made him an eligible employee under the plan. During the tax year at issue, the husband was paid \$480 in wages and received benefits under the plan of \$10,355, of which \$3,906 represented health insurance premiums under a policy for the taxpayer. The IRS took the position that the taxpayer failed to show that the husband actually paid those premiums or that he was reimbursed by the business if he did. IRS took the position that those premiums were deductible to the extent of 60 percent - the amount allowed for self-employed persons in 2000 (the deduction was an "above-the-line" deduction and would also not count as a deduction against self-

employment tax). The court agreed with the IRS. The taxpayer didn't produce any cancelled checks, receipts or premium statement showing that the husband actually paid or had the obligation to pay the premium (which would have made the premium fully deductible). That's a tough outcome. The form of the transaction must be correct, not just the substance. Here, all the couple had to do was have the husband pay the premium and then get reimbursed by the wife's business. They tried to short-circuit the process and lost some of the tax benefit as a result.

In the other case, the husband had been a sole proprietor farmer for 40 years.⁹ His wife helped him by doing chores and other miscellaneous odd jobs around the farm, but had never received any compensation for those tasks. The husband adopted a medical reimbursement plan in 1991 that allowed health insurance costs to be paid for eligible employees, and provided for additional reimbursement for up to \$8,000 of other medical expenses. In 1997, the wife signed an employment agreement. She kept the farm's books, ran errands for the farm and answered telephone calls. Her annual salary was \$2,004, and she participated in the medical reimbursement plan. Her employment agreement did not, however, set forth the number of hours of work, establish the days or times she would be available to work, or document the nature and extent of the services that she was to perform. In the year at issue (2001), the wife performed services for the farm, but there was no documentation of hours worked or what she had actually done. She was reimbursed \$9,502 for the year in question, with \$5,571 being paid on a joint health insurance policy and a Medicare supplement for the husband. So, her total compensation for 2001 was \$11,500. The husband deducted the entire amount of the medical reimbursement on Schedule F. IRS denied the \$9,502 deduction for reimbursed medical expenses and the court agreed. While the court was troubled as to whether there was proof of a bona fide employment relationship, that wasn't determinative of the outcome. Instead, the court held that the couple failed to establish whether any compensation paid to the wife in excess of the \$1,988 actually paid (IRS

conceded that amount was deductible) was reasonable inasmuch as the couple failed to document any hours or times the wife may have performed services for the farm. So, a full deduction would have been available if the couple had kept records.¹⁰

Other Cases Involving Agriplan/BIZPLAN

Since 2007, the U.S. Tax Court has decided five additional cases involving Agriplan/Bizplan.¹¹ Each opinion is instructive concerning the proper way to structure the spousal employment relationship and how reimbursement for medical expenses should be accomplished. Each case illustrates that attention to details is very important.

*Albers v. Comr.*¹² In this case, the court denied a deduction for “employee benefit program” payments. The husband farmed and set up a medical reimbursement plan for his wife. The question in the case was whether the couple could deduct as a business expense the \$8,216 claimed for “employee benefit programs” on their Schedule F. The court determined that the taxpayers failed to establish that the husband paid to his wife, either directly or indirectly under the medical reimbursement plan, the claimed \$3,586 of health insurance premiums and the claimed \$4,630 of medical and dental expenses to reimburse her for expenses that she incurred or paid. The court also held that the taxpayers failed to establish that any portion of the claimed premiums and expenses was an ordinary and necessary business expense. Again, the case points out that attention to details is critical with medical reimbursement plans.

*Eyler v. Comr.*¹³ In this case, IRS disallowed the taxpayers' deduction of health insurance premiums paid by the husband as an employer for the wife as the husband's sole employee. The couple claimed that the amount paid for the premiums was a deductible expense of the husband's employee benefit program under I.R.C. Sec. 162(a), and that the premiums were excludible from the wife's income as expenses incurred for medical care and as employer-provided health insurance coverage. The court held, however, that the claimed deduction was

properly disallowed since the taxpayer's failed to produce business records or canceled checks drawn on the business checking account establishing that the husband paid the premiums as the wife's employer rather than as the primary individual insured under the husband's health insurance policy which also covered the wife as spouse.

*Frahm v. Comr.*¹⁴ Here, the IRS denied deductions under I.R.C. Sec. 162(a) for payments made pursuant to a medical reimbursement plan. The husband owned and operated a farming business, in which he employed his wife. The husband, as the employer, provided a medical reimbursement plan for his wife. During the years at issue, pursuant to the plan, the husband (as the employer) paid, either directly or indirectly, the wife amounts for premiums for various policies covering herself, her husband, and/or both of them. IRS claimed that any payments for medical expenses made for the husband's benefit were not payments made pursuant to an employee benefit plan. But, the court disagreed with the IRS position. Instead, the court held that the payments were ordinary and necessary business expenses of the farming operation. So, the couple was able to deduct amounts paid by the farming operation through the medical reimbursement plan.

*Stephens v. Comr.*¹⁵ In the fourth case, the court agreed with IRS in disallowing a deduction on the taxpayers' Schedule F for health insurance and medical expenses of the wife who was paid \$2,000 per year under a the medical reimbursement plan. The court held that the payment was not an ordinary and necessary business expense, was paid out of a joint account and was not a reimbursement. As a result, the amount was deductible only as an above-the-line deduction (60 percent for tax year 2001 and 70 percent for tax year 2002).

*Shellito v. Comr.*¹⁶ The most recent involved a Kansas spousal farming operation that the husband operated primarily on leased land. The couple jointly owned three pickup trucks that were used on the farm and the husband individually owned other farm equipment,

including a tractor and a combine. The couple had a joint checking account, on which they both wrote checks to pay expenses. They also took out various farm loans with both of them signing most of the notes for the loans. The wife had assisted with farming chores for over twenty years before the medical reimbursement plan was established.¹⁷ In 2001, the couple executed an employment agreement and filled-out a pre-printed application for an Agriplan/BIZPLAN medical reimbursement plan. Under the plan, the wife was to be reimbursed for health insurance premiums for her and the family, up to \$15,000 for out-of-pocket medical expenses for her and the family and \$50,000 of term life insurance for herself. The wife also opened up a checking account in her name in which she deposited her monthly “paycheck” of \$100. For 2001, the wife paid almost \$8,000 in medical expenses and health insurance premiums for herself and the family for which she was reimbursed pursuant to the reimbursement plan. The wife did receive an IRS Form W-2 for 2001 on which wages of \$754 was reported. On the couple’s 2001 tax return, they claimed a Schedule F deduction of over \$15,000 for “Employee benefit programs” and a \$700 deduction for “Labor hired.” The wife was listed on the return as “HOUSE WIFE.” The same events occurred in 2002 except that reimbursement for medical expenses was greater as was the amount paid as “wages.” That resulted in a \$20,897 deduction being claimed on the 2002 return for “Employee benefit programs” and a \$1,200 deduction for “Labor hired.” Again, on the 2002 return, the wife was listed as “HOUSE WIFE.” For both 2001 and 2002, IRS disallowed the vast majority of the amount claimed for “Employee benefit programs.”

The Tax Court upheld the IRS determination on the basis that the wife was not a bona fide employee of her husband. The court rejected the couple’s argument that the 2001 employment agreement simply formalized a pre-existing employer-employee relationship, pointing out that the wife had never been remunerated for her services and, without remuneration, there could be no employment relationship. The court was convinced that nothing happened in 2001 that

changed the nature of the economic relationship between the couple and that the low-level of compensation that was paid beginning in 2001 was “illusory.” Instead, the court determined that the whole arrangement was for the purpose of simply reimbursing family medical expenses and insurance premiums in a tax deductible fashion. The court noted that the funds in the joint account were owned equally by the spouses. As such, the husband (the employer) owned the funds equally with the wife and amounts paid from the account were deemed to have been paid equally by each of them. So, the wife was “reimbursed” with her husband’s funds with any resulting economic benefit was directly offset and negated by the wife assuming and paying her husband’s liability for the family medical expenses. The end result was that the medical expenses continued to be paid from the joint checking account, just like they had been for many years prior. That further confirmed to the court that there was no bona fide employment relationship between the parties. The end result was that the court disallowed any deduction for employee program benefits.¹⁸

Summary

Based on the court decisions on the issue, it is critical that farm operations with farm spousal arrangements make sure that the employment agreement clearly specifies the number of hours that the spouse is required to work, the nature and extent of the work, the days and times the spouse is required to be available for work and, in general, the duties of the spouse as employee. Likewise, it is critical to have the spouse, as employee, document the number of hours the spouse actually works and the nature and extent of the services performed. An easy way to document those items could be by virtue of the use of a notebook or logbook which details the date, hours worked, and the nature of the services performed each day. Also, it is critical to establish a bona fide employment relationship and not use the couple’s joint checking account for paying reimbursed medical expenses.

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¹ That is the case for businesses that are not S corporations. Fringe benefits are statutorily disallowed to the spouse of a more than two percent shareholder of an S corporation. I.R.C. §§1372(b); 318. As for partnerships, a partnership (or LLC) can sponsor a written health insurance and/or medical expense reimbursement plan and provide these benefits to employees, including employees who are also spouses of partners (or spouses of LLC members), as long as the spouses themselves are not also partners (or members, as the case may be).

² UIL 105.06-05 (Mar. 29, 1999) and UIL 162.35-02 (Mar. 29, 1999).

³ In making the “bona fide employee” determination, the IRS looks to, among other things, the issuance of Forms W-2, appropriate withholding, and the regularity of payments (e.g., biweekly, monthly, etc.). In addition, it is important to document that the employee-spouse is an employee of the business, not a co-owner or partner. IRS views co-ownership of assets as precluding the use of I.R.C. §105 plans.

⁴ See *Wollenburg v. United States*, 75 F. Supp. 2d 1032 (D. Neb. 1999). See also *American Family Mutual Insurance Co. v. United States*, 815 F. Supp. 1206 (W.D. Wis. 1992); *Seidel v. Comr.*, T.C. Memo. 1971-238; Rev. Rul. 2002-58, 2002-2 C.B. 541; Rev. Rul. 71-403, 1971-2 C.B. 91.

⁵ The IRS position on this point is questionable. Ownership of the policy would not appear to be material to the issue of deductibility, and having the employee-spouse own the policy may not be possible due to health issues of the employee-spouse or other cost issues.

⁶ Rev. Rul. 71-588, 1971-2 C.B. 91.

⁷ *Speltz v. Comr.*, T.C. Summary Op. 2006-25.

⁸ *Snorek v. Comr.*, T.C. Memo. 2007-34

⁹ *Francis v. Comr.*, T.C. Memo. 2007-33.

¹⁰ The bottom line for self-employed persons using “boilerplate” medical reimbursement plans - pay attention to the details. There is more to the matter than simply adopting a plan and forgetting about it. Attention must be paid to details – both in the completion of the written employment agreement and in the recordkeeping of spousal hours worked and services performed.

¹¹ Information about Agriplan/BIZPLAN can be obtained at <http://www.agriplan-bizplan.com/index.html>.

¹² *Albers v. Comr.*, T.C. Memo. 2007-144.

¹³ *Eyler v. Comr.*, T.C. Memo. 2007- 350.

¹⁴ *Frahm v. Comr.*, T.C. Memo. 2007-351.

¹⁵ *Stephens v. Comr.*, T.C. Summary Op. 2008-18.

¹⁶ *Shellito v. Comr.*, T.C. Memo. 2010-41.

¹⁷ The wife assisted with planting and harvesting activities, operating farm equipment, feeding and caring for livestock, building and repairing fences, repairing equipment and keeping the farm’s books.

¹⁸ However, the court did not sustain an accuracy-related penalty against the couple because they had relied in good faith on the advice of their C.P.A. in establishing the medical reimbursement plan.