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Tax Court Decision on Medical Reimbursement Plans Vacated – Whether Spouse Is "Employee" To Be Determined Via Agency Principles

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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. In a recent decision of the U.S. Court of Appeals for the Tenth Circuit, the court rejected various IRS attacks on a medical reimbursement plan even where those details were closely followed.[2] Had the IRS prevailed on their arguments posited in the case, it would have essentially eliminated the use of medical reimbursement plans for farm proprietorships. The appellate court had some harsh words for the failure of the IRS to follow established caselaw and its own prior positions taken in medical reimbursement plan settings.

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.[3] 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;[4]
- 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;[5]

- 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.[6]

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.[7] 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.[8] 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.[9] 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.[10] 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 insomuch 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.[11]

Other Cases Involving Agriplan/BIZPLAN

Since 2007, the U.S. Tax Court has decided five additional cases involving Agriplan/Bizplan.[12] 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. [13] 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. [14] 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. [15] 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. [16] 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. [17] This case 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.[18] 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 agreement stated that the husband was employing his wife as a farm hand, but did not specify her work hours or compensation. However, she did keep a daily log of the hours that she worked on the farm – which was 1,169 hours in 2001 and 2,226 hours in 2002 (the years in issue).

The wife also opened up a checking account in her name in which she deposited her monthly "paycheck" of $100 along with the reimbursements she received from her husband for medical bills. The amounts he paid to her were written on their joint checking account. 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 $700 plus $54 in payroll tax was reported. On the couple's 2001 tax return, they claimed a Schedule F deduction of $15,593 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" and levied an accuracy-related penalty under I.R.C. §6662(a) of $1,389 for 2002.

> **Note:** It is important to note that the couple properly established an employment agreement and followed the details of the medial reimbursement plan and the IRS still denied the deduction. Each year they submitted detailed accountings of amounts claimed for medical expenses and insurance premium reimbursements to AgriPlan/Bizplan and received back a year-end report showing the total allowable benefit amount that they could report as a business expense deduction.

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 not have been an 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.[19]

> **Note:** The IRS also argued that the wife's payment of her medical expenses with funds from her individual checking account amounted to an assumption of her husband's duty under state law to cover family medical expenses. Thus, according to the IRS, the wife was not truly an employee of her husband.

On further review, the U.S. Tenth Circuit Court of Appeals vacated the Tax Court's decision and remanded the case.[20] The court noted that *Frahm v. Comm'r,*[21] was directly on point, involved substantially similar facts and resulted in a finding by the IRS that the wife was an employee for purposes of the health plan reimbursement deduction, and the IRS did not challenge the fact that the payments originating from the couple's joint checking account ended up in the wife's individual account. The court also noted that the taxpayers carefully followed all of the rules for properly establishing an employment relationship and deducting amounts paid under the plan for medical expense reimbursements. The court specifically rejected the IRS position that the deductibility of medical reimbursements hinges on whether or not the expenses might be paid from another source, even if that source has an obligation to pay, as lacking *any* support by caselaw.[22] Indeed, the court stated that, "[t]he Commissioner's concessions in *Frahm*, and the Tax Court's ruling, are irreconcilable with the case before us."

The court also held that reimbursed amounts were not disqualified from deductibility simply because they originated from the couple's joint account. That argument, the court noted, had never been used in previous cases and is not mentioned in Rev. Rul. 71-588.[23] In that Rev. Rul., IRS specifically acknowledged that "amounts reimbursed under an accident and health plan covering all bona fide employees, including the owner's wife, and their families are not includable in the employee's gross income and are deductible by the owner as business expenses."

The appellate court also noted that the IRS argument that Mrs. Shellito did not receive any economic benefit from the employment relationship was without merit because it ignored the reality of spousal employment. Such arrangements are entered into to decreasing the couple's income which would result from hiring an unrelated party to perform farmwork that the spouse is hired to do. The court stated, "…to narrow these kinds of cases to situations where the employed spouse is setting up a completely separate asset portfolio with her separate account does not find a supporting requirement in the reported cases."

The appellate court also stated that the reliance on the "substance-over-form" doctrine that IRS used to determine that the wife did not receive any compensation as a basis for concluding that there was no bona fide employment relationship had not been used in any of the prior medical reimbursement plan cases. The court stated, "[w]hy such an approach should be adopted now is problematic."

On remand, the Tax Court is to determine whether the wife was a bona fide employee by applying the common law principles of agency. That will require the Tax Court to determine whether the husband had the right to direct and control the means and manner in which the wife's farm work was to be done and what was to be accomplished. A multi-factored test is to be utilized to make that determination. The fundamental question to be determined on remand is whether the amounts paid to the wife were "compensation for personal services actually rendered."[24] Thus, if the health care reimbursements are found to be compensation, they are deductible. The answer to that question is tied to whether the structure of the arrangement was proper and whether the plan requirements were followed. It appears that both of those requirements were carefully satisfied.

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.

Also, the *Shellito* case points out the unwillingness of the IRS (at least in this case) on occasion to not follow established caselaw and its own pronouncements. That is not good for tax administration, and the appellate court appropriately scolded the IRS for the unsupportable positions that it took in the case.

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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] Shellito v. Comr., No. 10-9002, 2011 U.S. App. LEXIS 17724, *vacating* T.C. Memo. 2010-41.

[3] UIL 105.06-05 (Mar. 29, 1999) and UIL 162.35-02 (Mar. 29, 1999).

[4] 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.

[5] 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.

[6] 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.

[7] Rev. Rul. 71-588, 1971-2 C.B. 91.

[8] Speltz v. Comr., T.C. Summary Op. 2006-25.

[9] Snorek v. Comr, T.C. Memo. 2007-34

[10] Francis v. Comr., T.C. Memo. 2007-33.

[11] 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.

[12] Information about Agriplan/BIZPLAN can be obtained at http://www.agriplan-bizplan.com/index.html.
[13] Albers v. Comr., T.C. Memo. 2007-144.
[14] Eyler v. Comr., T.C. Memo. 2007- 350.
[15] Frahm v. Comr., T.C. Memo. 2007-351.
[16] Stephens v. Comr., T.C. Summary Op. 2008-18.
[17] Shellito v. Comr., T.C. Memo. 2010-41.
[18] 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.
[19] 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.
[20] Shellito v. Comr., No. 10-9002, 2011 U.S. App. LEXIS 17724, *vacating* T.C. Memo. 2010-41.
[21] T.C. Memmo. 2007-350.
[22] This is known as the doctrine of "necessaries," and it applies equally to husbands and wives. The doctrine imposes on each spouse a duty to provide for the other's necessities, including medical services, to the extent one spouse is unable to provide for themselves. The appellate court stated, "[i]t is puzzling that the Commissioner would even attempt to advance the argument that Mrs. Shellito's payments should be disregarded because they convert a legal support obligation into a deductible expense. This position has not been adopted by the Commissioner since it would punish a taxpayer for employing a spouse or family member."
[23] 1971-2 C.B. 91.
[24] I.R.C. §162(a)(1).