



Doctor My Eyes Have Seen the Deduction—Medical Expenses and the Spouse Employee



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Medical Expenses

(With apologies to Jackson Browne for the title this week...) A recent case give us a chance to look both at the planning issue of hiring a spouse in a proprietorship to get a medical reimbursement plan, and a general look at medical expenses under §213.

In one sense, the actual medical expense itemized deduction is normally of limited use due to the limitation imposed right up front in §213(a):

213(a) Allowance of Deduction. —There shall be allowed as a deduction the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent (as defined in section 152, determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B) thereof), *to the extent that such expenses exceed 7.5 percent of adjusted gross income.*

That 7.5% floor means that most taxpayers don't get a benefit.¹

However, this provision is used elsewhere to define medical expenses that are given a more significant benefit—such as those paid under a flexible spending account, a health savings account or a medical reimbursement plan of the employer.

Medical Expenses

The general definition of medical expenses is found at §213(d)(1), which provides a list of four general categories of medical care:

213(d)(1) The term “medical care” means amounts paid —

213(d)(1)(A) for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body,

213(d)(1)(B) for transportation primarily for and essential to medical care referred to in subparagraph (A),

213(d)(1)(C) for qualified long-term care services (as defined in section 7702B(c)), or

213(d)(1)(D) for insurance (including amounts paid as premiums under part B of title XVIII of the Social Security Act, relating to supplementary medical insurance for the aged) covering medical care referred to in subparagraphs (A) and (B) or for any qualified long-term care insurance contract (as defined in section 7702B(b)).

In the case of a qualified long-term care insurance contract (as defined in section 7702B(b)), only eligible long-term care premiums (as defined in paragraph (10)) shall be taken into account under subparagraph (D).

The key definition that brings in most medical care is the first one—a definition which bears looking at. While we may be used to seeing, in quick reference books, lists of items which “qualify” and “don't qualify” as medical deductions, those lists are compiled

¹ Arizona listeners—yes, I'm aware that at the state level we do get out of the 7.5% limitation—so we have a bit more interest in the itemized deduction than do practitioners in other states. But it's still a problem that we don't get the deduction on the federal return, since the federal marginal rate for most taxpayers is a lot higher than the Arizona rate.

generally from case law and rulings that look at this much more vague definition and work from there. It is important to understand that, as I've noted before, cases are very fact dependent, and rulings tend to have boundaries as well on the fact pattern—so you have to apply your actual facts to the Code definition after considering how the provision has been interpreted in situations close to your client's. That is, it isn't as simple as going down a checklist of “what's in” and “what's out” if your client's situation is at all unusual.

The definition provides that an item is medical care if it is “*for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body...*” We need to break down that sentence to understand the hurdles you need to clear to get a medical deduction.

First, whatever this item is, it must either deal with a *disease* or it must be for the purpose of *affecting any structure or function of the body*. This means, generally, that you must either be able to point to something that is considered by accepted medical standards to be a disease or you need to show that the item affects the structure or function of the body from a medical standpoint.

The disease test explains why, in 2002, the IRS issued a ruling² that announced the IRS now agreed that, in the case of a taxpayer that is diagnosed as medically obese (and there are specific medical standards) a deduction would be allowed for costs of a weight loss program (though not for foods provided). Previously, before obesity was considered recognized as a disease, treatment for weight loss was considered to be for “general well being” which is *not* a qualified medical expense. For that reason, a personal without a medical condition who buys a health club membership is generally not going to be allowed a medical deduction—it does not treat a specific disease.³

The functional test allows certain expenses that do not treat a specific disease, but nevertheless would likely be seen as medical expenses (though still subject to the “general well being” carve out noted above in the regulations). For instance, vasectomies and abortions are deductible medical expenses (see Revenue Ruling 73-201), as is an operation that renders a woman incapable of having children (Revenue Ruling 73-603). These procedures would not meet the “disease” definition, but they do affect a structure of the body, thus creating the allowance.

However, it is important to note that the regulations do prohibit a deduction for illegal medical treatments (Regulation §1.213-1(e)(2)), which this past year was cited by the IRS in a news release that indicated taxpayers who bought prescription drugs outside the country and, per current FDA regulations, illegally brought them back to the U.S. would not get a medical deduction for those drugs.

² Which I like to refer to as the “Jenny Craig” ruling given the fact pattern described.

³ Regulation §1.213-1(1)(ii)'s final sentence makes this clear

An important structure issue needs to be noted—this definition does not contain the prohibition you likely know exists on deducting “over the counter” drugs. That prohibition is found at §213(b) which provides:

213(b) Limitation With Respect to Medicine and Drugs. —An amount paid during the taxable year for medicine or a drug shall be taken into account under subsection (a) only if such medicine or drug is a prescribed drug or is insulin.

That’s important because, for a number of medical benefits provided elsewhere in the IRC, the reference to allowable medical expenses is only the §213(d) definition, which means that for many benefits (medical reimbursement plans for instance), *nonprescription drugs are allowed medical expenses.*

The Spouse on the Payroll

Many practitioners have heard discussion of using a medical reimbursement plan covering a spouse employee and the spouse’s dependents in order to get a medical deduction for a sole proprietor’s family. This week we had a small tax case where we find a step-by-step “playbook” for successfully implementing this technique—as well the items that the IRS considers challenge points for such a technique. The case is *Speltz v. Commissioner*, TC Summary 2006-25.

The standard caveat applies to any small case—this case cannot be cited as precedent and applies only to this taxpayer. But considered as an analysis of applying the law to a specific case, the case is useful in both outlining the potential problems and how to make sure you have a winning case.

Mrs. Speltz ran a child care service as a sole proprietorship. Mr. Speltz had a full time job, but assisted with the child care business during the late afternoon. The Speltzs established a medical reimbursement plan for the business on the advice of a tax adviser and they executed three documents:

- Employment agreement—this provided that Mr. Speltz would work for the daycare center an average of 12.5 hours a week in exchange for medical coverage limited to \$6,500 per year
- Salary redirection agreement—provided that \$542 per month would be redirected to a flexible spending account to be used for Mr. Speltz’s medical care
- Client data sheet—required that Mr. Speltz work a minimum of 12.5 hours a week and a minimum of 7 months a year

The IRS attacked the plan on a number of fronts. First they argued the plan was defective because there was no written plan. The court indicated that the benefits must be

provided:

To qualify for excludability, benefits must be received under a proper plan, notice or knowledge of the plan must be reasonably available to those covered, and there must be a bona fide employee. See secs. 105(b),(e), and 106(a); *Larkin v. Commissioner*, 48 T.C. 629, 635 (1967), affd. 394 F.2d 494 (1st Cir. 1968); *Tschetter v. Commissioner*, T.C. Memo. 2003-326 (there need not be a written plan or enforceable employee rights under the plan so long as the participant has notice or knowledge of the plan); sec. 1.105-5(a), Income Tax Regs.

The IRS went after the plan using the following arguments:

Respondent argues that Mr. Speltz's medical premiums and reimbursements should not be excluded from petitioners' income because there was no proper plan under section 105(b). Alternatively, if there was a proper plan, respondent argues that notice or knowledge of the plan was not reasonably available to Mr. Speltz. Respondent also argues that Mr. Speltz did not meet his contractual obligations under the "client data sheet" to work 12.5 hours each week. Finally, respondent argues that Mr. Speltz was not an employee of the daycare.

The court found there was a proper plan, noting:

The daycare accident and health plan is detailed in Mrs. Speltz's "client data sheet," which states that the medical benefits plan would be effective in March 2000, that employees were eligible to receive up to \$6,500 a year in reimbursements, and that employees had to work a minimum of 12.5 hours a week to be eligible to receive benefits. On these facts, we find that the daycare established a proper accident and health plan.

The IRS even had the audacity to suggest Mr. Speltz didn't know about the plan. The court rapidly dismissed this one (tongue in cheek note to the IRS—I think this position is a great example of an unreasonable position to use in giving Circular 230 presentations):

Respondent also argues that notice or knowledge of the plan was not reasonably available to Mr. Speltz. We disagree. Mr. Speltz signed a document indicating that his salary would be in the form of reimbursements for insurance premiums and medical expenses up to \$6,500 a year, he credibly testified that he had knowledge of the accident and health plan, and most importantly, Mr. Speltz used the plan. See *id.* (a taxpayer's signing the document declaring the plan is evidence that the taxpayer had knowledge of the plan); see also *Charles Schneider & Co. v.*

Commissioner, 500 F.2d 148, 155 (8th Cir. 1974) (the Court is the exclusive judge of the credibility of the witnesses in making its factual findings), affg. T.C. Memo. 1973-130. We therefore find that Mr. Speltz had notice and knowledge of the plan.

The IRS had a more useful position in arguing over an inconsistency in the documents. The client data sheet required that Mr. Speltz work a minimum of 12.5 hours a week—and the IRS attempted to claim that meant he had to work 12.5 hours each week or he wasn't eligible under the terms of the plan. The court noted this matter, but considering that the employment agreement indicated an average hours test felt, taken as a whole, the plan required an average of 12.5 hours.

What this points out, though, is that a taxpayer is going to be expected to show that he truly lived up to the terms of the plan. *The documents are important, and following them even more so.* Advisers need to be sure clients don't just treat the documents as "legal paperwork" to be paid about as much attention to as the EULAs⁴ you breeze by when installing software.

Finally, the most important IRS argument was that Mr. Speltz was not actually an employee. The judge spent quite a bit of the opinion analyzing the specific facts of Mr. Speltz's work. The Speltz had a lot of documentation (frankly more than many taxpayers with such plans are likely to have). The court noted the following in determining that Mr. Speltz was an employee:

- Mrs. Speltz had the right to control Mr. Speltz's activities. As the court noted, this is the crucial test for an employee. Mr. Speltz activities did not, in actuality, require a lot of control, but the issue was whether she had the right to control those activities. The employment agreement helped a lot here, as did the fact that Mrs. Speltz actually performed many actions that clearly had her generally controlling what was done in the daycare operations, and what Mr. Speltz would end up doing each day.
- The Speltzs had records of Mr. Speltz's actual work. Mrs. Speltz's calendar documented when Mr. Speltz would be working in the center (Mrs. Speltz used such times often to perform tasks outside the center that needed to be taken care of while Mr. Speltz supervised the children).
- The court found the case distinguishable from cases where it had been held no true employment relationship existed.

⁴ End user licensing agreement—that stuff in the tiny box you are told to scroll through and read before pressing OK to allow the installation of software.

Appendix—Speltz Case

PURSUANT TO INTERNAL REVENUE CODE SECTION 7463(b), THIS OPINION MAY NOT BE TREATED AS PRECEDENT FOR ANY OTHER CASE.

Thomas B. Copeland, for petitioners. Melissa J. Hedtke, for respondent.

KROUPA, Judge: This case was heard pursuant to the provisions of section 7463¹ of the Internal Revenue Code in effect at the time the petition was filed. The decision to be entered is not reviewable by any other court, and this opinion should not be cited as authority.

Respondent determined deficiencies in petitioners' Federal income taxes of \$921² for 2000 and \$1,082 for 2001. The issues for decision are:

1. Whether petitioners, husband and wife, had an employer-employee relationship. We find that they did.
2. Whether petitioners may exclude from gross income medical benefits of \$3,279 in 2000 and \$4,539 in 2001 paid by an employer-spouse to an employee-spouse. We find that they may.
3. Whether petitioners may deduct from gross income medical benefits of \$3,279 in 2000 and \$4,539 in 2001 paid by an employer-spouse to an employee-spouse. We find that they may.

Background

Some of the facts have been stipulated and are so found. The stipulation of facts and the accompanying exhibits are incorporated by this reference. Petitioners resided in Rollingstone, Minnesota, at the time they filed the petition.

Maureen Speltz

Petitioner Maureen Speltz (Mrs. Speltz) has operated a sole proprietorship daycare

business in petitioners' home since 1982. Mrs. Speltz has an elementary education degree, and she has been licensed by the State of Minnesota to run the daycare business since 1987. Mrs. Speltz cared for up to 16 children daily during the years at issue.

Mrs. Speltz has managed the daycare since 1987 through the years at issue. Mrs. Speltz established the daycare's rules, policies, and hours of operation. She established a daycare business checking account and credit card account in her name and purchased a professional pre-school curriculum that she has used to instruct the children.³ In addition, Mrs. Speltz drafted all parental contracts, addressed parental complaints, negotiated daycare rates, collected payment, administered bookkeeping, handled State of Minnesota regulatory personnel, utilized the services of Mr. Speltz, and taught the curriculum.

In comparison, Mr. Speltz, while integral to the daycare, had a limited and narrowly defined role during 2000 and 2001. Mr. Speltz assisted Mrs. Speltz by monitoring the children from approximately 2:30 p.m. until 6:00 p.m. and by performing other maintenance-type tasks. Mr. Speltz's part-time role was designed specifically to fit a medical reimbursement plan that Mrs. Speltz established with the help of a tax adviser.

Medical Reimbursement Insurance Plan

Mrs. Speltz established an employer-provided accident and health plan for employees with the help of a tax adviser in 2000. Mrs. Speltz executed three documents in 2000, an employment contract, a salary redirection document, and a client data sheet.

The employment contract described Mr. Speltz's job duties. Mrs. Speltz and Mr. Speltz signed the contract. Mr. Speltz's duties were described as childcare, lawn care, chopping firewood, and repairing toys and sundry items. Mr. Speltz was also required to work an "average" of 12.5 hours weekly in return for a medical reimbursement benefit limited to \$6,500 per year. Medical benefits, according to the contract, included deductibles, insurance premiums, and medical costs not covered by insurance.

The Employee Salary Redirection document provided that \$542 per month would be directed to a flexible spending account on Mr. Speltz's behalf to pay for Mr. Speltz's insured and uninsured healthcare costs. Mr. Speltz signed the employee salary redirection document as an "employee" and Mrs. Speltz as his "employer."

In addition, Mrs. Speltz signed a client data sheet requiring Mr. Speltz to work a "minimum" of 12.5 hours a week and a "minimum" of 7 months a year. The client data sheet also stated that Mr. Speltz's medical reimbursement was limited to \$6,500 per

year.

Mrs. Speltz relied upon an Internal Revenue Service Coordinated Issue Paper, entitled “Health Insurance Deductibility for Self-Employed Individuals,” dated March 29, 1999, and Rev. Rul. 71-588, 1971-2 C.B. 91, in setting up the plan.⁴ Each document permits, under certain circumstances, a sole-proprietor employer-spouse to deduct medical benefits provided to an employee-spouse, and the employee-spouse to exclude those same benefits from his or her gross income.

Mr. Speltz

Mr. Speltz has provided childcare services (and other general services) for the daycare since 2000 and has been reimbursed under the daycare's accident and health plan for a limited amount of medical care expenses and insurance premiums as compensation for his services.

Mr. Speltz also worked full time during the years at issue as a machinist for Fastenal Company, Inc. (Fastenal). Mr. Speltz's hours at Fastenal were from approximately 6 a.m. until approximately 2:15 p.m. Mr. Speltz had medical and dental insurance through Fastenal. Mr. Speltz's spouse and dependents were eligible to receive benefits. Mr. Speltz also had a snow removal and lawncare service during 2000 and 2001.

Mr. Speltz began working for the daycare when he returned home from his full-time job on weekdays, around 2:30 p.m., and he worked until at least 6 p.m., when the daycare closed. Mr. Speltz cared for all the children if Mrs. Speltz was absent, usually when Mrs. Speltz had doctor or dentist appointments. For a short period of time, Mr. Speltz cared for a small boy whose mother had to work very early from 5 a.m. until 6 a.m. Generally, however, Mrs. Speltz directed Mr. Speltz to monitor and care for about five or six older children when he arrived home.⁵ Mr. Speltz monitored the children indoors and whenever possible outdoors, where the children could be active playing kickball, soccer, and basketball, and sledding on the vast stretch of property that petitioners maintained according to State of Minnesota daycare standards. Sometimes Mr. Speltz took the children on nature walks along the creek running through petitioners' property. Mr. Speltz also took the children for rides in a trailer connected to his tractor, and he often took them across the many acres of petitioners' farm to collect firewood that Mr. Speltz chopped to heat petitioners' home.⁶ In addition, Mr. Speltz spent time repairing the children's toys, cleaning, and organizing the daycare areas.

Mr. Speltz also performed tasks benefiting petitioners personally, including picking up

mail, groceries, chopping firewood, and transporting the wood by tractor from their distant farmhouse to their home. If Mr. Speltz took the older children in the trailer when he picked up the firewood, he might spend up to 2 hours returning because he drove the children around the property.

During the snowy Minnesotan winter months, Mr. Speltz plowed petitioners' driveway and shoveled snow from the walkway to petitioners' house. Mr. Speltz did this several times daily on blustery days as Mrs. Speltz's clients were usually mothers carrying small children who dropped them off and picked them up at several times during the day (Mr. Speltz sometimes left his full-time job to do this).

Mrs. Speltz directed that Mr. Speltz perform only childcare and maintenance tasks, and she made contemporaneous notes detailing his activities. Mr. Speltz's assistance was integral to Mrs. Speltz's daycare business. Moreover, as the nature of Mr. Speltz's daycare-related work varied little, he required minimal instruction. Though petitioners derived a personal benefit from some of Mr. Speltz's activities, Mr. Speltz would not have spent the amount of time or devoted the degree of care to those activities were there no daycare business.

Training

Mrs. Speltz directed Mr. Speltz to take classes in nutrition and general childcare because the State of Minnesota and County in which petitioners resided required daycare personnel to have this training. Mr. Speltz's training consisted of about 2 hours of child-nutrition training and about 4 hours of child-behavioral guidance.

Mrs. Speltz substantiated that Mr. Speltz worked 525.25 hours in 2000 and 735 hours in 2001, an average of 12.84 hours a week in 2000 and 14.13 hours a week in 2001.

License

Mrs. Speltz had a State of Minnesota issued daycare license. From 1987 through February 1999, Mrs. Speltz's license listed her name only. In February 1999, the State issued the license in Mrs. Speltz's and Mr. Speltz's names. Mr. Speltz did not apply for the license and took no part in interviews or inspections required to obtain the license. The State of Minnesota listed Mrs. Speltz's and Mr. Speltz's names most likely because they were listed as co-owners of the home where Mrs. Speltz maintained the daycare. The license

issued in August 2001 omitted Mr. Speltz's name and listed only Mrs. Speltz's name.

Tax Returns

Petitioners reported daycare income and expenses on Schedules C, Profit or Loss From Business, of their joint Federal income tax returns for 2000 and 2001, listing their principal business as "child care." Petitioners deducted \$3,279 as an employee benefit program expense in 2000, including \$705.82 for health insurance premiums. Petitioners deducted \$4,539 as an employee benefit program expense in 2001, including \$968.06 for health insurance premiums.

Respondent disallowed petitioners' claimed employee benefit program expense deductions because respondent found petitioners failed to establish that the amounts were ordinary and necessary business expenses or that Mr. Speltz was a bona fide employee of the daycare. Respondent mailed petitioners a deficiency notice on February 23, 2004, and petitioners timely filed a petition.

Discussion

We are presented with two issues, the excludability of medical premiums and reimbursements from petitioners' gross income and the deductibility of those same amounts from the daycare business income. Regarding the excludability issue, we must determine whether petitioners entered into a valid arrangement for the payment of health benefits under section 105(b) and whether Mr. Speltz was a bona fide employee of the daycare. Regarding the deductibility issue, we must determine whether the deduction amount was an ordinary and necessary business expense of the daycare.

Respondent makes a number of alternative arguments to disallow the deductions and exclusions. Respondent argues that petitioners' section 105(b) plan was improper and/or failed on its own terms, that Mr. Speltz was not a bona fide employee of the daycare, and that the expenses were not ordinary and necessary business expenses. Petitioners counter that the medical premiums and reimbursements should be excluded from Mr. Speltz's gross income because petitioners set up a proper section 105(b) plan for daycare employees and that Mr. Speltz was a bona fide employee. Petitioners also contend that the medical premiums and reimbursements are deductible from the daycare business income because they were ordinary and necessary business expenses of the daycare. We first address the burden of proof.

I. Burden of Proof

The Commissioner's determinations are presumptively correct, and the taxpayers bear the burden of proving that the Commissioner's determinations are erroneous. Rule 142(a); see *Welch v. Helvering*, 290 U.S. 111, 115 (1933). Taxpayers also bear the burden of proving that they are entitled to the claimed deductions. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934).

A taxpayer's burden, however, may shift to the Commissioner if the taxpayer introduces "credible evidence" complete with the necessary substantiation and documentation. See sec. 7491(a); *Higbee v. Commissioner*, 116 T.C. 438, 440-443 (2001). To shift the burden, the taxpayer must also have complied with requirements to cooperate with the Commissioner's reasonable requests for witnesses, information, documents, meetings, and interviews. Sec. 7491(a)(2). The taxpayer has the burden to prove the requirements have been met. *Snyder v. Commissioner*, T.C. Memo. 2001-255 (citing H. Conf. Rept. 105-599, at 240-241 (1998), 1998-3 C.B. 747, 994-995).

Petitioners reasonably complied with respondent's requests for information, documents, and meetings. Petitioners also produced credible evidence to establish that Mr. Speltz worked a sufficient number of hours and the nature of the activities he performed.⁷ Accordingly, we find that section 7491 shifts the burden of proof to respondent. Respondent therefore bears the burden of proving that petitioners are not entitled to exclude or deduct Mr. Speltz's reimbursements for insurance premiums and medical expenses.

II. Excludability of Medical Premiums and Reimbursements

Gross income generally includes all income from whatever source derived. Sec. 61(a). This section has been interpreted broadly to encompass all gains except those specifically excluded by Congress. See *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955).

Consistent with this rule, payments by an employer to an employee through accident and health insurance for personal injuries or sickness are generally included in gross income. Sec. 105(a). An exception exists, however. Employees may exclude from gross income employer-paid "reimbursements" for medical care expenses. See secs. 105(b), 106(a),

213(d); *Schmidt v. Commissioner*, T.C. Memo. 2003-325; see also Rev. Rul. 71-588, 1971-2 C.B. 91 (sanctioning payments from an employer-spouse to an employee-spouse).⁸ We must therefore determine whether the exception applies and whether petitioners may exclude benefits from income.

To qualify for excludability, benefits must be received under a proper plan, notice or knowledge of the plan must be reasonably available to those covered, and there must be a bona fide employee. See secs. 105(b),(e), and 106(a); *Larkin v. Commissioner*, 48 T.C. 629, 635 (1967), affd. 394 F.2d 494 (1st Cir. 1968); *Tschetter v. Commissioner*, T.C. Memo. 2003-326 (there need not be a written plan or enforceable employee rights under the plan so long as the participant has notice or knowledge of the plan); sec. 1.105-5(a), Income Tax Regs.

Respondent argues that Mr. Speltz's medical premiums and reimbursements should not be excluded from petitioners' income because there was no proper plan under section 105(b). Alternatively, if there was a proper plan, respondent argues that notice or knowledge of the plan was not reasonably available to Mr. Speltz. Respondent also argues that Mr. Speltz did not meet his contractual obligations under the "client data sheet" to work 12.5 hours each week. Finally, respondent argues that Mr. Speltz was not an employee of the daycare. We address each argument in turn.

Whether There Was a Proper Plan

Section 105(b) and the underlying regulations provide guidelines as to what constitutes an accident and health plan. See sec. 105(e); sec. 1.105-5(a), Income Tax Regs. A plan may be nonfunded or funded, insured or uninsured, it may cover one or more employees, and different plans may exist for different classes of employees. See sec. 105(e); *Wigutow v. Commissioner*, T.C. Memo. 1983-620 (the regulation contemplates a plan for the benefit of a single employee); sec. 1.105-5(a), Income Tax Regs. So long as the participant has notice or knowledge of the plan, there is no requirement that it be in writing or that an employee's rights under the plan be enforceable. See *Wigutow v. Commissioner, supra*.

The daycare accident and health plan is detailed in Mrs. Speltz's "client data sheet," which states that the medical benefits plan would be effective in March 2000, that employees were eligible to receive up to \$6,500 a year in reimbursements, and that employees had to work a minimum of 12.5 hours a week to be eligible to receive benefits. On these facts, we find that the daycare established a proper accident and health plan.

Whether Mr. Speltz Had Notice or Knowledge of the Plan

Respondent also argues that notice or knowledge of the plan was not reasonably available to Mr. Speltz. We disagree. Mr. Speltz signed a document indicating that his salary would be in the form of reimbursements for insurance premiums and medical expenses up to \$6,500 a year, he credibly testified that he had knowledge of the accident and health plan, and most importantly, Mr. Speltz used the plan. See *id.* (a taxpayer's signing the document declaring the plan is evidence that the taxpayer had knowledge of the plan); see also *Charles Schneider & Co. v. Commissioner*, 500 F.2d 148, 155 (8th Cir. 1974) (the Court is the exclusive judge of the credibility of the witnesses in making its factual findings), affg. T.C. Memo. 1973-130. We therefore find that Mr. Speltz had notice and knowledge of the plan.

Whether Mr. Speltz Met the Hourly Requirement

Respondent also argues that Mr. Speltz worked less than the minimal hour requirement and, consequently, failed to fulfill his contractual obligations under the accident and health plan. More specifically, respondent cites Mrs. Speltz's "client data sheet," which states that employees are to work a "minimum" of 12.5 hours a week and a minimum of 7 months a year. Respondent interprets the term "minimum" as requiring Mr. Speltz to work 12.5 hours "every" week, rather than an average of 12.5 hours a week.

Interpreting the client data sheet, as respondent contends, to require Mr. Speltz to work 12.5 hours every week would render the 7 month a year minimum requirement superfluous —Mr. Speltz would by definition have to work 12 months a year. Moreover, petitioners' employment contract requires employees to work an "average" of 12.5 hours a week, not a "minimum" of 12.5 hours. We find that Mrs. Speltz intended employees to work an average of 12.5 hours a week.

Interpreting the client data sheet in this manner produces consistency among the client data sheet, the employment contract, petitioners' stated intent that Mr. Speltz work an average of 12.5 hours a week, and that petitioners documented that Mr. Speltz worked an average of 12.5 hours a week. Accordingly, Mr. Speltz fulfilled his contractual obligations under the accident and health plan. We next determine whether Mr. Speltz was a bona fide employee of the daycare.

Whether Mr. Speltz Was an Employee

Whether an employer-employee relationship exists is a factual question. See *Profl. & Executive Leasing, Inc. v. Commissioner*, 862 F.2d 751, 753 (9th Cir. 1988), affg. 89 T.C. 225 (1987); *Air Terminal Cab, Inc. v. United States*, 478 F.2d 575, 578 (8th Cir. 1973); *Packard v. Commissioner*, 63 T.C. 621, 629-630 (1975); see also *Haeder v. Commissioner*, T.C. Memo. 2001-7. Courts typically apply a common law agency test to determine whether an employer-employee relationship exists. See, e.g., *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 323-324 (1992); *Community for Creative Non-Violence v. Reid*, 490 U.S. 730, 751-752 (1989); *Matthews v. Commissioner*, 92 T.C. 351, 360 (1989), affd. 907 F.2d 1173 (D.C. Cir. 1990). Moreover, where a family relationship is involved, close scrutiny is required to determine whether a bona fide employer-employee relationship existed and whether payments were made on account of the employer-employee relationship or on account of the family relationship. See *Denman v. Commissioner*, 48 T.C. 439 (1967); *Haeder v. Commissioner*, *supra*; *Shelley v. Commissioner*, T.C. Memo. 1994-432; *Martens v. Commissioner*, T.C. Memo. 1990-42, affd. without published opinion 934 F.2d 319 (4th Cir. 1991); *Jenkins v. Commissioner*, T.C. Memo. 1988-292, affd. without published opinion 880 F.2d 414 (6th Cir. 1989); *Furmanski v. Commissioner*, T.C. Memo. 1974-47. Because we shifted the burden under section 7491, respondent has the burden to prove that Mr. Speltz was not a bona fide employee of the daycare during the years at issue.

In determining whether a hired person is an employee under the general common law of agency, we consider several non-exclusive factors.⁹ See *Nationwide Mut. Ins. Co. v. Darden*, *supra*; *NLRB v. United Ins. Co.*, 390 U.S. 254, 258 (1968); *Profl. & Executive Leasing, Inc. v. Commissioner*, 89 T.C. 225, 232 (1987), affd. 862 F.2d 751, 753 (9th Cir. 1988). Inevitably cases turn on the particular facts of each case, and no one factor is controlling. See *Profl. & Executive Leasing, Inc. v. Commissioner*, *supra*.

The “fundamental” test of whether an employer-employee relationship exists is whether the hiring party has the “right to control” the activities of the individual whose status is in issue. See *Profl. & Executive Leasing, Inc. v. Commissioner*, *supra*; *McGuire v. United States*, 349 F.2d 644, 646 (9th Cir. 1965); *Packard v. Commissioner*, *supra* at 629; *Weber v. Commissioner*, 103 T.C. 378, 387 (1994), affd. 60 F.3d 1104 (4th Cir. 1995); see also *AlSCO Storm Windows, Inc. v. United States*, 311 F.2d 341, 343 (9th Cir. 1962); secs. 31.3401(c)-1(b), 31.3121(d)-1(c)(2), Employment Tax Regs. We consider this factor first.

Mr. Speltz was contractually obligated to work for the daycare, and he credibly testified that he understood Mrs. Speltz had the right to control his activities. See *Charles Schneider & Co. v. Commissioner*, 500 F.2d at 155. When Mr. Speltz arrived home, Mrs. Speltz generally split the children into two groups, directing which children Mr. Speltz

cared for and where he cared for them. Mrs. Speltz also controlled the amount of compensation Mr. Speltz received, and she had the contractual right to discharge Mr. Speltz.

Further, Mr. Speltz did not require repetitious instruction. His tasks were limited and consistent. See *Ewens & Miller v. Commissioner*, 117 T.C. 263, 270 (2001) (the employer need not supervise every detail of the work environment or set the employee's hours to control the employee) (citing *Gen. Inv. Corp. v. United States*, 823 F.2d 337, 342 (9th Cir. 1987)); *Weber v. Commissioner*, *supra* at 387 (the degree of control necessary to find employee status varies with the nature of the services provided). Mrs. Speltz provided a sufficient level of direction and control for Mr. Speltz to perform his required duties under the circumstances. We find on the record that Mrs. Speltz had the right to control Mr. Speltz.

In addition to the control factor, other factors support petitioners' employer-employee characterization. For instance, Mrs. Speltz's calendar notations during the years at issue confirm that Mr. Speltz consistently worked for the daycare, she paid Mr. Speltz in employee benefits, Mr. Speltz's work was integral to the daycare's operation, Mr. Speltz was trained to work in childcare, and petitioners' employment contract evidences petitioners' intent to create an employer-employment arrangement. See generally *Community for Creative Non-Violence v. Reid*, 490 U.S. 730, 751-752 (1989).

Moreover, this case is distinguishable from cases finding that no employer-employee relationship existed among family members, usually where the taxpayers failed to substantiate the services provided. See, e.g., *Shelley v. Commissioner*, *supra* (taxpayer did not document any services the taxpayer's spouse performed); *Martens v. Commissioner*, *supra* (little to no records substantiated the services provided). Petitioners substantiated the tasks Mr. Speltz performed in detail.

We also find *Haeder v. Commissioner*, *supra*, which respondent cited, distinguishable. In *Haeder*, the Court found no employer-employee relationship existed between two spouses, where one spouse had a legal practice at home and the other spouse assisted with secretarial, clerical, bookkeeping, and cleaning services. *Haeder v. Commissioner*, T.C. Memo. 2001-7. In *Haeder*, the taxpayer-attorney admitted that the law practice had few clients during the years at issue and required little assistance. Moreover, only the taxpayer-attorney testified, and the Court found that testimony vague, generalized, and conclusory. Nor did the taxpayers document the spouse's purported work activities or the time spent working. *Id.*

Our case is therefore distinguishable from *Haeder*. While the record in *Haeder* was “devoid” of credible evidence that an employer-employee relationship existed, petitioners

submitted credible evidence and testimony concerning the nature of Mr. Speltz's activities and Mrs. Speltz's direction of those activities.

Finally, we have applied close scrutiny to the facts and find that the daycare payments were made on account of the employer-employee relationship and not on account of the family relationship. See *Denman v. Commissioner*, 48 T.C. 439 (1967); *Haeder v. Commissioner, supra*; *Shelley v. Commissioner*, T.C. Memo. 1994-432; *Martens v. Commissioner*, T.C. Memo. 1990-42. Mr. Speltz's activities were essential to the daycare business operations. Accordingly, we find that payments made under the daycare's medical benefits plan in the form of reimbursements are excludable from petitioners' gross income under section 105(b).

III. Deductibility of Medical Premiums and Reimbursements

We next determine whether Mrs. Speltz may deduct the medical cost of insurance premiums and medical reimbursements paid on Mr. Speltz's behalf from daycare business income. Petitioners may deduct medical costs attributable to Mr. Speltz if they substantiated the amount deducted and established that the amounts were ordinary and necessary and reasonable in amount.¹⁰

Whether Payments to Mr. Speltz Were Ordinary and Necessary Business Expenses

Respondent argues that petitioners' employee benefit program expense should be disallowed because petitioners deducted, in part, personal expenses, which are not ordinary and necessary business expenses and are therefore not deductible. Petitioners aver that the amounts deducted were ordinary and necessary business expenses and that the personal characteristics of the activities Mr. Speltz performed should not supplant the predominant business purpose of those activities.

Taxpayers may deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered. Sec. 162(a)(1). An expense is considered "ordinary" if commonly or frequently incurred in the trade or business of the taxpayer. *Deputy v. du Pont*, 308 U.S. 488, 495-496 (1940). An expense is "necessary" if it is appropriate or helpful in carrying on a taxpayer's trade or business. *Commissioner v. Heininger*, 320 U.S. 467, 475 (1943); *Welch v. Helvering*, 290 U.S. at 113.

Ordinary and necessary business expenses include payments to employees for sickness, hospitalization, medical expense, or a similar benefit plan. Secs. 162(a), 213(a); sec. 1.162-10(a), Income Tax Regs. The test for deductibility in the case of compensation payments is whether they are reasonable in amount and are in fact payments purely for services. See *Cardwell v. Commissioner*, T.C. Memo. 1982-453 (citing *United States v. Haskel Engg. & Supply Co.*, 380 F.2d 786, 788 (9th Cir. 1967)); sec. 1.162-7(a), Income Tax Regs. Expenses must also be directly or proximately related to the taxpayer's trade or business. *Deputy v. du Pont, supra* at 494-495; sec. 1.162-1, Income Tax Regs.

While taxpayers may generally deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business, taxpayers may not deduct personal, living, or family expenses. See secs. 162(a), 262; see also *Feldman v. Commissioner*, 86 T.C. 458, 464 (1986); *Sharon v. Commissioner*, 66 T.C. 515, 522-525 (1976), affd. 591 F.2d 1273, 1275 (9th Cir. 1978). Moreover, where there is a mixture of business and personal aspects, some discretion is permitted to determine which considerations predominate and whether any part of the expenditure may qualify for a deduction. See *Feldman v. Commissioner, supra* at 464; *Heineman v. Commissioner*, 82 T.C. 538, 542 (1984) (the distinction between business expenses and personal expenses is based on a weighing and balancing of the facts and circumstances in each case); *Sharon v. Commissioner, supra* at 524 (a weighing and balancing of the facts is required to give the business and personal characteristics their proper order of importance).

We agree with respondent that the hours Mr. Speltz spent picking up mail and groceries and those spent transporting firewood without children are not sufficiently business oriented to warrant an expense deduction. Nonetheless, Mr. Speltz completed a substantial number of hours of business-oriented services for the daycare that Mrs. Speltz credibly substantiated. We therefore find that the medical expense deductions attributable to Mr. Speltz's business-oriented activities were ordinary and necessary business expenses of the daycare.

Whether the Payments Were Reasonable in Amount

We must also determine whether the amounts paid to Mr. Speltz as compensation were reasonable in amount. Mr. Speltz was paid \$3,279 in 2000 and \$4,539 in 2001. Whether amounts paid as wages are reasonable compensation for services rendered is a question of fact to be decided on the basis of the facts and circumstances of each case. See *Estate of Wallace v. Commissioner*, 95 T.C. 525, 553 (1990), affd. 965 F.2d 1038 (11th Cir. 1992). Further, there are no fixed rules or exact standards for determining what constitutes

reasonable compensation. See *Golden Constr. Co. v. Commissioner*, 228 F.2d 637, 638 (10th Cir. 1955), affg. T.C. Memo. 1954-221. With these rules in mind, we determine whether the compensation Mr. Speltz received for business-related services was reasonable in amount.

Mrs. Speltz recorded that Mr. Speltz worked 517.25 hours in 2000 and 655 hours in 2001. During those years, Mr. Speltz received medical benefits of \$3,279 and \$4,255.58, respectively. Mr. Speltz therefore received approximately \$6.34 an hour in 2000 ($\$3,279/517.25$) and \$6.50 an hour in 2001 ($\$4,255.58/655$). Mr. Speltz's hourly rate is comparatively low considering the \$13 an hour that Mrs. Speltz testified she would have had to pay a daycare substitute. Eliminating even half of Mr. Speltz's hours would produce a not unreasonable amount of compensation at \$12.69 an hour in 2000 ($\$3,279/258.5$) and \$13.06 an hour in 2001 ($\$4,255.58/325.75$). Even assuming *arguendo*, therefore, that half the hours Mrs. Speltz logged for Mr. Speltz were personal and disallowable, we would nonetheless still find the compensation provided Mr. Speltz in the years at issue reasonable in amount.

IV. Whether Petitioners May Deduct Insurance Premiums

In the alternative, respondent argues that the “insurance premium” component of Mr. Speltz's reimbursements is not deductible under section 162(l). On the contrary, petitioner contends that section 162(l) applies only to self-employed individuals and that because the deductions are attributable to Mr. Speltz, an employee, section 162(l) does not apply.¹¹ We agree.

Under section 162(l), a self-employed taxpayer may deduct the cost of medical insurance premiums under certain conditions. A self-employed taxpayer may not deduct the cost of medical insurance premiums, however, if the self-employed taxpayer is eligible to participate in a subsidized health plan of another employer of the taxpayer or of a spouse's employer. Sec. 162(l)(2)(B).

Mrs. Speltz is self-employed. She deducted on the daycare Schedules C the cost of medical insurance premiums paid for Mr. Speltz under the daycare's accident and health plan for employees, and she was eligible to receive medical benefits through Mr. Speltz's subsidized health plan with Fastenal, his full-time employer.

While section 162(l) applies to Mrs. Speltz because she is self-employed, section 162(l) does not apply to Mr. Speltz. See secs. 162(l)(1)(A), 401(c)(3). Because the premiums were paid for medical insurance for Mr. Speltz, the limits of section 162(l) and

section 162(l)(2)(B) do not apply. Accordingly, petitioners are entitled to deduct their expenses for medical insurance premiums for Mr. Speltz.

In reaching our holding, we have considered all arguments made, and, to the extent not mentioned, we conclude that they are moot, irrelevant, or without merit. To reflect the foregoing and the concessions of the parties,

Decision will be entered for petitioners.

¹ All section references are to the Internal Revenue Code in effect for the years at issue, unless otherwise indicated, and Rule references are to the Tax Court Rules of Practice and Procedure.

² All monetary amounts have been rounded to the nearest dollar.

³ The curriculum was a pre-kindergarten program designed to teach children colors, letters, and numbers.

⁴ Internal Revenue Service Coordinated Issue Papers and Revenue Rulings are generally not entitled to deference in this Court. See *Lunsford v. Commissioner*, 117 T.C. 159, 182 (2001); see also *N. Ind. Pub. Serv. Co. v. Commissioner*, 105 T.C. 341, 350 (1995), affd. 115 F.3d 506 (7th Cir. 1997).

⁵ When the children were split into two groups, Mrs. Speltz watched the younger children, whose care involved diapering, toilet training, and playing with toys.

⁶ Firewood was the only source of heat in their home.

⁷ Petitioners conceded that some of the hours Mrs. Speltz noted were personal and could not be counted. Mrs. Speltz subtracted those hours from the tabulation of the hours Mr. Speltz spent performing daycare-related tasks.

⁸ We are aware that revenue rulings are not binding on this Court or other Federal courts. *Rauenhorst v. Commissioner*, 119 T.C. 157, 171 (2002); *Frazier v. Commissioner*, 111 T.C. 243, 248 (1998). The public has a right, however, to rely on positions taken by the Commissioner in published guidance. *Alumax, Inc. v. Commissioner*, 109 T.C. 133, 163 n.12 (1997), affd. 165 F.3d 822 (11th Cir. 1999); *Am. Campaign Acad. v. Commissioner*, 92 T.C. 1053, 1070 (1989); *Nissho Iwai Am. Corp. v. Commissioner*, 89 T.C. 765, 778 (1987); see also Rev. Proc. 89-14, sec. 7.01(5), 1989-1 C.B. 814, 815 (taxpayers may rely on published revenue rulings in determining the tax treatment of their own transactions).

⁹ Courts have looked to factors including the hiring party's right to control the employee, the skill required, the source of the instrumentalities and tools, the location of the work, the duration of the relationship between the parties, whether the hiring party has the right to assign additional projects to the hired party, the extent of the hired party's discretion over when and how long to work, the method of payment, the hired party's role in hiring and paying assistants, whether the work is part of the regular business of the hiring party, whether the hiring party is in business, provides employee benefits, and the tax treatment of the hired party. See *Community for Creative Non-Violence v. Reid*, 490 U.S. 730, 751-752 (1989).

¹⁰ We previously determined that an employer-employee relationship existed.

¹¹ The deduction amounts of \$705.82 in 2000 and \$968.06 in 2001 constituted medical, dental, and cancer insurance premiums. The full amounts deducted were \$3,279 in 2000 and \$4,539 in 2001.