A Family Affair—Spouses and Medical Reimbursement Plans
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Medical Reimbursent Plan Losses for Sole Proprietors

The Tax Court issued opinions on Thursday in two cases that deal with an issue we discussed back about a year ago in the case of *Speltz v. Commissioner*, TC Summary 2006-25. In that case, the taxpayer prevailed against an IRS attack on the medical reimbursement plan the taxpayer had adopted that covered her spouse-employee. The Tax Court ruled in that case that the spouse was truly an employee of the enterprise and that a proper plan existed.

In discussing the case, I noted that the court was very impressed with the quality of the records the taxpayers had on the work Mr. Speltz had performed. Now we find out what happens when taxpayers don't have such records and other evidence suggests that, just perhaps, the spouse wasn't truly an employee of the enterprise.

Medical Reimbursement Plans and Proprietors

Employees do not generally have to include in their income amounts received either from health insurance that was paid for by their employer or, in the matter we are concerned with here, amounts paid directly by the employer. IRC §105(b) provides:

> (b) Amounts expended for medical care
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> Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include amounts referred to in subsection (a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by him for the medical care (as defined in section 213(d)) of the taxpayer, his spouse, and his dependents (as defined in section 152,

> determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B) thereof). Any child to whom section 152(e) applies shall be treated as a dependent of both parents for purposes of this subsection.

As we discussed last year in reviewing this provision there are a couple of limitations that create issues for such plans in many cases. First, as noted, the anti-discrimination provisions in §105(h) make the plan less than desirable for businesses that employ individuals other than the owner and his/her immediate family.

Second, and the key issue looked at in the *Speltz* case and the two cases we will consider today, is the provision found in §105(g) which provides:

> (g) Self-employed individual not considered an employee
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> For purposes of this section, the term "employee" does not include an individual who is an employee within the meaning of section 401(c)(1) (relating to self-employed individuals).

This provision means that the plans don't generally work for the sole proprietor. However, in Revenue Ruling 71-588 the IRS provided a potential out for a proprietorship where the spouse of the proprietor works for the business. That ruling, which is very short, provides the following holding:

> **Rev. Rul. 71-588**
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> The taxpayer operated a business as a sole proprietorship with several bona fide fulltime employees including his wife. The taxpayer had an accident and health plan covering all employees and their families. During 1970 two employees, including the wife, incurred expenses for medical care for themselves, their spouses, and their children, and were reimbursed pursuant to the plan. The reimbursed amounts qualified both as amounts received under an accident or health plan for employees within the meaning of section 105(e) of the Internal Revenue Code of 1954 and as amounts described in section 105(b) of the Code.
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> Held, the reimbursed amounts received by the employees are not includible in their gross income pursuant to section 105(b) of the Code and these amounts are deductible by the taxpayer as a business expense under section 162(a) of the Code.

The wife, being a bona fide employee, was able to exclude payments for coverage for herself, her children and her spouse—who just happened to be the owner of the business.

Note that a key factor in both the Revenue Ruling and the *Speltz* case is the finding that the spouse was a bona fide employee. As well, a second hurdle that is not mentioned in the ruling but must also be cleared is the reasonable compensation rule found at §162(a)(1) which provides:

> (a) In general
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> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--
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> (1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

The payment of a medical reimbursement amount is "other compensation" for purposes of Section 162. So in addition to showing the spouse is a bona fide employee of the entity, the taxpayer must also show that the total compensation received, including the medical reimbursement, is reasonable for the services actually rendered.

The Danger of "Off the Shelf" Tax Planning

The two cases ruled on in Thursday's cases both involved medical reimbursement plans administered by the same organization—AgriPlan/BizPlan, an organization that has marketed its services online and through a number of organizations to persuade farmers and business owners to adopt its medical reimbursement plan to cover the employee spouse. A Google search on that name will turn up a significant number of links on various business and farming organizations to the organization.

The basic idea they peddle clearly does work—Revenue Ruling 71-588 makes that crystal clear. However, as these cases note, the mere existence of a valid written plan does not eliminate the need to fulfill the other requirements of such a plan, requirements that may not be obvious to unsophisticated taxpayers who adopt these plans without understanding the need to do more than merely pay the organization for the plan document.

The two cases we look at are the cases of *Snorek v. Commissioner*¸(TC Memo 2007-34) and *Francis v. Commissioner*¸ (TC Memo 2007-33). Both taxpayers resided in Minnesota, operated businesses there (Mrs. Snorek ran an upholstery business and Mr. Francis operated a farm), and adopted a plan provided by the same organization noted above. Note that in neither case did the documentation they adopted cause the tax benefits to be lost—rather other operational factors caused the taxpayers to not receive all of the benefits they had claimed.

Did the Employer Pay the Premium?

In the Snorek case, Mrs. Snorek 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. Mrs. Snorek executed an employment agreement with Mr. Snorek near the end of 2000 where she agreed to pay Mr. Snorek a whopping $480 a year in wages and made him an eligible employee under the plan.

In 2001, Mr. Snorek was paid the $480 in wages for the year. Mr. Snorek also received benefits under the medical reimbursement plan of $10,355, of which $3,906 represented premiums paid to Blue Cross/Blue Shield under an individual health insurance policy for Mrs. Snorek. That $3,906 of premiums is what became the issue for an unusual reason—the IRS took the position that the Snoreks did not show that Mr. Snorek actually paid those premiums or that he was actually reimbursed by the business even if he did. The IRS took the position that those premiums were only deductible as allowed under §162(l)—which, for the year in question, allowed only 60% of the premium to be deducted above the line and also would not count as a deduction against the self-employment tax.

While this may seem like a very technical violation, the Tax Court indicated that it was enough to cause the loss of the deduction. The Court held:

> Petitioners introduced the transmittal form that Mr. Snorek submitted to the plan, on which he claimed he paid the health insurance premiums for Mrs. Snorek. Petitioners introduced no documentary evidence, however, showing that Mr. Snorek actually paid the health insurance premiums for Mrs. Snorek. Petitioners did not, for example, introduce receipts or canceled checks showing that Mr. Snorek paid the health insurance premiums for Mrs. Snorek. Petitioners also did not introduce the premium statement or policy itself, which may have identified the party responsible for making the premium payments for the insured. Petitioners' failure to produce this documentation caused respondent to determine that Mrs. Snorek paid the health insurance premiums for herself. Nothing in the record rebuts this determination nor convinces us that petitioners have carried their burden of proving that Mr. Snorek paid the health insurance premiums for Mrs. Snorek to entitle him to deduct 100 percent of the premium payments.

> Accordingly, we hold that petitioners may deduct only $2,344 (60 percent) of the $3,906 health insurance premiums for Mrs. Snorek under section 162(l).

This is a clear case that indicates the importance of getting the *form* of the transaction correct when you have full control over that form. While, in substance, the taxpayers ended up economically in the same position, the fact is since they were using a highly technical ruling that relies on a very technical distinction, it's important that the distinction always be respected.

I would suspect that a few taxpayers with these types of plans might have problems in this area if the IRS attacked the plan. Note that from the court case it appears that if, in fact, Mr. Snorek had paid the premiums on the policy and then received a check from Mrs. Snorek's business as a reimbursement, all would have been fine. But the fact that the taxpayers may have short circuited this process (which appears likely since it should have been clear that showing Mr. Snorek had paid the premiums and been reimbursed would have given them the desired result under the IRS view) caused the loss of the benefit.

The Importance of Being Reasonable

While the Snoreks were able to preserve most of the deduction in their case, the other taxpayer whose case was decided the same day was less fortunate. The case of *Francis v. Commissioner* deals with same issue the IRS attempted to litigate in the *Speltz* case—was there a legitimate employment relationship and were the payments to that spouse, including the medical reimbursement benefit, reasonable compensation? In this case, the IRS succeeded in eliminating the medical benefit.

Mr. Francis had operated a farm for 40 years as a sole proprietorship. Mrs. Francis assisted Mr. Francis by performing various farming chores since Mr. Francis began operating the farm, although she had not received compensation for such work. Mr. Francis adopted a medical reimbursement plan in 1991 that allowed health insurance costs to be paid for eligible employees, and to be additionally reimbursed for up to $8,000 of other medical expenses.

In 1997 Mrs. Francis signed an employment agreement with Mr. Francis. She would keep the farm's books, run business errands and answer telephone calls. She would receive an annual salary of $2,004 and would participate in the medical reimbursement plan. However, the agreement did not establish the number of hours she would work nor establish the days or times she would be available to work.

In the year in question (2001) she performed services for the farm, though there was no documentation of how many hours she had worked nor was there any documentation of what exactly she had done. She did receive $1,998 in wages that year (apparently she wasn't bothered that she was "shorted" by $6).

The court did note a set of facts that, it appears, seemed significant to the court in deciding the reality of this arrangement. The court noted:

> Mrs. Francis also ran errands for a farming business operated by petitioners' son in 2001. Petitioners' son did not treat Mrs. Francis as an employee of his farming operation. Petitioners' son performed services on the farm without being treated as an employee of the farm.

Mrs. Francis was reimbursed $9,502 for the year in question, with $5,571 being paid on a joint health insurance policy issued by Blue Cross/Blue Shield and a Medicare supplement for Mr. Francis. Thus, Mrs. Francis' total compensation for 2001, considering both her wages and the medical reimbursement was $11,500. The entire amount of the medical reimbursement was deducted on Schedule F by Mr. Francis.

The Tax Court's key concern is telegraphed early in its opinion. The Court recites the standard line about deductions being a matter of legislative grace, but then adds the following proviso:

> We look to the general rule that deductions are a matter of legislative grace, and the taxpayer must show that he or she is entitled to any deduction claimed. Rule 142(a); *Deputy v. du Pont*, 308 U.S.

> 488, 493 (1940). This includes the burden of substantiation. *Hradesky v. Commissioner*, 65 T.C. 87, 89-90 (1975), *affd. per curiam* 540 F.2d 821 (5th Cir. 1976).

A key first issue is whether Mrs. Francis was an employee of the farm. The Tax Court outlined the facts on whether she was an employee first:

> The deductibility of employee benefit plan expenses generally requires proof, in the first instance, of an employer-employee relationship. Respondent concedes that Mr. Francis had the right to control[5] Mrs. Francis in her performance of services for the farm, but he also points to several factual inconsistencies that discredit petitioners' characterization of Mrs. Francis as an employee of the farm. Specifically, Mrs. Francis performed services for the farm for many years before 1997 (the year her employment agreement was executed), Mrs. Francis performed services for their son's farming operation without being treated as an employee of the son's operation, and petitioners' son performed services on the farm without being treated as an employee.
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> [5]Although no single factor is controlling, the "right to control" the activities of the individual whose status is in issue is the "fundamental test" of whether an employer-employee relationship exists. *Profl. & Executive Leasing, Inc. v. Commissioner*, 89 T.C. 225, 232 (1987), *affd.* 862 F.2d 751, 753) (9th Cir. 1988).

However, the Court didn't worry about this issue as it turns out—it decides it didn't need to decide that fact.

> While these facts are troubling,[6] we need not determine whether Mrs. Francis was a bona fide employee of the farm to decide this case. Even assuming arguendo that Mrs. Francis was a bona fide employee,[7] we find that petitioners failed to prove that any compensation paid to Mrs. Francis in excess of $1,998 was reasonable in amount given that petitioners failed to document any hours or times Mrs. Francis may have performed services for the farm.
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> [6] Equally as troubling is respondent's argument that no bona fide employer-employee relationship existed, yet respondent conceded that petitioners were entitled to deduct $1,998 of "wages" paid to Mrs. Francis.
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> [7] If we were to find Mrs. Francis was a bona fide employee, respondent would concede that the claimed employee benefit plan expense would be an ordinary and necessary expense.

Having decided that it didn't really want or need to deal with whether Mrs. Francis was an employee, the Court then analyzed the reasonableness (or lack thereof) of the amount paid on her behalf through the benefit plan.

To analyze the point, the Court performed the following analysis:

> Whether amounts paid to an employee 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, although a number of factors have been identified as relevant.[8] 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 Mrs. Francis received for business-related services was reasonable in amount.

> The employment agreement for Mrs. Francis did not set the number of hours she was required to work to earn her pay and benefits, nor did Mrs. Francis keep a time log recording the number of hours she worked for the farm in 2001. Petitioners did not establish what Mrs. Francis earned on an hourly basis because they did not prove how many hours she worked, and they did not establish what employees doing comparable work on other similarly sized farms in the vicinity were paid hourly.
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> We apply close scrutiny to the facts in a family situation and find petitioners did not prove that any of the compensation paid to Mrs. Francis for services she provided the farm was reasonable in amount to the extent it exceeded the $1,998 that respondent has conceded to be deductible. See *Denman v. Commissioner*, 48 T.C. 439 (1967); *Haeder v. Commissioner*, T.C. Memo. 2001-7; *Shelley v. Commissioner*, T.C. Memo. 1994-432; *Martens v. Commissioner*, T.C. Memo. 1990-42, *affd*. 934 F.2d 319 (9th Cir. 1991). Accordingly, we hold that petitioners are not entitled to deduct the $9,502 claimed employee benefit plan expense under section 162(a).
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> [8] See *Miller & Sons Drywall, Inc. v. Commissioner*, T.C. Memo. 2005-114, for a list of the relevant factors.

This is a case where there might have been a deduction if records had been kept—and also a good example of what might have happened in the *Speltz* case had they not maintained records of the activity that took place.

Lessons

It is important to note that these cases are not a reversal of Revenue Ruling 71-588, or even an invalidation of the plans that were being administered by this organization. Rather it shows that tax planning in this area involves more details than an "adopt and forget" style situation. Clients who use this type of plan need to be aware that all three cases (including the *Speltz* case where the IRS lost) indicate that the IRS may consider this to be an overused type of plan and they are sending out a warning shot to taxpayers who are using this type of plan.

You should review with clients that have adopted reimbursement plans of this type the issues the IRS is questioning, and help clients insure they are taking care of the details. You also need to counsel client that there's more than just adopting a plan that their trade organization might be suggesting they take on.