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Employing the Spouse to Qualify for Medical Benefits

-by Neil E. Harl*

Attempts to qualify a spouse as an employee in a husband-wife farming operation for family medical benefits go back decades.¹ The battle is likely not over even with a favorable taxpayer decision by the Tenth Circuit Court of Appeals in 2011.² That decision only binds the Internal Revenue Service in the Tenth Circuit area (six states – Colorado, Kansas, Oklahoma, New Mexico, Utah and Wyoming). Tax Court decisions issued over the years provide “substantial authority”³ to the contrary elsewhere in the United States.⁴

History of the controversy

It has been clear for decades that Section 105(b) plans⁵ should be approached with care in order to be successful. Under that provision, amounts paid for medical care are not included in gross income –

“ . . . if paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by him for the medical care . . . of the taxpayer, his spouse, and his dependents. . . .”⁶

In the ruling often cited as authority for such plans,⁷ the ruling states that the factual situation in the ruling involved “. . . a sole proprietorship with several bona fide full-time employees, including his wife.”⁸ However, a 1971 General Counsel’s Memorandum⁹ which preceded the ruling in question¹⁰ revealed that there were actually only two employees in the facts of the ruling released to the public,¹¹ one of whom was the spouse. The GCM expressed concern that the IRS position, if it were to become widely known, “might encourage abuses” so the actual ruling did not reveal the true facts. The original GCM, which dealt with the factual situation in 1965, had recommended denial of deductibility¹² and was reconsidered in the 1971 GCM.¹³ So the initial authority was clouded in controversy.

In the 1971 ruling released to the public,¹⁴ in the year in question the two employees, one of whom was the spouse, incurred expenses for medical care for themselves, their spouses and their children and were reimbursed under the plan.¹⁵ The reimbursed amounts were not included in the employees’ gross incomes and were deductible by the taxpayer as a business expense.

Albers v. Commissioner

As an example of the Tax Court’s handling of deductibility for such plans, the taxpayers

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in *Albers v. Commissioner*¹⁶ deducted the costs for the Section 105(b) plan (popularly known as an Agri Plan/Biz Plan) as a trade or business expense on Schedule F. The Tax Court held that the taxpayer-employer (Mr. Albers) failed to establish that he paid the amount of the medical insurance premiums and the claimed reimbursed expenses for medical care for his wife as employee, her spouse (Mr. Albers) and her dependent children.¹⁷ Also, the Tax Court found that the taxpayers had failed to establish that any part of the claimed medical insurance premiums and the claimed medical expenses were ordinary and necessary business expenses paid or incurred by the sole proprietor in carrying on the farming operation.

For several years, self-employed taxpayers have been able to deduct from gross income (line 29 of the 2011 federal income tax return) 100 percent of amounts paid during the year for health insurance for themselves, their spouses and dependents.¹⁸ The deduction cannot exceed the taxpayer's net earned income derived from the trade or business for which the insurance was established.¹⁹

Shellito v. Commissioner

In the 2010 Tax Court case of *Shellito v. Commissioner*,²⁰ the taxpayers, husband and wife, carried on a farming operation on leased farmland. They maintained a joint checking account and entered into an Agri Plan/Biz Plan providing for reimbursement of up to \$15,000 in out-of-pocket medical expenses. The husband employed his wife in the operation but did not specify her work hours or compensation. The wife opened up a checking account in which she deposited the reimbursed medical expenses and her monthly paycheck of \$100.²¹ A Schedule F deduction was claimed for \$15,593 for 2001 and for \$700 as "labor hired."

IRS determined that the wife was not a bona fide employee of her husband and that the funds in the joint account were owned equally by the spouses with the medical deductions disallowed. The Tax Court agreed with the IRS determination.²² On appeal, the Tenth Circuit vacated the Tax Court decision and remanded the case with the Tax Court ordered to determine whether the wife was a bona fide employee by applying the common-law rules of agency.²³ Thus, the case is back in the Tax Court. Keep in mind, however, that the Tenth Circuit decision binds IRS *only in that six-state circuit*. Elsewhere, the various Tax Court decisions to the contrary constitute "substantial authority."²⁴ It is clear that the outcome of this and other cases depends heavily on the facts of the case.

ENDNOTES

¹ See, e.g., *Albers v. Comm'r*, T.C. Memo. 2007-144 (amounts cannot be claimed as a deduction on Schedule F (and presumably not on Schedule C) if employment not bona fide and not an ordinary and necessary business expense; involved Agri Plan/Biz Plan). Compare *Shellito v. Comm'r*, T.C. Memo. 2010-41, *rev'd*, 2011-2 U.S. Tax Cas. ¶ 50,595 (10th Cir. 2011) (farmer allowed Schedule F deduction for medical expense reimbursement and health insurance reimbursement paid to spouse; involved Agri

Plan/Biz Plan). See generally 4 Harl, *Agricultural Law* § 28.02[6][d][i] (2011); Harl, *Agricultural Law Manual* § 4.03[11] (2011); 1 Harl, *Farm Income Tax Manual* § 3.03[8][b] (2011 ed.). See also Harl, "Can Section 105 Plan Costs Be Deducted on Schedule F?" 18 *Agric. L. Dig.* 105 (2007).

² *Shellito v. Comm'r*, 2011-2 U.S. Tax Cas. ¶ 50,595 (10th Cir. 2011).

³ Treas. Reg. § 1.6662-4(d)(3)(iii).

⁴ E.g., *Albers v. Comm'r*, T.C. Memo. 2007-144.

⁵ I.R.C. § 105(b).

⁶ *Id.*

⁷ Rev. Rul. 71-588, 1971-2 C.B. 91. See Harl, "Can Section 105(b) Plan Costs Be Deducted on Schedule F?" 18 *Agric. L. Dig.* 2007).

⁸ *Id.*

⁹ The GCM was initially considered to be a confidential document but was later ordered released to the general public.

¹⁰ GCM 34488, April 30, 1971.

¹¹ Rev. Rul. 71-588, 1971-2 C.B. 91.

¹² See GCM 33127, Nov. 9, 1965.

¹³ GCM 34488, April 30, 1971.

¹⁴ Rev. Rul. 71-588, 1971-2 C.B. 91.

¹⁵ *Id.*

¹⁶ T.C. Memo. 2007-144.

¹⁷ *Id.*

¹⁸ I.R.C. § 162(l)(1).

¹⁹ I.R.C. § 162(l)(2)(A). See CCA 200524001, May 17, 2005 (self-employed sole proprietor could deduct medical insurance premiums for sole proprietor and family to extent of income from trade or business for which insurance purchased).

²⁰ T.C. Memo. 2010-41.

²¹ *Id.*

²² *Shellito v. Comm'r*, T.C. Memo. 2010-41.

²³ *Shellito v. Comm'r*, 2011-2 U.S. Tax Cas. ¶ 50,595 (10th Cir. 2011).

²⁴ See Treas. Reg. § 1.6662-4(d)(3)(iii).