1994-06-10

More on Husband-Wife Accident and Health Plans

Harl, Neil

Agricultural Law Digest

An Agricultural Law Press Publication | Volume 5, No. 12 | June 10, 1994
Editor: Robert P. Achenbach, Jr. | Contributing Editor Dr. Neil E. Harl, Esq. | ISSN 1051-2780

MORE ON HUSBAND-WIFE ACCIDENT AND HEALTH PLANS

— by Neil E. Harl*

The Internal Revenue Service has provided further guidance as to the deductibility of costs for health and accident plans for firms with few employees.[1] The topic was discussed in an earlier issue of *Agricultural Law Digest.*[2] The latest ruling confirms the major recommendations in that discussion.

General plan requirements

In general, costs of accident and health plans have been deductible[3] to employers and the benefits have not been taxable to employees.[4] This result is well established for plans involving several employees; the problems have been mostly associated with plans covering few employees where those employees are closely related. Under a typical "family plan," the husband as the sole proprietor adopts an accident and health plan to cover the employees (including the spouse) and deducts the costs involved (insurance costs or reimbursed costs to the employees). The covered employees can cover their dependents, one of whom is the sole priopprietor of the business. The outcome is 100 percent deductibility for plan costs which is, of course, quite an attractive result.

The greatest concern has been raised with plans set up by a sole proprietor and covering the sole proprietor's spouse as the only employee or as one of only a few employees.[5] The authority typically cited for such plans, *Rev. Rul. 71-588,*[6] involved "a sole proprietorship with several bona fide full-time employees including his wife." [7] However, the *General Counsel's Memorandum*[8] accompanying the 1971 revenue ruling revealed that there were, in fact, only two employees in that situation, one of whom was the spouse. The GCM stated that the IRS position in approving deductibility "might encourage abuses" and so urged that the published ruling not reveal the actual facts. In the 1971 ruling as published, the employees incurred medical expenses for medical care for themselves, their spouses and their children and were reimbursed under the plan. The reimbursed amounts were not included in the employees' gross incomes and were deductible by the taxpayer as a business expense.

1993 ruling

The latest ruling,[9] issued in late 1993, involved a sole proprietor who adopted a reimbursement plan for accident and health expenses. The plan, by its terms, covered all employees in the consulting business. Although the ruling is not completely clear on the subject, it appears that the spouse was the only employee.[10]

In the year in question, the sole proprietor reimbursed the spouse for expenses of medical care incurred by the spouse on behalf of the spouse, the sole proprietor and their dependents.

The Internal Revenue Service conceded that there was a bona fide employer-employee relationship between the sole proprietor and the spouse."[11] Citing *Rev. Rul. 71-588,*[12] the ruling held that amounts paid by the sole proprietor to the spouse under the plan were deductible as a business expense and the spouse could exclude those amounts from gross income.[13]

Suggestions to consider

All intra family transactions are subject to close scrutiny so plans involving only one employee, the spouse, should be approached with great care. For such arrangements, several factors are important.

• A bona fide employer-employee relationship is critical. In the 1993 ruling, that point was conceded. A highly significant factor in whether an employer-employee relationship exists is control over the manner and means of performance.

• The services should be well documented and should be rendered by the employee *in the business*.

• The compensation paid should be fairly reflective of the amount, type and value of services rendered.

Some factors may weaken the validity of such arrangements including —

• Participation by the employee-spouse in management (that would be more indicative of a partnership-like arrangement than an employer-employee arrangement).

• Part-time service as an employee as opposed to full-time employment.

• If the spouse's ownership or co-ownership of assets is uncompensated, an argument can be made that the compensation to the spouse is for the use of the spouse's assets, not for services rendered.

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

FOOTNOTES

The next issue will be published July 8, 1994.

1 See Ltr. Rul. 9409006, Nov. 12, 1993. See generally 7 Harl, *Agricultural Law* § 57.02[1][b] (1994); Harl, *Agricultural Law Manual* § 7.02[4][b][i] (1994).
2 See Harl, "Health Insurance for Employees," 2 *Agric. L. Dig*. 201 (1991). For a copy of this article, send $3.00 to Editor, Agric. Law Press, P.O. Box 5444, Madison, WI 57305.
3 I.R.C. § 162(a). See I.R.C. § 213(a).
4 I.R.C. § 105(b). See, e.g., Epstein v. Comm'r, T.C. Memo. 1992-53 (plan covered only officers).
5 See n. 2 *supra.*
6 1971-2 C.B. 91.
7 *Id*.
8 GCM 34488, April 30, 1971.
9 See. n. 1 *supra*.
10 *Id*.
11 *Id*.
12 1971-2 C.B. 91.
13 Ltr. Rul. 9409006, Nov. 12, 1993.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ANIMALS

FENCES. The creditor was an adjoining land owner of the Chapter 12 debtor. The debtor had reached an agreement with the creditor to build a fence between their properties, but although the creditor built the creditor's portion, the debtor did not build any fence. The creditor filed three claims in the bankruptcy case for damages to the creditor's crop caused by the debtor's cattle which moved on to the creditor's land. The debtor argued that Ill. Rev. Stat. , ch 54, ¶ 9.01, the Fence Act, placed the liability for the damages on the creditor because the creditor did not maintain the constructed fence. The court held that the Fence Act did not apply because the debtor did not construct the debtor's portion of the agreed to fence; therefore, the debtor was liable for negligently allowing the cattle to run at large. ***In re* Anderson & Sons Partnership, 165 B.R. 243 (Bankr. C.D. Ill. 1994)**.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

EXEMPTIONS

AVOIDABLE LIENS. The debtors claimed a homestead exemption for the equity remaining after a mortgage. The debtors sought to avoid a pre-petition judgment lien against the homestead as impairing their exemption. The Bankruptcy Court held that because the judgment lien exceeded the debtors' exemption amount, the lien was completely avoided. The District Court reversed, holding that the lien could be avoided only to the extent the lien impaired the exemption. ***In re* Osborne, 165 B.R. 183 (W.D. Va. 1993), *rev'g*, 156 B.R. 188 (Bankr. W.D. Va. 1993)**.

The debtors had claimed a rural homestead as exempt in a Chapter 7 case. Prior to the bankruptcy filing, a creditor obtained a judgment lien against the debtors' property. The debtors were denied a discharge under Section 727 and filed for avoidance of the judgment lien as impairing their homestead exemption. The court held that the denial of discharge did not affect the avoidance rights of the debtors for liens which impaired exemptions. The court also held that the judgment lien was not avoidable for impairing the homestead exemption because, under Texas law, judgment liens do not attach to property previously declared to be the debtor's homestead; therefore, the lien could not impair the homestead exemption. The appellate court reversed, holding that although the judicial lien was unenforceable against the homestead, the lien was avoidable as impairing the exemption through the cloud on the debtor's title created by the eventual liability of the debtor for the lien from the proceeds of the sale of the homestead. ***In re* Henderson, 18 F.3d 1305 (5th Cir. 1994), *aff'g unrep. D. Ct. dec. rev'g*, 155 B.R. 157 (Bankr. W.D. Tex. 1992)**.

JURISDICTION. The debtor had executed a pre-petition land sale contract to purchase timber land from the plaintiff. Eight days later, the debtor filed for Chapter 7. During the bankruptcy case, the debtor removed and sold timber from the property. The debtor then abandoned the property back to the plaintiff. The plaintiff filed for recovery of the value of the cut timber. The court held that it had no jurisdiction over the claim because the claim would not affect the bankruptcy estate. The court held that jurisdiction could not be predicated upon the possible effect on the debtor alone. ***In re* Mayhone, 165 B.R. 264 (Bankr. W.D. Ark. 1994)**.

FEDERAL TAXATION-*ALM* § 13.03[7].*

DISCHARGE. The debtors failed to file a federal income tax return for 1988 but filed a statement of intent to file a joint return after filing for an extension of time to file but did not file a return. The IRS prepared a substitute return for 1988. The court held that the statement of intent to file a joint return did not convert the substitute return into a filed return; therefore, the 1988 taxes were nondischargeable because no return was filed. ***In re* Eastwood, 164 B.R. 989 (Bankr. E.D. Ark. 1994)**.

The debtor failed to file and pay taxes owed for 1974-1981. Pursuant to a plea bargain agreement, the debtor pled guilty, under I.R.C. § 7203, to willfully failing to file an income tax return for 1976 in exchange for dropping other charges. The debtor also filed returns for the missing years but only paid the taxes due for one year. The IRS argued that the taxes still owed for the 1974-1981 taxable years were nondischargeable under Section 523(a)(1)(C) for willful attempt to evade taxes. The Bankruptcy Court held that the debtor's guilty plea was an admission only of the element of willfulness of the failure to file and pay taxes but did not prove that the debtor made any act or commission to evade taxes; therefore, the taxes were dischargeable. The appellate court held that the Bankruptcy Court applied the wrong standard in using the criminal definition of "willfully attempted to evade" and should have used the lesser civil