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## MORE GUIDANCE ON SECTION 105 PLANS

— by Neil E. Harl\*

In recent years, with rising medical costs, and without full deductibility for health and accident plan costs by self-employed individuals,<sup>1</sup> some taxpayers have been encouraged by plan promoters to establish so-called "Section 105" plans with the self-employed individual's spouse hired as an employee.<sup>2</sup> Numerous questions have been raised about the plans including whether expenses incurred before a plan's adoption are excludible from the gross income of the employee.<sup>3</sup> The Internal Revenue Service has recently provided additional guidance on such plans in two Coordinated Issue Papers under the Industry Specialization Program.<sup>4</sup>

The so-called "Section 105" plans are of two basic types—(1) plans may provide for reimbursing medical expenses of employees (those plans are subject to anti-discrimination rules),<sup>5</sup> or (2) plans may be insured in which case there is apparently no nondiscrimination requirement.<sup>6</sup>

### Retroactive adoption

In the latest guidance,<sup>7</sup> IRS acknowledged that employers often adopt self-insured accident and health plans to cover medical expenses incurred before the date of adoption of the plan but within the same taxable year.<sup>8</sup> The question is whether the amounts come within the exception<sup>9</sup> which specifies that gross income does not include amounts paid, directly or indirectly, to the employee to reimburse the employee for expenses incurred by the employee, spouse or dependents for medical care.<sup>10</sup>

The Internal Revenue Service position is that, to be excludible, there must be a "plan."<sup>11</sup> An accident or health plan (1) must cover one or more employees, (2) may be insured or uninsured, (3) need not be enforceable, and (4) need not be in writing.<sup>12</sup> However, in order to have a plan, the employer must be committed to the rules and regulations governing payment.<sup>13</sup> These rules, IRS pointed out, must be known to employees as a definite policy and be determinable before the employee's medical expenses are incurred.<sup>14</sup> Thus, it is the position of IRS that payments for reimbursements of medical expenses incurred before the adoption of a plan are not considered to be paid or received under an accident or health plan for employees.<sup>15</sup> Accordingly, those amounts are includible in the employee's gross income and are not excludible under the special exception for Section 105 plans.<sup>16</sup>

The IRS guidance takes the position that the expense paid by the employer is, nonetheless, deductible by the employer if it is an ordinary and necessary business

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expense.<sup>17</sup> That is the case even though the amounts are not excludible by employees.

### Basic requirements for a Section 105 plan

One of the Coordinated Issue Papers addresses the requirements of eligibility for Section 105 plans.<sup>18</sup> The position of the Internal Revenue Service is that the costs of accident and health coverage, including medical expense reimbursements, are deductible by the employer (even though the employer is the spouse of the employee) if the employee is determined to be a bona fide employee of the business “under the common law rules or otherwise provides services to the business for which accident and health coverage is reasonable compensation.”<sup>19</sup> The guidance points out that if the “employee-spouse” does not meet this test, the accident and health coverage is a non-deductible personal expense.<sup>20</sup> This requirement has been a critically important condition of eligibility in the past.<sup>21</sup> In a 1993 private letter ruling,<sup>22</sup> IRS conceded the existence of an employer-employee relationship in a husband-wife arrangement (one employee, the spouse, in a consulting business) and held that the costs were deductible to the employer-spouse with the amounts paid not taxable to the employee-spouse.<sup>23</sup> The special exception allowing benefits to be excludible only applies to “employees.”<sup>24</sup>

The guidance cautions that the adoption agreement and plan document must provide that the employee-spouse is eligible to participate and mentions specifically that spouses as employees are expected to meet the service requirements imposed on current as well as new employees.<sup>25</sup> If the service requirement has not been consistently applied to all employees, a self-insured plan could be considered discriminatory.<sup>26</sup>

The guidance states that the extent and nature of the spouse’s involvement in the business operations are critical.<sup>27</sup> The guidance notes that part-time employment does not negate employee status but the performance of nominal or insignificant services “that have no economic substance or independent significance” may be challenged.<sup>28</sup>

### Spouse as co-owner

Another passage of the guidance issued by IRS states that “a spouse may be a self-employed individual engaged in the trade or business as a joint owner, co-owner, or partner.”<sup>29</sup> The guidance gives an example of a “significant investment” of the spouse’s separate funds in (or significant co-ownership or joint ownership of) the business assets and states that such facts would support a finding that the spouse is self-employed in the business rather than an employee.<sup>30</sup> This position is in accord with the position recently taken by the Kansas City Region of the Social Security Administration that a bona fide employer/employee relationship cannot exist if spouses jointly own the real estate utilized in a farming operation.<sup>31</sup>

This point bears very close watching. It could invalidate many farm Section 105 arrangements involving spouses. Indeed, it would run counter to the conventional estate planning practice of balancing estates.

### In conclusion

The greatest surprise in the Coordinated Issue Papers is the failure to discuss the possible application of proposed regulations under I.R.C. § 125 on cafeteria plans to Section 105 plans.<sup>32</sup> That omission is unfortunate and leaves open an avenue for further debate in this area.

### FOOTNOTES

- <sup>1</sup> The deduction rises to 100 percent for years after 2002 (60 percent for 1999-2001 and 70 percent for 2002). H.R. 4328, Sec. 2002, 105th Cong., 2d Sess. (1998).
- <sup>2</sup> I.R.C. §§ 105, 106. See generally 4 Harl, *Agricultural Law* § 28.02[6][d] (1998); Harl, *Agricultural Law Manual* § 4.03[11] (1998).
- <sup>3</sup> See I.R.C. § 105(b). See also Harl, “Effective Date of ‘Section 105’ Plans,” 6 *Agric. L. Dig.* 121 (1995).
- <sup>4</sup> IRPO ¶ 80,400, “Health Insurance Deductibility for Self-employed Individuals,” March 29, 1999; IRPO ¶ 80,600, “Retroactive Adoption of an Accident and Health Plan,” March 29, 1999.
- <sup>5</sup> I.R.C. § 105(h).
- <sup>6</sup> See I.R.C. § 105(h)(6).
- <sup>7</sup> See n. 4 *supra*.
- <sup>8</sup> IRPO ¶ 80,600, *supra* n. 4.
- <sup>9</sup> I.R.C. § 105(b).
- <sup>10</sup> *Id.*
- <sup>11</sup> IRPO ¶ 80,600, *supra* n. 4.
- <sup>12</sup> Treas. Reg. § 1.105-5(a).
- <sup>13</sup> IRPO ¶ 80,600.
- <sup>14</sup> *Id.* See *American Family Mutual Ins. Co. v. United States*, 815 F. Supp. 1206 (W.D. Wis. 1992).
- <sup>15</sup> IRPO ¶ 80,600.
- <sup>16</sup> I.R.C. § 105(b).
- <sup>17</sup> I.R.C. § 162(a).
- <sup>18</sup> IRPO ¶ 80,400, *supra* n. 4.
- <sup>19</sup> *Id.* See Rev. Rul. 71-588, 1971-2 C.B. 91.
- <sup>20</sup> IRPO ¶ 80,400, *supra* n. 4.
- <sup>21</sup> See Rev. Rul. 71-588, 1971-2 C.B. 91. Compare GCM 34488, April 30, 1971 (actually only two employees, one of whom was spouse, rather than “several bona fide full-time employees” as stated in Rev. Rul. 71-588, *supra*; GCM states fear that IRS position “might encourage abuses” so published ruling did not reveal actual facts), with GCM 33127, Nov. 9, 1965 (original GCM which was reconsidered in GCM 34488, *supra*).
- <sup>22</sup> Ltr. Rul. 9409006, Nov. 12, 1993.
- <sup>23</sup> *Id.*
- <sup>24</sup> I.R.C. §§ 106(a), 105(b).
- <sup>25</sup> IRPO ¶ 80,400, *supra* n. 4.
- <sup>26</sup> *Id.* See I.R.C. § 105(h).
- <sup>27</sup> IRPO ¶ 80,400, *supra* n. 4.
- <sup>28</sup> *Id.*
- <sup>29</sup> *Id.*
- <sup>30</sup> *Id.*
- <sup>31</sup> Internal Memorandum No. 98-01, March 3, 1998, discussed in 10 *Agric. L. Dig.* 33, 37-38 (1999).
- <sup>32</sup> See Prop. Treas. Reg. §§ 125-2, Q&A 7, paragraphs (a), (b)(6), 1.125-1, Q&A 17. See Harl, “Effective Date of ‘Section 105’ Plans,” 6 *Agric. L. Dig.* 121 (1995).