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HEALTH INSURANCE FOR EMPLOYEES

— by Neil E. Harl*

The rising cost of medical and hospital care and the cost of insurance coverage have led to increased interest in ways to make such costs fully deductible without the benefits being includible in income for the taxpayer.¹ Through 1991 (and the first six months of 1992 if the President signs the bill extending the deduction through June 1992), a 25 percent deduction is allowed for health and accident amounts for self-employed individuals² provided — (1) the taxpayer is not eligible to participate in any subsidized health plan maintained by an employer for the taxpayer or the taxpayer's spouse and (2) the amount deducted is limited to the earned income derived from the trade or business for which the deduction is being claimed.³ The deduction does not reduce the taxpayer's self-employment income for purposes of calculation of self-employment taxes.⁴ The remaining 75 percent (through 1991) and the entire amount after 1991 can be included with other medical expenses as an itemized deduction to the extent such expenses exceed 7.5 percent of adjusted gross income.⁵

Employee plans. Numerous firms and individuals are promoting plans which, although varying in detail, all involve full-income tax deductibility of health and accident coverage by an employer, including a sole proprietor. The approach suggested is to hire the spouse as an employee, obtain health and accident coverage for the employee and deduct the cost as a business expense. Moreover, individuals are typically assured by the promoters that the benefits are not included in the employee's gross income. The employer is able to participate in the plan to the extent of benefits of coverage being available to dependents (which includes the sole proprietor).

The promoters uniformly cite Revenue Ruling 71-588⁶ as authority for such plans. It is noted that the sole proprietorship in that ruling had "several bona fide full-time employees including his wife."⁷

Rev. Rul. 71-588⁸ was accompanied by a General Counsel's Memorandum (GCM)⁹ which was originally confidential but was released several years ago when all GCMs were made public. Contrary to what is recited in the revenue ruling, the GCM reveals that the wife in the fact situation involved

"was one of two employees and both employees were

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covered by the plan. Her annual salary was \$3,600 and under the plan she was entitled to reimbursements up to \$3,500 per year. The other employee received an annual salary of \$8,000 and was entitled to reimbursements of \$2,000 per year. In 1961, the husband paid his wife \$3,469.21 for medical expenses that she excluded from her gross income and he deducted as a business expense. Of this amount, \$2,402 was attributable to dental work performed on the husband."¹⁰

The GCM indicates that the IRS originally determined that the costs were merely payment of personal family expenses and were not income tax deductible to the husband as employer. The General Counsel's office disagreed and concluded that a bona fide employer-employee arrangement existed and that the payments were deductible and not taxable to the wife as employee.¹¹ IRS was asked to reconsider that determination and affirmed the earlier holding in the 1971 GCM.¹²

Despite the affirmance of the earlier GCM, the General Counsel's office stated that —

"We are disturbed that *** was entitled to reimbursements of up to \$3,500 per year while the second employee was entitled to only \$2,000 per year in reimbursements, although she received a salary of \$8,000 or more than twice that received by ***. This apparent absence of a relationship between services rendered and benefits provided suggests that the plan, if it existed, was not a 'plan for employees' but a plan primarily for the benefit of *** and her employer-husband. [sic] While the fact that all employees under a particular plan RECEIVE the same benefits regardless of whether they receive the same salary is not considered significant, the fact that the greater benefit in this case goes to the employee with the lesser salary, the wife, does indicate that the plan if it exists may be primarily designed for the benefit of the taxpayer and his wife rather than 'for employees.' If the employer-husband could not offer some explanation related to his wife's status as employee for providing her with greater benefits than her higher-salaried co-worker, we would be inclined to conclude that the plan was primarily designed to benefit *** in her status as wife. Thus the plan would not be a 'plan for employees,' and *** would not be entitled to exclude the reimbursements [sic] from her gross income under section 105(b). Cf. Samuel Levine, 50 T.C. 422 (1968)."

The 1971 GCM goes on to state —

"Finally, and although we appreciate the policy of publishing revenue rulings of general interest, we realize that publication of a detailed revenue ruling based on the *** facts might encourage abuses. To reconcile the

arguments for and against publication, we suggest the proposed revenue ruling be drafted in digest form substantially as follows:

"Amounts paid by an employer, pursuant to an accident and health plan covering all of his employees, to his spouse in her capacity as a bona fide employee as reimbursements for expenses incurred by her for the medical care of herself, her husband, and their children, if they otherwise qualify as 'amounts received under an accident or health plan for employees,' are amounts described in section 105(b) of the Internal Revenue Code of 1954 and the benefits of that section are not to be denied solely because of the marital relationship. Therefore, such amounts are not includable in the employee-wife's gross income. Furthermore, such amounts will be deductible by the husband as business expense under section 162 of the Code."

The revenue ruling as *actually published* stated,

"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.

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.

Requirements for a plan. In order for a sole proprietorship health care arrangement to have a reasonable chance of surviving the high level of scrutiny expected, several requirements must be met —

- The sole proprietor and the spouse must be able to demonstrate that a bona fide employer-employee relationship exists. A major factor in such a relationship is control by the sole proprietor as employer over the manner and means of performance. Both parties must acknowledge that the sole proprietor is the boss and controls the hours of work, how the employment is carried out and all other relevant details of employment.

- The evidence must be clear that the employee-spouse renders services *in the business*; services rendered in the

operation of the home are immaterial for this purpose. The rendition of services in the business must be well documented.

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

Factors that weaken the arrangement. Several factors weaken sole proprietorship-spouse arrangements and failure in one or more areas can be fatal to the arrangement.

- Participation by the employee-spouse in management is more indicative of a partnership arrangement than an employer-employee relationship.

- The ownership or co-ownership of land or other assets used in the business by the employee-spouse in itself does not necessarily preclude a genuine employer-employee relationship but contributing assets on an uncompensated basis raises a question of the proper characterization of amounts paid to the spouse. At the very least, what purports to be employee compensation could be partially or totally reclassified as rent or other compensation for assets provided to the business.

- Service as a part-time employee is less supportive of eligibility of a spouse as employee to participate in a health care plan than full-time service. Many spousal employee situations involve only part-time employment. The fact that other part-time employees have not been eligible for health and accident coverage in the past is not helpful.

All intra-family transactions are subject to close scrutiny and husband-wife arrangements can be expected to be subjected to extraordinary review. If the benefits of an arrangement flow singularly to a spouse, and not to other employees, one can expect a challenge on any one of a number of bases. Many farm sole proprietorships do not involve unrelated employees.

In conclusion. For a health care arrangement involving a spouse as employee to succeed with the costs tax deductible and the benefits not includible in the employee's income, several conditions must be met. At the present time, with very little supportive authority for situations where the spouse is a bona fide employee but is the only employee, and a part-time employee at that, the risk of a challenge by the Internal Revenue Service must be viewed as substantial with a not insignificant chance that the challenge will be successful.

FOOTNOTES

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| <p>¹ See generally Harris, "Health Insurance for Farmers," 9 Agric. L. Update 4 (1991).</p> <p>² I.R.C. § 162(1).</p> <p>³ I.R.C. § 162(1)(2).</p> | <p>⁴ I.R.C. § 162(1)(4).</p> <p>⁵ I.R.C. §§ 162(1)(3), 213(a).</p> <p>⁶ 1971-2 C.B. 91.</p> <p>⁷ <i>Id.</i></p> <p>⁸ <i>Id.</i></p> <p>⁹ GCM 34488, April 30, 1971.</p> | <p>¹⁰ <i>Id.</i></p> <p>¹¹ <i>Id.</i> See GCM 33127, Nov. 9, 1965.</p> <p>¹² GCM 34488, April 30, 1971.</p> |
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CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL

ADMINISTRATIVE EXPENSE. The debtor had obtained a bankruptcy court order allowing the debtor to

borrow money from a creditor and grant a security interest on crops to be grown with the borrowed money. After the debtor defaulted on the loan, the creditor sought administrative expense status for the deficiency on the loan after sale of the collateral. The court held that the