COORDINATED ISSUE ALL INDUSTRIES HEALTH INSURANCE DEDUCTIBILITY FOR SELF-EMPLOYED INDIVIDUALS UIL 162.35-02

ISSUES:

- 1. Where an employer, who is self-employed, provides accident and health coverage to his spouse as an employee, is the cost of that coverage deductible by the employer-spouse under section 162 of the Internal Revenue Code.
- 2. Where an employer, who is self-employed, provides accident and health coverage to his spouse as an employee, is the cost of that coverage and medical reimbursements excludable by the employee under sections 106 and 105(b) of the Code.

CONCLUSIONS:

- 1. The cost of the accident and health coverage is deductible by the employerspouse if he provides such coverage to his spouse as an employee.
- 2. Both the cost of the coverage and the medical reimbursements are excludable from the gross income of the employee-spouse .

STATEMENT OF FACTS:

An arrangement is marketed through accounting firms and a national tax return preparer that encourages self-employed persons to deduct 100% of accident and health plan expenses. This arrangement has been utilized by the self-employed in partnerships, limited liability corporations, subchapter S corporations and sole proprietorships. Through this promotion, a self-employed individual hires his or her spouse as an employee. The employer-spouse provides family accident and health coverage for the employee-spouse through a self-insured medical expense reimbursement plan or by purchasing an accident and health insurance policy. The employer-spouse is then covered by the plan as a member of the employee's family.

By utilizing this arrangement, the employer-spouse deducts 100% of the cost of providing health coverage to himself and his family, including reimbursement of medical expenses. Expenses claimed for reimbursement include insurance premiums and other expenses not reimbursed by insurance. The employee-spouse excludes from gross income the cost of the health coverage and medical expense reimbursements.

Often, compensation for the employee-spouse is determined upon the amount of the accident and health cost for the taxable year. In this situation, Form W-2 is not issued or is issued for a small dollar amount because the cost of the coverage and medical expense reimbursements are excluded from the employee-spouse's income.

LAW AND ANALYSIS:

ISSUE 1:

Section 162(a)(I) of the Code provides that a taxpayer may deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

Section 1.162-7(a) of the Income Tax Regulations provides that there shall be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

Section 1.162-10(a) of the regulations provides, in part, that amounts paid or incurred within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare or similar benefit plan (other than deferred compensation plans referred to in section 404 of the Code) are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business.

Section 262(a) provides that except as otherwise provided, no deduction shall be allowed for personal, living, or family expenses.

In Rev. Rul. 71-588, 1971-2 C.B. 91, the taxpayer operated a business as a sole proprietorship with several bona fide full-time employees, including his wife. The taxpayer had a self-insured accident and health plan that covered all employees and their families. During 1970, two of the employees, including the wife, incurred expenses for medical care for themselves, their spouses and their children, and were reimbursed pursuant to the plan. Under these facts, the Service held that the amounts paid in reimbursement were deductible by the taxpayer as business expenses under section 162 of the Code and excludable by the employees (including the wife) under section 105(b) of the Code.

Accordingly, the Service's position is that the cost of accident and health coverage, including medical expense reimbursements, are deductible by the employer-spouse <u>if</u> the employee-spouse 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 the accident and health coverage is reasonable compensation. However, if the "employee-

spouse" does not meet this standard, the accident and health coverage is a personal expense under section 262(a) of the Code, which is not deductible under section 162(a). Other Code provisions apply in this situation.

Section 213(a) allows a deduction for expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent to the extent that such expenses exceed 7.5 percent of adjusted gross income.

Section 162(I) provides, in the case of a self-employed individual, there shall be allowed an amount equal to the applicable percentage under this section of the amount paid during the taxable year for insurance which constitutes medical care for the taxpayer, his spouse, and dependents.

If the "employee-spouse" is not an employee of the "employer-spouse's" business, or does not otherwise provide services to the business, the cost of accident and health insurance purchased by the "employer-spouse" is deductible by the employer-spouse only up to the applicable percentage under section 162(I) of the Code. The cost of insurance in excess of the applicable percentage is deductible to the extent permitted under section 213(a) of the Code.

In addition, if the "employee-spouse" is not an employee of the "employer-spouse's" business or does not otherwise provide services to the business, amounts paid by the "employer-spouse" for the reimbursement of medical expenses under the self-insured plan for himself, his spouse, and his dependents are only deductible to the extent provided under section 213(a) of the Code.

Note that if an accident and health insurance policy is purchased in the name of the employer-spouse the limitations of section 162(I) of the Code apply, notwithstanding that the policy provides coverage for the employer-spouse, the employee-spouse and their dependents.

ISSUE 2:

Section 104(a)(3) of the Code provides that, except in the case of amounts attributable to and not in excess of deductions allowed under section 213, gross income does not include amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer.

Section 106(a) of the Code provides that gross income of an employee does not include employer-provided coverage under an accident and health plan.

Section 105(a) of the Code provides that, generally, amounts received by an employee through accident and health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.

Section 105(b) of the Code provides an exception to the general rule of inclusion under section 105(a). Section 105(b) states that gross income does not include amounts referred to in subsection (a) (employer-provided accident and health insurance) if such amounts are paid, directly or indirectly, to the employee to reimburse the employee for expenses incurred by him, his spouse or dependents for medical care.

Section 105(e) provides that amounts received under an accident or health plan for employees shall be treated as amounts received through accident or health insurance for purpose of sections 105(a) and (b).

Accordingly, because self-insured medical expense reimbursement plans are treated as accident and health insurance under section 105(e), medical expense reimbursements paid under such plans are excludable from the employee's gross income under section 105(b) (to the extent benefits do not discriminate in favor of highly compensated individuals under section 105(h)).

The Service's position is that the cost of accident and health coverage or medical expense reimbursement is excludable from gross income by the employee-spouse only **if** the employee-spouse is a bona fide employee under the common law rules. If the "employee-spouse" is not a bona fide employee, then the cost of accident and health coverage provided by the "employer-spouse" is not excluded from the gross income of the "employee-spouse" under section 106(a) of the Code, because the section 106 exclusion only applies to the "gross income of an employee". Similarly, medical expense reimbursements received by the "employee-spouse" are not excluded from gross income under section 105(b) of the Code. However, if the cost of accident and health coverage provided by the "employer-spouse" is included in the "employee-spouse's" gross income, all amounts received by the "employee-spouse" and family for personal injury and sickness under the coverage are excludable under section 104(a)(3).

An additional factor to consider in this situation is the eligibility provisions of a selfinsured accident or health plan. The adoption agreement and plan document must provide that the employee-spouse is eligible to participate. For example, very often a specific service requirement applies to current employees as well as new employees. This waiting period may not have been applied to the employee-spouse, but may have been used to exclude other employees. Thus, if it is not documented that the employee-spouse has met the service requirement, the employee-spouse may not participate and medical expense reimbursements would not be excludable under section 105(b) because they would not be received under an accident and health plan. In addition, if the service requirement has not been consistently applied to all employees, the self-insured plan could be discriminatory under section 105(h).

Whether the "employee-spouse" is an employee, must be determined on a case-bycase basis. See Attachment for additional guidance.

The extent and nature of the spouse's involvement in the business operations are critical. Although, part-time work does not negate employee status, the performance of nominal or insignificant services that have no economic substance or independent significance may be challenged. Merely calling a spouse an "employee" is not sufficient to qualify a non-working spouse as an employee.

In addition, a spouse may be a self-employed individual engaged in the trade or business as a joint owner, co-owner, or partner. For example, a significant investment of the spouse's separate funds in (or significant co-ownership or joint ownership of) the business assets may support a finding that the spouse is self-employed in the business rather than an employee.

Marital property or community property laws that give a spouse an ownership interest in a business operated by a self-employed individual may be relevant, but not necessarily conclusive, for determining whether the spouse is also self-employed in that business. Note that state laws that impose on one family member a legal obligation to support another family member are generally irrelevant in determining the tax treatment of fringe benefits. <u>See</u>, Rev. Rul. 73-393, 1973-2 C.B. 33.

Under sections 318 and 1372 of the Code, a spouse of more than a 2-percent shareholder of a subchapter S corporation is treated as more than a 2-percent shareholder for certain employee fringe benefit purposes, including accident and health benefits. Thus, both the spouse and the more than 2-percent shareholder are treated as partners in a partnership for benefit purposes. <u>See</u>, Rev. Rul. 91-26, 1991-1 C.B. 184. For the tax treatment of limited liability corporations, see Rev. Rul. 88-76, 1988-2 C.B. 360.

INDUSTRY'S ARGUMENTS:

Promoters of this arrangement do not dispute the assertion that the critical issue is whether the "employee-spouse" is a bona fide employee of the "employer-spouse's" business. If the employee-spouse is a bona fide employee, then Rev. Rul. 71-588 is applicable for purposes of deductibility and income tax exclusion.

ATTACHMENT

The following is a brief outline of the law regarding employment status. It is important to note that either worker classification – independent contractor or employee – can be valid. For an in-depth discussion, see the training material "Independent Contractor or Employee?", Training 3320-102 (Rev. 10-96) TPDS 84238I, for determining employment status. The training materials are also available on the IRS home page on the Internet at http://www.irs.ustreas.gov.

In determining a worker's status, the primary inquiry is whether the worker is an independent contractor or an employee under the common law standard. Under the common law, the treatment of a worker as an independent contractor or an employee originates from the legal definitions developed in the law of agency – whether one party, the principal, is legally responsible for the acts or omissions of another party, the agent – and depends on the principal's right to direct and control the agent.

Guidelines for determining a worker's employment status are found in three substantially similar sections of the Employment Tax Regulations: sections 31.3121(d)-1, 31.3306(i)-1, and 34.3401(c)-1, relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding. The regulations provide that an employer-employee relationship exists when the business for which the services are performed has the right to direct and control the worker who performs the services. This control refers not only to the result to be accomplished by the work, but also to the means and details by which that result is accomplished. In other words, a worker is subject to the will and control of the business not only as to what work shall be done but also how it shall be done. It is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if the employer has the right to do so. To determine whether the control test is satisfied in a particular case, the facts and circumstances must be examined.

The Service now looks at facts in the following categories when determining worker classification: behavioral control, financial control and relationship of the parties.

Behavioral Control

Facts that substantiate the right to direct or control the details and means by which the worker performs the required services are considered under behavioral control. This includes factors such as training and instructions provided by the business. Virtually every business will impose on workers, whether independent contractors or employees, some form of instruction (for example, requiring that the job be performed within specified time frames). This fact alone is not sufficient evidence to determine the worker's status. The weight of "instructions" in any case depends on the degree to which instructions apply to how the job gets done rather than to the end result.

The degree of instruction depends on the scope of instructions, the extent to which the business retains the right to control the worker's compliance with the instructions, and the effect on the worker in the event of noncompliance. The more detailed the instructions that the worker is required to follow, the more control the business exercises over the worker, and the more likely the business retains the right to control the methods by which the worker performs the work. The absence of detail in instructions reflects less control.

Financial Control

Whether the business has the right to direct or control the economic aspects of the worker's activities should be analyzed to determine worker status. Economic aspects of a relationship between the parties illustrate who has financial control of the activities undertaken. The items that usually need to be explored are whether the worker has a significant investment, unreimbursed expenses, whether the worker's services are available to the relevant market, the method of payment and opportunity for profit or loss. The first four items are not only important in their own right but also affect whether there is an opportunity for the realization of profit or loss. All of these can be thought of as bearing on the issue of whether the recipient has the right to direct and control the means and details of the business aspects of how the worker performs services.

The ability to realize a profit or incur a loss is probably the strongest evidence that a worker controls the business aspects of services rendered. Significant investment, unreimbursed expenses, making services available, and method of payment are all relevant in this regard. If the worker is making decisions which affect his or her bottom line, the worker likely has the ability to realize profit or loss.

Relationship of the Parties

The relationship of the parties is important because it reflects the parties' intent concerning control. Courts often look to the intent of the parties; this is most often embodied in contractual relationships. A written agreement describing the worker as an independent contractor is viewed as evidence of the party's intent that a worker is an independent contractor – especially in close cases. However, a contractual designation, in and of itself, is not sufficient evidence for determining worker status. The facts and circumstances under which a worker performs services are determinative of a worker's status. This means that the substance of the relationship governs the worker's status, not the label.