

APPEALS

INDUSTRY SPECIALIZATION PROGRAM
COORDINATED ISSUE

SETTLEMENT GUIDELINES

INDUSTRY: All Industries
ISSUE: Health Insurance Deductibility for Self-Employed Individuals
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UIL NO.: 162.35-02
FACTUAL/LEGAL ISSUE: Factual

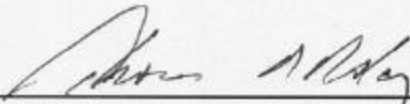
APPROVED:



DIRECTOR, APPEALS LMSB AREA 2

JAN 25 2001

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DIRECTOR, APPEALS LMSB OPERATING UNIT

JAN 25 2001

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EFFECTIVE DATE: JAN 25 2001

**APPEALS
INDUSTRY SPECIALIZATION PROGRAM
COORDINATED ISSUE**

SETTLEMENT GUIDELINES

**HEALTH INSURANCE DEDUCTIBILITY FOR
SELF-EMPLOYED INDIVIDUALS**

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.

EXAMINATION DIVISION POSITION

1. The cost of the accident and health coverage is deductible by the employer-spouse if he/she provides such coverage to his/her 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 .

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.

BACKGROUND

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.

LEGAL DISCUSSION AND ANALYSIS

ISSUE 1:

Section 162(a)(1) 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 **if** 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(l) 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(l) 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(l) 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 self-insured 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-by-case basis. See Legal Discussion and Analysis for "Independent Contractor vs. Employee" in the next Section.

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. See, 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. See, 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.

Legal Discussion and Analysis – Independent Contractor vs. Employee

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: 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.

SETTLEMENT GUIDELINES

- The critical issue is whether the “employee-spouse” is a bona fide employee of the “employer-spouse’s “ business.
- Whether the “employee-spouse” is a bona fide employee of the “employer-spouse’s” business must be determined on a case-by-case basis.
 1. Extent and nature of the spouse’s involvement in the business.
 2. Merely calling a non-working spouse an “employee” is not sufficient to qualify a non-working spouse as an employee.
 3. Is the spouse self-employed individual engaged in the trade or business as joint owner, co-owner, or partner?
 4. Is there significant investment of the employee-spouse’s separate funds or significant co-ownership or joint ownership of the business assets? Is the “employer-spouse” or “employee-spouse” a more than 2% shareholder in an S Corporation? see Rev. Rul. 91-26 & 88-76.
- The status of spouse as an employee or independent contractor is determined under common law rules. If the spouse is an independent contractor, the cost of accident and health insurance may not be excluded by the spouse under I.R.C. § 106(a). The deduction under I.R.C. § 162(a) may still be available to the self-employed individual. However, if the spouse is not an employee and does not provide services as an independent contractor, the accident and health coverage is a personal expense of the self-employed individual under I.R.C. § 262(a) which is not deductible under I.R.C. § 162(a). In that situation, other Code provisions apply. I.R.C § 213(a); 162(l).
- Consider the eligibility provisions of self-insured accident or health plans. Check the adoption agreement and the plan document to determine whether the employee-spouse has satisfied all service requirements under the plan. All benefit provisions, including those relating to service requirements, must be consistently applied to ALL employees for the plan not to be discriminatory under I.R.C. § 105(h).
- If the “employee-spouse” is a bona fide employee of the “employer-spouse’s” business, Rev. Rul. 71-588 is applicable.

- Cost of the accident and health coverage is deductible under I.R.C. § 162(a)(1) by a self-employed individual if it is provided to his/her spouse who is a bona fide employee of the business, or if the spouse is an independent contractor who provides services to the business for which the accident and health coverage is reasonable compensation.
- Cost of accident & health coverage is excludible from gross income by the “employee-spouse” under I.R.C. § 106(a) only if the “employee-spouse” is a bona fide employee of the “employer-spouse’s” business.
- If the “employee-spouse” is not a bona fide employee because he/she is an independent contractor, the cost of accident and health coverage provided by the company and deducted by the company under I.R.C. § 162(a) must be included by the spouse in gross income.
- If the spouse does not provide any services to the company at all, the cost of accident and health coverage may not be deducted by the company under I.R.C. § 162(a). In that case, the deduction is governed by I.R.C. § 162(l) and 213 and the accident and health insurance coverage is considered to be accident and health insurance purchased by an individual for his/her family, which is not included in the spouse’s gross income.
- If the “employee-spouse” is a bona fide employee and the cost of coverage was excluded under I.R.C. § 106(a), the medical reimbursement received by the “employee-spouse” are excluded from gross income under I.R.C. § 105(b).
- If the spouse is not a bona fide employee because he/she is an independent contractor, amounts received through accident and health insurance for personal injuries or sickness are excluded from gross income under I.R.C. § 104(a)(3).
- If the spouse does not provide services to the company at all, amounts received through accident and health insurance for personal injuries or sickness are excluded from gross income under I.R.C. § 104(a)(3).
- The accident and health policy should be purchased in the name of the “employee-spouse”. If it is in the name of the “employer-spouse” IRC 162(l) applies.

The issue is determined based on facts provided. A determination based on these facts is to be made as to whether the “employee-spouse” is a bona fide employee or not. Under current law, self-employed individuals will be allowed to deduct their medical coverage expenses fully in the year 2006. The promoters of the arrangements

discussed under this paper are trying to accelerate such deduction. There are many bills pending in Congress which call for allowing self-employed individuals to deduct full amounts of their medical coverage. If that becomes the law, such arrangements will have no purpose.

The issue is highly factual in nature and there is no case law. Issue will be settled on a case-by-case basis in consultation with the ISP Coordinator.

IRM 8.7.1.6.6.3 explains the approval procedures for appeals officers and team chiefs. Also, Delegation Order # 247 requires examination case managers to obtain the approval from both Exam & Appeals Specialists.