

UNITED STATES TAX COURT

FRANCIS H. & TAMRA R. RUESCHENBERG, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 23096-97S.

Filed June 29, 1999.

Robert Kohorst, for petitioners.

Henry N. Carriger, for respondent.

CARLUZZO, Special Trial Judge: This case was heard pursuant to the provisions of section 7463 of the Internal Revenue Code of 1986, as amended and in effect at the time the petition was filed. The decision to be entered is not reviewable by any other court, and this opinion should not be cited as authority. Unless otherwise indicated, subsequent section references are to the Internal Revenue Code of 1986, as amended and in effect for the

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years in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

Respondent determined deficiencies in petitioners' 1993, 1994, and 1995 Federal income taxes in the amounts of \$1,445, \$1,556, and \$2,132, respectively. The issue for decision is whether for each year in issue the petitioners are entitled to deduct, as trade or business expenses, health and life insurance premiums and other medical expenses.

Background

Some of the facts have been stipulated and are so found. Petitioners are husband and wife. They have four children. At the time the petition was filed, petitioners resided in Westphalia, Iowa. References to petitioner are to Francis H. Rueschenberg.

In 1983, petitioner started a carpet cleaning business (the business). The business was organized, owned, and operated as a sole proprietorship by petitioner. Prior to 1993, Tamra Rueschenberg (Mrs. Rueschenberg) provided various services to the business on an informal basis.

On or about December 28, 1992, petitioner and Mrs. Rueschenberg entered into a "Written Employment Agreement" (the employment agreement). The employment agreement is signed by Mrs. Rueschenberg as the employee and petitioner as the employer. The document is not dated; the parties have stipulated the above

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date. In return for compensation of \$210 per month and other employment related benefits, Mrs. Rueschenberg agreed to provide specified services as an employee of petitioner in connection with the business.

The document that embodies the employment agreement was part of a "turn key" employment benefits package system marketed by Total Administrative Services Corporation (TASC), Madison, Wisconsin under the trade names "Bizplan" and "AgriPlan" (the benefits system). The benefits system apparently included various preprinted forms that could be used by a sole proprietor who hires a spouse as an employee. The employment agreement, for example, contains numerous preprinted provisions, with blank areas to be filled in specifying: (1) The employer, (2) the employee, (3) the type of business involved, (4) the nature of services to be provided by the employee (followed by a paragraph that provide to the employer), (5) the amount of the employee's compensation, and (6) payment intervals. At the conclusion of the document the following legend appears:

IMPORTANT NOTICE:

The Written Employment Agreement included in your packet is a Sample of the type of agreement that can be used between the employer and the employee (spouse).

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A Written Employment Agreement can be used to further solidify the formal working relationship between the employer and employee(spouse). However, the ability for a sole proprietor farmer or business owner to take advantage of AgriPlan or BizPlan does not rely upon this written agreement as long as an Employer/Employee relationship exists.

In this case it appears that petitioners merely filled in the blanks on the "Sample" agreement.

As provided in section 3 of the employment agreement, petitioner agreed to provide "certain benefits according to the terms and provisions of an established plan outlined in the Plan Summary." According to the "established plan", which was described in documents prepared by TASC, petitioner made available to all "eligible" employees of his business the following benefits: (1) Major medical insurance coverage, (2) life insurance coverage, and (3) reimbursement of covered medical expenses for the employee and the employee's family. Relevant for our purposes, to be eligible to participate in the plan an employee must have worked at least 35 hours per week for petitioner. During the years in issue, Mrs. Rueschenberg was the only individual deemed by petitioner to be eligible to participate in the plan.

Although the employment agreement and other business records maintained by petitioner indicate that Mrs. Rueschenberg was paid on a monthly basis, that was not the case. Instead, she received her compensation on an annual basis. On each occasion,

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petitioner would borrow the amount she was to be paid. She would receive a check for the appropriate amount and either endorse the check over to the lender, or cash the check and use the proceeds to satisfy the debt incurred by petitioner in order to make the payment to her. For each year in issue, petitioner issued a Form W-2 to Mrs. Rueschenberg that reflected each payment. Social Security and Medicare taxes were withheld from Mrs. Rueschenberg's wages as though she were petitioner's employee.

During each of the years in issue, Mrs. Rueschenberg provided various services to petitioner in connection with his carpet cleaning business. She answered the phone, made appointments, kept certain books and records, ordered supplies, picked up supplies, and assisted petitioner in certain cleaning jobs. For purposes of trial she prepared a written estimate of the amount of hours she spent each week in so doing; however no simultaneous business records tracked the amount of time she spent working for the business during any of the years in issue.

Petitioners filed timely joint Federal income tax returns for the years 1993, 1994, and 1995. They did not elect to itemize deductions for any of those years. Included with each return is a Schedule C on which the following items of income and expenses of petitioner's carpet cleaning business are reported:

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Item	1993	1994	1995
Gross receipts,	\$18,178	\$19,252	\$21,827
Other income	0	0	2,007

Wages deduction	2,520	2,520	2,520
Employee benefit programs deduction	5,344	4,674	51000
Other deductions	8,291	7,737	11,032
Net profit	2,023	4,321	5,282

The deduction for wages for each year relates to the amount paid by petitioner to Mrs. Rueschenberg as described above. The employee benefit programs deduction for each year relates to the amount that petitioner paid for health insurance for himself and his family, life insurance for Mrs. Rueschenberg, and medical expenses not otherwise covered by the health insurance.

During the years in issue, petitioner and his family were covered by a health insurance policy issued by Blue Cross and Blue Shield of Iowa. Petitioner is the named policy holder. Attributes of the policy include a \$900 deductible and major medical coverage. This health insurance has been in affect since 1990. The policy is described as a family plan extending coverage to petitioners and their four children. Petitioner paid \$4,214.34 for this policy during 1993. This amount was included in the employee benefits expense deduction claimed for that year.

During each year in issue Mrs. Rueschenberg was the named insured on a term life insurance policy. Petitioner was the named beneficiary. The cost of the policy was approximately \$100

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per year. The premiums paid for this term life insurance policy were included in the employee benefits expense deductions claimed on the Schedules C for petitioner's carpet cleaning business as listed above.

During 1993 certain medical expenses totaling \$1,029 were incurred by petitioners or their children and included in the employee benefits expense deduction claimed for that year.

In the notice of deficiency, for each year in issue, respondent disallowed the employee benefits expense deduction claimed on the Schedule C. According to the explanation contained in the notice of deficiency, the deduction was disallowed for each year because petitioners failed to establish that it was "an ordinary and necessary business expense" and the amount deducted each year "was reasonable in amount in terms of * * * (Mrs. Rueschenberg's) overall compensation." The other adjustments made in the notice of deficiency are not in dispute.

Discussion

In general, a taxpayer is allowed a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered. See sec. 162(a)(1). A fair reading of the explanation for the disallowances contained in the notice of deficiency suggests that respondent denied the employee

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benefits deductions because, when added to Mrs. Rueschenberg's wages, the total amount of the compensation petitioner paid to her for each year was not reasonable.

At trial respondent retreated somewhat from the explanation provided in the notice of deficiency and argued that the entire amount of each deduction here under consideration should be disallowed because (1) Mrs. Rueschenberg was not an employee of petitioner, but, if so, (2) she was not an eligible employee under the terms of the plan. Respondent further attacked the health and life insurance components of each deduction by arguing (1) the cost of the health insurance should not be allowed as part of the deduction because the health insurance policy was not issued to Mrs. Rueschenberg but to petitioner, and (2) the cost of Mrs. Rueschenberg's life insurance should not be allowed as part of the deduction because petitioner was the named beneficiary on Mrs.

Rueschenberg's life insurance policy. According to respondent, petitioner's arrangement with Mrs. Rueschenberg was an attempt to convert nondeductible personal expenses into deductible business expenses.

Petitioners contend that Mrs. Rueschenberg was a bona fide employee of petitioner. They further contend that she was an eligible individual within the meaning of the plan and the benefits she received pursuant to the plan are deductible as ordinary and necessary business expenses within the meaning of

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section 162. We turn our attention first to Mrs. Rueschenberg's employment status. Petitioners contend that Mrs. Rueschenberg was petitioner's employee during each year in issue; respondent disagrees. According to respondent, Mrs. Rueschenberg provided services to petitioner as the owner of the business not as his employee, but as his spouse. There is no precise definition of the term "employee" contained in the Internal Revenue Code that resolves the dispute between the parties on this point. The question of whether an individual is an employee of another is generally considered a question of fact. See Packard v. Commissioner, 63 T.C. 621, 629 (1975). In resolving such questions, this and other Federal Courts apply what is commonly referred to as the common-law test embodied in sections 31-3121(d)-1(c)(2) and 31.3401(c)-1(b), Employment Tax Regs. See Matthews v. Commissioner, 907 F.2d 1173, 1178 (D.C. Cir. 1990), affg. 92 T.C. 351 (1989); Packard v. Commissioner, *supra*. The fundamental test in establishing whether a common-law employment relationship exists is whether the person for whom services are being performed can control the manner, means, and ultimate result of the work.

Initially, we note that respondent's position on this point is greatly undermined by his failure to disallow the deduction for Mrs. Rueschenberg's wages claimed each year. Be that as it may, Mrs. Rueschenberg and petitioner testified at trial and

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explained her role in connection with the business and the extent of his authority over what she did. In this regard, we are satisfied that the services she provided during each year in issue in connection with the business were provided as petitioner's employee rather than as his spouse.

Nevertheless, being petitioner's employee does not in and of itself result in the allowance of the deductions here in dispute. To qualify for a deduction under section 162(a), an expense must be "ordinary and necessary". In this case, it would not have been "necessary" for petitioner to incur the employee benefit expenses on behalf of Mrs. Rueschenberg unless she was an "eligible employee".

To be eligible for the employee benefits offered to the petitioner's employees, the employee must have worked at least 35 hours per week. Obviously, with respect to their joint Federal income tax liability for each year, it benefited petitioners to have Mrs. Rueschenberg treated as an eligible employee of petitioner. Although petitioner, as the owner of the business, made the determination that Mrs. Rueschenberg worked at least 35 hours per week and thus was an eligible employee, there is little evidence in the record to support his determination on that point. There were no simultaneous business records kept that tracked the number of hours that she worked during any of the years in issue. The amount of her wages for each year suggests

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that she worked substantially less than the minimum amount required to be eligible for benefits as an employee of the business. Mrs. Rueschenberg's attempt to reconstruct the amount of time spent working for the business several years after the fact is not reliable enough to support a finding that she worked the specified number of hours per week to be eligible for the benefits. There is insufficient evidence in the record to support a finding that Mrs. Rueschenberg was an "eligible employee" of petitioner during any of the years in issue. That being the case, the employee benefit expense deductions claimed on her account are not allowable because petitioners have failed to establish that it was a necessary business expense for petitioner to have incurred those expenses.

Petitioners also face other obstacles to the employee benefit expense deductions. The health insurance policy was a family policy owned by petitioner. Normally, the cost incurred by an individual for securing health insurance is a personal or family expense, the deduction of which is prohibited by section 262.

Taxpayers who elect to itemize deductions under section 63(e) can deduct the cost of health insurance as a medical expense itemized deduction to the extent allowed by section 213. Self-employed individuals may deduct a percentage of the cost of health insurance coverage for the individual and the individual's

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family, regardless of whether the individual elects to itemize deductions. See sec. 162(l).

Mrs. Rueschenberg was covered under the health insurance policy as a member of petitioner's family, not as his employee. Because petitioners did not elect to itemize deductions for any of the years in issue, even if Mrs. Rueschenberg did qualify for benefits as an eligible employee under the plan, petitioners would be, and are, only entitled to deduct a portion of the cost of this health insurance for each year in issue as allowed under section 162(l). Only the amount petitioner paid for health insurance during 1993 can be determined from the evidence. The Court assumes that the same information for the other years is readily available and should not be in dispute and expects the parties to take that information into account in the submission of the Rule 155 computations.

Finally, the cost of Mrs. Rueschenberg's life insurance policy would not be deductible even if she were an eligible employee. Section 264(a)(1) provides that no deduction shall be allowed for premiums on any life insurance policy if the taxpayer claiming the deduction is directly or indirectly a beneficiary under the policy. Here petitioner is the named beneficiary on Mrs. Rueschenberg's life insurance policy.

Considering the foregoing, petitioners are not entitled to a deduction for the employee benefit expenses claimed on the

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Schedule C for the business for each year in issue, and respondent's determinations in this regard are sustained.

Reviewed and adopted as the report of the Small Tax Case Division.

To reflect the foregoing,

Decision will be
entered under Rule 155.