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Medical Reimbursement Deduction

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The Tax Appeals court ruled in favor of the taxpayer in an IRC §105 medical reimbursement plan case. IRC §105 is a deduction the IRS carefully scrutinizes upon audit. It is imperative farmers participating in these plans review the plan requirements and follow them carefully.

For a number of years, some organizations have been aggressively promoting medical reimbursement plans to farmers. The tax savings results from these plans allowing a farmer to employ his spouse and furnish her and her family with health insurance. All of the family out-of-pocket medical expenses are reimbursed. IRC §105 allows employee medical expense reimbursements to be deductible to the employer and nontaxable to the employee as a fringe benefit.

The farmer gains from participating in the plan in two ways. First, he deducts the insurance and medical expenses on Schedule F providing a tax deduction on both the federal and state levels. Second, because the expense reduces the Schedule F profit, it also reduces the self-employment tax. In order to meet the requirements of IRC §105, the employer must meet certain requirements. He must have a written employment agreement with the spouse. The agreement must also show the maximum reimbursement, the amount of cash wages, and the duties of the employee. The farmer may not discriminate among employees if the employees meet certain age and length of service requirements. Typically, this is not a problem as the spouse is the only employee.

In audits, the IRS looks carefully at these plans. They have found many of the farmers participating in the plans have not followed all of the rules. Some participants have taken the case to court .Some courts have denied the deduction and other courts have ruled in favor of the farmer. These decisions have all been based on the facts and circumstances of each case.

In 2001, Milo and Sharlyn Shellito were advised that they could qualify for the plan and had their CPA prepare the appropriate documents which they signed. They began claiming the medical deductions beginning with their 2001 income tax return. Upon audit, the IRS disallowed the deduction in 2001 and 2002.

The Shellito's took the IRS to Tax Court and the court released its decision in 2010 [1]. While the Shellito's followed all of the rules, the IRS argued Mrs. Shellito had been an unpaid employee of the farm since 1978 and was not a bona fide employee in 2001 and 2002. The health insurance and medical

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expenses were paid from the Shellito's joint checking account, rather than from a separate account of Mrs. Shellito. They said the employment agreement was a mere formalism because nothing actually changed in the behavior of Mrs. Shellito or the payment of the health expenses.

The IRS also argued nothing had changed as Mrs. Shellito entered her occupation as HOUSEWIFE on the income tax return.

The Shellito's appealed the Tax Court decision and the results of the appeal were issued in 2011 [2].

The Appeals Court vacated the decision that Mrs. Shellito was not a bona fide employee and remanded for reconsideration. The Appeals court said Mrs. Shellito documented the hours worked and testified to the duties performed and she clearly established that she paid the health-related expenses.

The Shellito case underscores the importance of closely adhering to the requirements of a medical reimbursement plan.

References

1. Shellito v. Comm'r., T.C. Memo 2010-41, (Mar. 3, 2010)
2. Shellito v. Comm'r, No. 10-9002, 2011 U.S. App. LEXIS 17724 (10th Cir. Aug. 24, 2011).