CIRCUIT COURT OVERRULES IRS'S ATTEMPT TO DENY FARMER'S DEDUCTION

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Shellito Case Study

Milo and Sharlyn Shellito operate a family farm in Kansas, where they raise cattle and grow wheat, corn and soybeans. Like every hardworking farm family, the Shellitos are always looking for ways to run their farm more cost-effectively and in 2001 they set up an AgriPlan to help accomplish this goal. This medical reimbursement program allows qualified farmers to deduct 100% of their federal, state and FICA taxes for family medical costs; average plan savings are over $5,500 a year.

AgriPlan includes comprehensive instructions that walk farmers through the steps needed to ensure compliance with employment and tax rules—issues that can be especially tricky when a self-employed individual hires a spouse. For the Shellitos this included establishing that Milo is the owner and operator of the farm who makes all decisions regarding the farm operation and directs his wife's work on the farm, and that Sharlyn is a farm employee who works roughly 40 hours a week. (It is not necessary for the employed spouse to work 40 hours a week for the Plan to work. Many employees on the Plan work as little as ten hours or less a week.)

To implement AgriPlan, the Shellitos created and signed an employment agreement for Sharlyn and opened an individual checking account for her. Sharlyn used this account to pay family insurance premiums and medical bills not covered by insurance for the couple and their two children. Milo paid her $100 per month as wages and reimbursed her for the payment of medical bills and expenses out of her account.

Following the rules of AgriPlan closely, Sharlyn kept a daily log of her hours spent on farm work, and the couple kept tax records that reflected this arrangement, deducting and reporting payroll taxes and issuing W-2s. Each year the Shellitos provided TASC with a detailed year-end accounting of amounts claimed for medical expenses and insurance premium reimbursements, and received a report indicating the total allowable benefit amount. They then reported this as a business expense deduction.

Having followed AgriPlan to the letter, the Shellitos had few concerns when they learned that the Internal Revenue Service (IRS) was planning to audit them.

The IRS Audit

The audit, which started in 2004, looked at tax years 2001 and 2002. During this time, the family's non-taxable medical expenses were $15,593 in 2001 and $20,897 in 2002, resulting in savings of $3,995 and $6,947 respectively.

According to the Shellitos' accountant, Geran Kuhlmann, the IRS agent on the case disallowed the medical insurance premium deductions because they were in the taxpayer's name instead of the employee's name. "That was an oversight on the part of their insurer," said Kuhlmann. "The Shellitos had alerted the insurance company and when they started getting billings in the spouse's name, they assumed that ownership had been changed."

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Kuhlmann advised the Shellitos not to accept the IRS's decision—a choice with surprising consequences. "The agent not only disallowed the health insurance, she pretty much disallowed everything on the medical," said Kuhlmann.

Fortunately, the Shellitos had a backup plan: the AgriPlan Audit Guarantee. "TASC appointed one of its lawyers to take over and all we had to do was supply him with proof that we'd complied with the Plan," said Sharlyn.

The IRS built their case on the assertion that Sharlyn was not a bona fide employee of her husband. As evidence, the IRS cited that before 2001 Sharlyn had worked on the farm without compensation for about 20 years, and that on their Form 1040 for the years in question, Sharlyn's occupation was listed as housewife. The fact that Sharlyn's wages originated from the couple's joint checking account was also a sticking point for the IRS.

TASC turns case around

After losing two Tax Court appeals, the case was sent to the Tenth Circuit Court. "Without TASC we would have never gotten this far," says Sharlyn. "We would have had to hire an attorney on our own and that would have cost us a lot of money—probably more than we owed."

A three-member judicial panel unanimously reversed the Tax Court's decision. One major issue was the faulty reasoning used to determine whether Sharlyn was Milo's employee. The Tenth Circuit didn't dictate Sharlyn's employment status, it simply required the Tax Court to examine the issue again, this time using the common law tests to determine if Sharlyn was—or was not—Milo's employee.

The Court of Appeals also dismissed the argument that funds for medical reimbursement must be paid from a separate account and that funds can't be paid out of a joint checking account, saying the argument that Sharlyn owned half of the funds in the joint checking account did not withstand scrutiny. Lastly, the Tenth Circuit Court emphasized there was no minimum wage that must be paid in these situations—and that there was nothing wrong with Sharlyn's small cash wage plus large fringe benefits!

AgriPlan makes it easy to stay on the right side of tax laws

In handing down their ruling, the Tenth Circuit Court stated that the Shellitos had "crossed all of the t's and dotted all of the i's with respect to the employment relationship." "It was 100 percent important," said Kuhlmann. "If they hadn't followed AgriPlan's instructions so closely, I think they would have lost this case."

"The Shellitos did so well in the Court of Appeals because of the instructions, advice and support from TASC," added tax expert Vern Hoven. "And their entire legal defense didn't cost them a dime!"

The Shellitos continued using AgriPlan throughout the audit and are using the program to this day. Their advice for other family farmers: "Join it!"

"It's easy, it works and you can count on TASC to stand with you if you run into problems," said Sharlyn. "I can't recommend it enough."