AgriPlan® BizPlan®

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

A TASC White Paper

TASC®

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AgriPlan (for farmers) and BizPlan (for small business owners) are medical reimbursement plans based on Section 105 of the Internal Revenue Code, Revenue Ruling 71-588 and Letter Ruling 9409006. Available to business owners nationwide, these plans are designed to meet the needs of sole proprietors, corporations, limited liability companies and partnerships. The programs can be used to manage expenses for health insurance and uninsured medical, dental, and vision care costs, as well as premiums for dental insurance, long-term care insurance, life and disability income insurance for eligible employees and their families. Plan deductions are available at the federal, state, and social security tax levels and all clients who follow TASC's parameters can count on its Audit Guarantee.

SUMMARY

A recent Circuit Court ruling strongly supports the tax savings provided to sole proprietors through Section 105 Medical Reimbursement Plans. Critical to the court's favorable ruling is close adherence to the procedures prescribed by TASC's AgriPlan and BizPlan. When a Kansas farmer had his Section 105 deduction challenged by the Internal Revenue Service (IRS), TASC came to the rescue!

TASC Provided Legal Assistance

TASC, a national leader in employee benefit plans administration, recently helped a Kansas farm couple, Milo and Sharlyn Shellito, who had their Section 105 Plan audited by the Internal Revenue Service (IRS). TASC provided legal assistance for the Shellitos and was able to prove that their adherence to the company's AgriPlan program had kept them in compliance with all Section 105 Plan regulations. A three-member judicial panel of the Tenth Circuit Court of Appeals unanimously reversed Tax Court decisions that affected the couple's medical expense deductions.

This case highlighted potential concerns that self-employed individuals can run into when employing a spouse and affirmed the value of AgriPlan as a legitimate tax-planning device. In handing down the ruling, the Court stated that the Shellitos, "crossed all of the t's and dotted all of the i's with respect to the employment relationship."

The ruling makes it absolutely clear that if a sole proprietor follows AgriPlan rules and regulations, that the program will be upheld by the courts. In fact, the Court found the IRS' attempt to challenge AgriPlan, when the rules were clearly followed, both "puzzling" and "surprising."

CASE BACKGROUND

Milo and Sharlyn Shellito operate a family farm in Kansas. The farming operation consists of approximately 2,300 acres of leased and 47 acres of deeded land used to raise around 200 head of cattle, as well as wheat, sorghum, corn and soybeans. Milo commenced farming in 1978, and was joined by Sharlyn in 1982. Milo owned all the numerous pieces of equipment used in the farm operation, including the combines and tractors, as evidenced by bills of sale in his name, and his leased land was solely in his name through and including the years in question in this case, 2001 and 2002. He made all the decisions regarding the farm operation, including expansion and equipment acquisition, and directed his wife in the work she did on the farm. The Shellitos filed joint form 1040 income tax returns for 2001 and 2002, together with Schedule F "Profit and Loss From Farming" forms reporting all farm income and expenses and listing Milo as the sole proprietor.

Sharlyn's Employment on the Farm

Sharlyn has worked on the farm continuously since approximately 1982, putting in about 40 hours per week on average. Her duties included assisting with planting and harvesting crops, operating tractors and equipment, feeding and caring for the large cattle herd, building and repairing fences, maintaining and performing basic repairs of equipment, running necessary farm errands, handling the farm records and books, and performing all the other tasks related to the farm. This work was done for her husband; in other words, he made all the business and operating decisions and did so without her input or consent. He directed her in her work including means, methods and what was to be accomplished. She did not regard herself as a business partner.

This medical reimbursement program allows qualified self-employed business owners (such as family farmers) to deduct 100% of their family's federal, state and FICA taxes for family medical expenses.

The Shellitos handled their business, personal income and expenses through a single, joint checking account from which both of them wrote checks. They also financed the farming operations with multiple loans from the Smith County State Bank and Trust Company on promissory notes signed by both Milo and Sharlyn (one was signed by Sharlyn alone). The only real property owned by the Shellitos, 47 acres, is held in joint tenancy, and Sharlyn has an ownership interest in three pick-up trucks used in farming operations. Additionally, the Shellitos were both named on insurance policies covering the farm and its equipment.

Cost-Effective Business Solution

Like every hardworking farm family, the Shellitos are always looking for ways to run their farm more cost-effectively and in 2001, on the advice of their accountant, set up an AgriPlan (Section 105 Health Reimbursement Arrangement) to help accomplish this goal. This medical reimbursement program allows qualified self-employed business owners (such as family farmers) to deduct 100% of their family's federal, state and FICA taxes for family medical expenses including: all family health insurance premiums including dental and vision (post-tax), qualified long-term care insurance premiums, all out-of-pocket medical, dental and vision care expenses, including over-the-counter supplies and insulin, cancer insurance premiums, term life ($50,000 max.) and disability income insurance premiums for employees only.

To take advantage of AgriPlan Milo formally employs Sharlyn, and by doing so, the amount Milo reimbursed Sharlyn's medical expenses as part of her compensation may now be deducted at 100 percent as an employee benefit expense. The result: Sharlyn's compensation in benefits and wages have created a tax savings for the farm. The average Plan savings are $5,500 a year.

AgriPlan includes comprehensive instructions that walk small business owners through the steps needed to ensure compliance with employment and tax rules.

AgriPlan includes comprehensive instructions that walk small business owners 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. When implementing their AgriPlan, the Shellitos created and signed an employment agreement for Sharlyn dated May 29, 2001. The agreement declared that Milo was employing his wife as a hired hand to do farm work he directed her to do. Sharlyn concurrently opened an individual checking account from which she commenced thereafter to pay the family's medical bills not covered by insurance, as well as insurance premiums (including her employer-husband's).

Governing Regulations

Business expense deductions for medical reimbursement payments to an employee are governed by § 162(a) and (a)(1) of the Internal Revenue Code and accompanying Treasury Department regulations. They provide as follows: 162. Trade or business expenses (a) In general. — There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including — (1) a reasonable allowance for salaries or other compensation for personal services actually rendered; I.R.C. § 162(a)(1). As the language of the statute indicates, "[t]he test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services." Treas. Reg. § 1.162-7 (emphasis added). The regulations provide that "[a]amounts paid or accrued within the taxable year for. . . a sickness, accident, hospitalization, medical expense . . . or similar benefit plan, are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business." Treas. Reg. § 1.162-10(a).

Non-Taxable Income

In addition to the employer being able to deduct such benefit plan payments, they are not includable in the taxable income of the employee. Specifically, employer provided insurance coverage is not included pursuant to I.R.C. § 106(a), and amounts paid directly or indirectly to the employee as reimbursement for expenses incurred by the employee for his or her care or the care of the employee's spouse or dependents, are not includable pursuant to I.R.C. § 105(b). The exclusion from income of the amounts here in question is not in issue.

View the complete Tenth Circuit Court ruling online. Search on "United States Tax Court No. 102223-06."

The application of those provisions to farming and other small business sole proprietorships where one spouse is employed by the other in a bona fide employment relationship has long been acknowledged by the Internal Revenue Service.

As part of their employment agreement, Milo paid Sharlyn $100 per month as wages as well as reimbursing her for the payment of medical bills and expenses out of her account. He made these payments to her by checks signed by him, on their joint checking account, for deposit into her individual account.

As directed by AgriPlan, Mrs. Shellito kept a daily log of her hours spent doing farm work, although not specifying what work was done. The log totals showed 1,169 hours worked after May 29 in 2001, and 2,226 hours in 2002. In addition, the couple kept accurate tax records reflecting this arrangement, deducting and reporting payroll taxes on the $100/monthly wages and issuing W-2s.

Thus, they reported wages ($700 plus $54 in employment taxes in 2001, and $1,200 plus $92 in employment taxes in 2002) as income on their joint income tax returns—offset by like amounts ($700 and $1,200) taken as expenses for labor hired on Schedule F. Finally, the couple transmitted annually to AgriPlan detailed year-end accountings 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. 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.

THE IRS' CASE AGAINST THE SHELLITOS

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."

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.

The Shellitos and Kuhlmann then appealed the case to a local Tax Court. The Tax Court upheld the IRS findings stating that Sharlyn was not her husband's employee because she was not compensated. The court reasoned that Sharlyn obtained no economic benefit from funds paid into her individual account from the couple's joint checking account due to the fact that she is presumed to be an equal owner in the funds in that account. Further, her payment of medical expenses from her individual checking account was simply an assumption of her husband's liability under state law for the family's medical expenses. Accordingly, the court concluded that the form of the transactions in question did not reflect their substance and did not give rise to a true employment relationship.

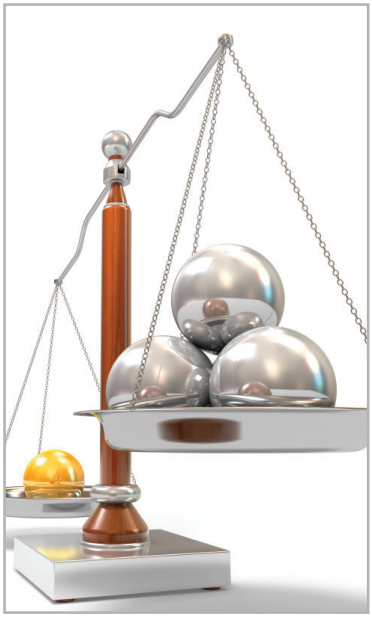
As additional support for its conclusion, the court pointed to the fact that Sharlyn had done the same farm work for 19 years without compensation, and that on the tax return for the years in question, Sharlyn listed her occupation as "housewife." Based on those findings, the Shellitos' appeal was declined.

TASC PROVIDES SUPPORT

Fortunately, the Shellitos had a backup plan: the AgriPlan Audit Guarantee. They reached out to TASC and AgriPlan for support. "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 case was appealed 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."

TENTH CIRCUIT COURT OF APPEALS



A three-member judicial panel unanimously reversed the Tax Court's decision. In handing down their decision, the panel cited six previous decisions that were directly relevant to this case. All involve spousal employees and medical benefit plans, and business expense deductions on either Schedule F or Schedule C. Four of the six decisions involve AgriPlan and three of those decisions involve sole proprietor farming operations. Let's review through each of the Tax Court's arguments and the Tenth Circuit Court's response.

Determination of Employment

One of the major issues the Tenth Circuit Court cited in their findings was the faulty reasoning used to determine whether Sharlyn was Milo's employee. The Tax Court had argued that Sharlyn's claimed compensation was illusory because (a) her payment of medical expenses simply relieved Milo of his obligation under Kansas law to pay for her medical expenses (the Doctrine of Necessaries); and (b) she obtained no economic benefit from checks written to her by her husband out of their joint checking account in which she was presumed to have an equal ownership interest, even though the funds passed through Sharlyn's individual account. The Tax Court made these propositions, saying: "We conclude that Sharlyn received no remuneration under the purported employment arrangement and consequently during the years at issue, as in the preceding years, there was no bona fide employment relationship." They further claimed that Shellitos' employment agreement failed for lack of economic substance.

The Circuit Court found it puzzling that the Tax Court would even attempt to advance the argument that Sharlyn's payments should be disregarded.

The Tenth Circuit Court didn't agree with the Tax Court saying it was erroneous for the district court to rely on the Kansas Doctrine of Necessaries. The Kansas Doctrine of Necessaries applies equally to husbands and wives and imposes upon each a duty to provide for the other's necessities, including medical services. See St. Francis Reg'l Med. Ctr., Inc. v. Bowles, 836 P.2d 1123, 1125-28 (Kan. 1992). Thus, the duty only comes into force to the extent that one of the spouses is unable to provide for themselves. Here, Sharlyn, by way of compensation received from her employment by her husband's farming business, was able to provide for her own medical services.

Puzzled by Tax Courts' Argument

The Circuit Court found it puzzling that the Tax Court would even attempt to advance the argument that Sharlyn's payments should be disregarded because they convert a legal support obligation into a deductible expense. In their findings, the Circuit Court stated, "that position has not been adopted by the Commissioner since it would punish a taxpayer for employing a spouse or family member." Revenue Ruling 71-588, 1971-2 C.B. 91, 1971 WL 26635 (1971), and Rev. Rul. 59-110, 1959-1 C.B. 45, 1959 WL 12187 (1959) (Employee-Dependent), were both based on determinations that an obligation to support does not preclude favored tax treatment in their respective situations. And, although Rev. Rul. 59-110 was superseded by Rev. Rul. 73-393, 1973-2 C.B. 33, 1973 WL 33072, the general conclusion has remained the same: "[F]or wages paid to the child for services actually performed, the fact that there may be a legal obligation to support the child is not determinative of the deductibility of such wages as a business expense." Id. The same reasoning applies to a spouse.

The Court of Appeals stated that the proposition that the deductibility of medical reimbursement payments depends on whether or not medical expenses might be paid from another source, (even if that source has an obligation to pay), is also not supported by any case law, and would result in inconsistent treatment of benefit plans and a disincentive to employers to provide benefits. Accordingly, in analyzing whether Sharlyn received compensation, any obligation arising from the Kansas common law Doctrine of Necessaries must be excluded.

The Courts Own Words:

- **"It is puzzling..."**
- **"Clearly erroneous..."**
- **"Is flawed..."**
- **"Does not withstand scrutiny..."**
- **"Ignores the reality of spousal employment..."**
- **"Is not supported by any case law..."**
- **"Such an approach is inconsistent with the facts..."**
- **"The argument is based on an improper implicit finding..."**

The Tenth Circuit Court Didn't Dictate Sharlyn's Employment Status

To be fair, 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.

Sharlyn received no economic benefit because her financial position with a separate account was the same as without it ignores the reality of spousal employment.

The Court of Appeals stated,"that if the use of a single joint account disqualifies spousal employment, it is strange that this threshold bar has not been used in the decided cases. Significantly, none of the cases referred to earlier relied on the existence and use of joint checking accounts, as such, as a disqualifying factor. Whether the joint account-compensation disqualifier appears in the IRS audit guides, internal memoranda or other materials is at least problematic if for no other reason than its omission from Rev. Rul. 71-588, as well as the case law. Furthermore, a separate account requirement would simply invite another structural layer: here, a separate account for the business of the farm, from which funds would simply be transferred to the general joint account and/or to Mrs. Shellito's separate account (plus, the business account would probably be in joint tenancy anyway because the business relied on Mrs. Shellito to do the bookkeeping)."

Separate Accounts

In addition, the argument that Sharlyn received no economic benefit because her financial position with a separate account was the same as without it ignores the reality of spousal employment. Combined gross income would obviously not change. Employment of a spouse in a small business is done to avoid decreasing the couple's income, which would result from paying an unrelated hired hand. And, to narrow these kinds of cases to situations where the employed spouse is setting up a completely separate asset portfolio with her separate account does not find a supporting requirement in the reported cases.

There was also evidence in the record to rebut the presumption of equal ownership. Milo testified that the joint account was the account that was his business account, used for all the business income and expenses, and that it was a joint account because the bank required Sharlyn's name to be on it as well. The inequality of contributions to the account is readily apparent from the fact that the family's income came from the sole proprietorship farming business.

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. First, it does not address the purported other half of payments she would have received (hard to do since the funds are fungible). More to the point, this argument is based on an improper implicit finding that there was no proof presented to suggest that the Shellitos did not equally own the funds in their joint checking account. As the Shellitos pointed out, the Kansas Supreme Court has held that, "the presumption of equal ownership can be rebutted with evidence regarding the owner's relative contribution to the asset and donative intent." Brewer v. Schalansky, 102 P.3d 1145, 1150 (Kan. 2004).

Minimum Wage Concern

Finally, 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. Sharlyn was paid in two ways: a wage of $100 per month plus substantial medical reimbursement benefits amounting to more than $20,000 in 2002. The Court did not seriously dispute Sharlyn's total claimed compensation package as being adequate in the farm work market for the work performed. The evidence clearly establishes the payment by Sharlyn of the health-related expenses in question, and her reimbursement for those payments, citing the abundance of documentary evidence and proof of billing and payments available in this case.

FINDINGS

For these reasons, the Court of Appeals was compelled to vacate and remand this case to the Tax Court for further consideration. It further advised the Tax Court to begin its analysis of whether or not Sharlyn was a bona fide employee by applying the common law agency doctrine. It did so reluctantly, due to the fact that this case had been pending either administratively or before the courts for an inordinate period of time, burdening the taxpayers with uncertainty with respect to their affairs. (The Tax Court was given 45 days from the date of the ruling to re-examine the issue of Sharlyn's employee status. The Tax Court decided not to re-examine this issue.)

AGRIPLAN STANDS UP FOR THE SELF-EMPLOYED

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," Kuhlmann said. "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 and CPA 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."

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."

Footnotes

[1] Milo L. Shellito; Sharlyn K. Shellito, Petitioners - Appellants, v. Commissioner of Internal Revenue, Respondent - Appellee., (10th Cir) 10-9002, August 24, 2011; 2011-1 USTC ¶50,595; reversing and remanding, TCM 2010-411

[2] During 2001, a taxpayer who was self-employed was permitted to deduct only 60% of the cost of health insurance premiums paid for himself, his spouse, and his family. I.R.C. § 162(l)(1). That percentage increased to 70% in 2002, and 100% for years 2003 and after. Id. Also in 2001 and 2002 (and continuing to the present), any unreimbursed medical expenses that a taxpayer paid out of pocket could only be deducted to the extent that they exceeded 7.5% of the taxpayer's adjusted gross income. Id. § 213(a). Amounts paid to an employee pursuant to a healthcare reimbursement plan, however, were fully deductible as a business expense. Id. § 162(a)(1); Treas. Reg. § 1.162-10(a).

[3] Rev. Rul. 71-588, 1971-2 C.B. 91 (1971) provides as follows: Amounts reimbursed under an accident and health plan covering all bona fide employees, including the owner's wife, and their families are not includable in the employee's gross income and are deductible by the owner as business expenses.

[4] Frahm v. Comm'r., T.C.M. 2007-351, 2007 WL 4179352 (Nov. 27, 2007), Francis v. Comm'r., T.C.M. 2007-33, 2007 WL 424601 (Feb. 8, 2007), Albers v. Comm'r., T.C.M. 2007-144, 2007 WL 1649090 (June 7, 2007), and Snorek v. Comm'r., T.C.M. 2007-34, 2007 WL 424536 (Feb. 8, 2007).

BENEFITS OF AGRIPLAN AND BIZPLAN

An AgriPlan or BizPlan Section 105 Health Reimbursement Arrangement (HRA) are tax-advantaged benefit programs that enable small business owners to deduct 100% of their family's medical expenses as business expenses, saving on average of $5,500 or more a year!

AgriPlan and BizPlan include everything your clients need to ensure their Plan meets the documentation and compliance requirements established by the Internal Revenue Service (IRS), Department of Labor (DOL), and Employee Retirement Income Security Act (ERISA).

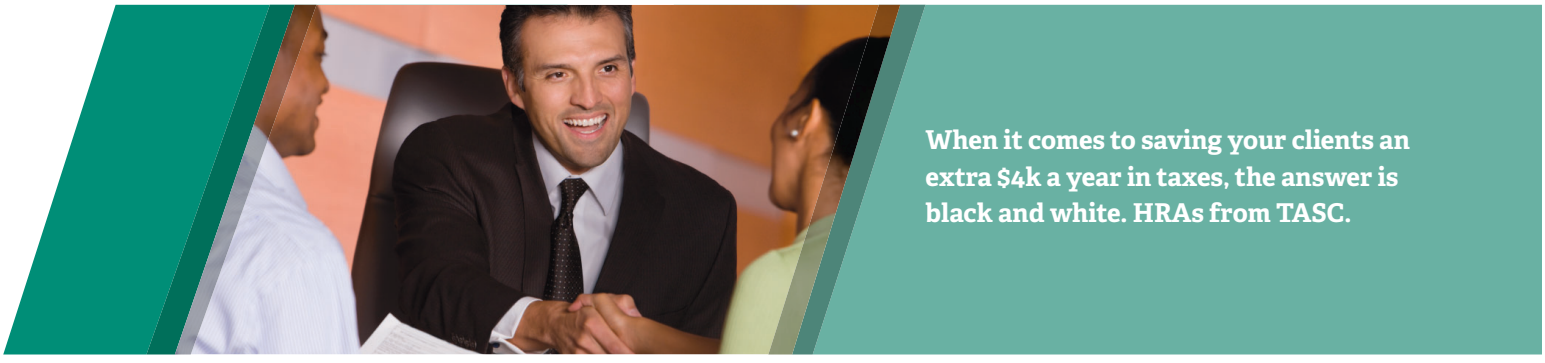
Protect Your Bottom Line and Ensure Peace of Mind

TASC protects your bottom line and ensures peace of mind. As demonstrated in this white paper, your AgriPlan and BizPlan clients are protected by an industry-exclusive Audit Guarantee! In the unlikely event they are audited, TASC will defend your client in court and assume financial responsibility for any penalty and/or interest as it pertains to their Plan if they follow the procedures and guidelines outlined by TASC. And, TASC will refund 100% of your client's administration fee if they do not deduct at least $2,000 in a Plan year.

Benefits Package

In addition to a cash wage, an employee benefits package includes reimbursement of the employee's family healthcare expenses. Reimbursable expenses, like the ones listed below, are effective the first day of the month your client enrolls in AgriPlan or BizPlan. Insurance premiums, on the other hand, can be reimbursed back to the beginning of the calendar year. Employees receive the following benefits in which employers can reimburse and, in turn, deduct on their business tax forms Schedule C, F, 1065, 1120, and 1120S:

- Health insurance premiums (including qualified long-term care insurance and cancer insurance)
- Dental insurance premiums
- Non-insured medical out-of-pocket expenses.
- Term life insurance (employee only, no dependents of employee).
- Disability insurance (employee only, no dependents of employee).



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