Effective Date of "Section 105" Plans

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— by Neil E. Harl*

Promotional efforts by firms selling the so-called "Section 105" plans have raised the question of whether benefits of plans may be obtained on a retroactive basis.\(^1\) The issue is, for example, whether a plan established on December 31 is considered effective for the entire year.\(^2\) As one accountant's publication claims —

"In order to claim a 100% deduction for the 1994 tax year, your clients must be enrolled in [the] plan no later than December 31, 1994. Even though a self-employed business owner enrolls late in the year, §105 plan deductions are retroactive and may include expenses for the full year."\(^3\)

In general it is believed that such "retroactive" deductions are impermissible.

General nature of plan

Employer contributions to a health and accident plan are generally not taxed to the employees.\(^4\) Moreover, the employees are generally not taxed on the benefits received under the plan.\(^5\)

Health or accident coverage must be provided under a plan or the coverage and benefits cannot be excluded from the employees' incomes.\(^6\) The plan must be an arrangement for payment to employees in the event of personal injury or sickness.\(^7\) The plan does not have to be in writing, although a written plan is highly advisable. The employees' rights do not have to be legally enforceable\(^9\) and there is no requirement of notice to the employees. If employees are not, however, notified of the plan, that is some evidence that no plan exists.\(^10\)

An amount received under a plan under which employees' rights were not legally enforceable is treated as received under a plan only if, on the date the employee was injured or becomes ill, the employee was covered by a plan providing for payments in the event of illness or injury.\(^11\)

The question of retroactivity

Several months ago, proposed regulations were issued under Internal Revenue Code Section 125 involving so-called cafeteria plans.\(^12\) That code section authorizes employee plans providing an array or "cafeteria" of benefits including health and accident coverage.\(^13\) The regulations issued under that code section in proposed form state —

"... reimbursements...must be paid specifically to reimburse the participant for medical expenses incurred during the period of coverage."\(^14\)

The proposed regulations under sections 125 of the Code are made applicable to health and accident plans generally.\(^15\) The proposed regulations state:

"These rules apply with respect to a health plan without regard to whether the plan is provided through a cafeteria plan."\(^16\)

The proposed regulations go on to state —

"Medical expenses reimbursed under a health FSA [flexible spending arrangement] must be incurred during the participant's period of coverage under the FSA... expenses are not treated as incurred during a period of FSA coverage if such expenses are incurred before the later of the date the health FSA is first in existence or the participant first becomes enrolled under the health FSA."\(^17\)

The regulations further specify that medical expenses incurred before the later of the date of the plan's effective date and the date the participant is enrolled in the plan are not treated as incurred during the period for which the participant is covered.\(^18\)

In the case of American Way Mutual Insurance Co. v. United States,\(^19\) the court, in dealing with retroactivity under a cafeteria plan, found the plan to be deficient because of the retroactivity feature.

Thus it does not appear that section 105 plans can be made retroactive in terms of benefits or coverage.

Caution for small plans

Although a recent private letter ruling\(^20\) specifically sanctioned a one-employee plan, where that single employee was the sole proprietor's spouse, it is vital to success of such small plans that a bona fide employer-employee relationship exist. In that ruling, issued in late 1993,\(^21\) the IRS conceded that a bona fide employer-employee relationship existed. Thus, the costs involved were deductible for the employer and benefit amounts were not taxable to the employee, even though the employer was one of the employee's dependents and thus was covered by the plan.
In general, it is believed important to assure, in addition, that — (1) services rendered by the employee be in the business, not in the household; (2) the compensation paid be fairly reflective of the amount, type and value of services rendered; (3) the employee's participation in management be limited; and (4) the employee be compensated separately for any property, such as land, provided to the business.

The self-employed deduction

The deduction for health insurance costs of self-employed individuals has been extended on a permanent basis at a level of 25 percent for 1994, 30 percent in 1995 and later years.22

FOOTNOTES

1 See Harl, Agricultural Law § 57.02[1] [1995]; Harl, Agricultural Law Manual § 7.02[4][b][i]. See also Harl, "Health Insurance for Employees", 2 Agric. L. Dig. 201 (1991); Harl, "More on Husband-Wife Accident and Health Plans," 5 Agric. L. Dig. 89 (1994).
3 Id.

BANKRUPTCY

GENERAL-ALM § 13.03.*

DISCHARGE. The debtor was a partner in a horse breeding and racing business and had obtained secured loans from a creditor. The creditor sought to have the loans declared nondischargeable because of fraud by the debtor in making financial statements and for the unauthorized sale of collateral. The Bankruptcy and District Courts held that the creditor failed to prove that the financial statements were false when made but that one loan was nondischargeable because the debtor had sold the collateral without prior consent of the creditor and without payment of the proceeds on the loan. The appellate court reversed the second holding because the court found that the creditor had knowledge of the debtor’s sales of collateral without prior consent and the creditor had failed to take steps to protect its collateral. In re Wolfson, 56 F.3d 52 (11th Cir. 1995), rev’d unrep. D. Ct. dec. aff’d, 148 B.R. 638 (Bankr. M.D. Fla. 1992).

EXEMPTIONS

AVOIDABLE LIENS. The debtor owned a residence with a fair market value of $36,000. The residence was subject to consensual liens of $28,500 and a judgment lien of $10,954.29. The debtor claimed a homestead exemption for the amount of equity after the consensual liens and the judgment lien of $10,954.29. This amount exceeded the debtor’s interest in the residence without any liens, $36,000, by $10,954.29; therefore, the judicial lien of $10,954.29 was avoidable in its entirety. As the court noted in quoting from the legislative history of the amendment of Section 522(f), the formula effectively allows complete avoidance of judicial liens if the debtor seeks an exemption for the amount of equity remaining after consensual liens. In re Jones, 183 B.R. 93 (Bankr. W.D. Pa. 1995).

IRA. In 1991, the debtor rolled over funds from a terminated pension plan to an IRA. The debtor filed for Chapter 7 in 1994 and claimed $286,000 in the IRA as exempt under Mass. Gen. Law, ch 235, § 34. The trustee objected to the exemption to the extent the rolled over amount exceeded 7 percent of the debtor’s total income for the five years before the bankruptcy filing. The debtor argued that the 7 percent limit did not apply to rolled over funds but only applied to new deposits. The court held that the statute was unambiguous and limited the IRA exemption to an amount equal to 7 percent of the debtor’s income for the five pre-petition years. In re Goldman, 182 B.R. 622 (Bankr. D. Mass. 1995).

GRAIN ELEVATORS. The debtors owned and operated grain elevators. The Missouri Department of Agriculture (the Department) obtained a state court order to seize the debtor’s grain-related assets and seized the debtors’ grain-related assets and placed the proceeds in an escrow account for the grain producers who had grain stored with the debtors. The Department held hearings to determine the amount of the producers’ claims and issued an order for the distribution of the grain proceeds. That order became final when no one objected within 30 days after the