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Can Section 105 Plan Costs Be Deducted on Schedule F?

-by Neil E. Harl

In a decision handed down on June 7, 2007, the Tax Court held that a married couple operating a farming business was not entitled to a deduction for the costs of “employee benefit programs” on Schedule F.¹ The plan in question, which was sold to the taxpayers by a commercial firm, involved a medical reimbursement plan authorized by I.R.C. § 105(b) of the Internal Revenue Code.

Nature of Section 105(b) plans

In general, under valid Section 105(b) plans, costs are deductible and the benefits are not taxable to the employees.² Under that provision, amounts are not included in gross income-

“... if paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by him for the medical care... of the taxpayer, his spouse, and his dependents...”³

It has been clear for some time that Section 105(b) plans should be approached with care in order to be successful. In the ruling often cited for such plans,⁴ the ruling recites that the factual situation in the ruling involved “... a sole proprietorship with several bona fide full-time employees including his wife.”⁵ However, a 1971 General Counsel’s memorandum (which was initially a confidential document but was ordered released to the general public), revealed that there were actually only two employees in the ruling situation, one of whom was the spouse.⁶ The GCM expressed fear that the IRS position, if it were to become widely known, “might encourage abuses” so the actual ruling did not reveal the actual facts.⁷

In the 1971 ruling,⁸ in the year in question the two employees, one of whom was the spouse, incurred expenses for medical care for themselves, their spouses and their children and were reimbursed under the plan.⁹ The reimbursed amounts were not included in the employees’ gross incomes and were deductible by the taxpayer as a business expense.

IRS ruled, in 2002,¹⁰ that amounts reimbursed under a self-insured medical plan prior to the establishment of the plan were not excludible from income by the recipients.¹¹

Albers v. Commissioner

In Albers v. Commissioner¹² the taxpayers, Mr. and Mrs. Albers, deducted the costs for the Section 105(b) plan as a trade or business expense on Schedule F. The owner or owners of an unincorporated business are entitled to claim all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.¹³ That includes amounts paid to an employee pursuant to an employee benefit plan for an expense that the

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² § 162(a)(11).
⁴ Transcript of Decisions of the Tax Court, 610 (1972).
⁵ W-9CB (1974).
⁶ Transcript of Decisions of the Tax Court, 610 (1972).
⁷ Ibid.
⁸ Transcript of Decisions of the Tax Court, 610 (1972).
⁹ Transcript of Decisions of the Tax Court, 610 (1972).
¹⁰ Transcript of Decisions of the Tax Court, 610 (1972).
¹¹ Transcript of Decisions of the Tax Court, 610 (1972).
¹² Transcript of Decisions of the Tax Court, 610 (1972).
¹³ Transcript of Decisions of the Tax Court, 610 (1972).
¹⁴ Transcript of Decisions of the Tax Court, 610 (1972).
¹⁵ Transcript of Decisions of the Tax Court, 610 (1972).
¹⁶ Transcript of Decisions of the Tax Court, 610 (1972).
¹⁷ Transcript of Decisions of the Tax Court, 610 (1972).
¹⁸ Transcript of Decisions of the Tax Court, 610 (1972).
¹⁹ Transcript of Decisions of the Tax Court, 610 (1972).
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³⁷ Transcript of Decisions of the Tax Court, 610 (1972).
³⁸ Transcript of Decisions of the Tax Court, 610 (1972).
³⁹ Transcript of Decisions of the Tax Court, 610 (1972).
⁰ Transcript of Decisions of the Tax Court, 610 (1972).
employee pays or incurs.\textsuperscript{14} However, a self-employed taxpayer operating an unincorporated business is not entitled to deduct health insurance costs paid or incurred by the taxpayer for the taxpayer, spouse and dependents except as provided in I.R.C. § 162(l).\textsuperscript{15} That subsection limited the deduction to a percentage of the total through 2002.\textsuperscript{16} Since 2002, the allowable percentage has been 100 percent of the deduction but that was not the case in Albers v. Commissioner\textsuperscript{17} which arose in 2001 when the percentage was 60 percent.\textsuperscript{18}

The Tax Court found that the taxpayer-employer (Mr. Albers) failed to establish that he paid the amount of the insurance premiums and the claimed reimbursed expenses for medical care for his wife as employee, her spouse (Mr. Albers) and her dependent children.\textsuperscript{19} Moreover, the Tax Court found that the taxpayers had failed to establish that any part of the claimed medical insurance premiums and the claimed medical expenses were ordinary and necessary business expenses paid or incurred by the sole proprietor (Mr. Albers) in carrying on his farming operation.\textsuperscript{20} Consequently, the deduction claimed on Schedule F for “employee benefit programs” was disallowed.\textsuperscript{21}

Where should the amounts have been deducted?

Self-employed persons may deduct from gross income (line 29 on the 2006 federal income tax return, for example) 100 percent of amounts paid during the year for health insurance for themselves, their spouses and dependents.\textsuperscript{22} The deduction cannot exceed the taxpayer’s net earned income derived from the trade or business for which the insurance plan was established.\textsuperscript{23} Amounts eligible for the deduction do not include amounts paid for any period during which the self-employed individual is eligible to participate in a subsidized health plan maintained by the employer or the spouse’s employer.\textsuperscript{24}

Thus, it continues to be important to deduct the medical insurance amounts in the prescribed manner even though 100 percent of the amounts paid for health insurance may be deductible.

\textbf{FOOTNOTES}

\begin{itemize}
\item[3] I.R.C. § 105(b).
\item[5] Id.
\item[7] Id. The original GCM, GCM 33127, Nov. 9, 1965, was reconsidered in GCM 34488, supra.
\item[9] Id.
\item[12] T.C. Memo. 2007-144.
\item[14] Id. See Treas. Reg. § 1.162-10(a).
\item[17] T.C. Memo. 2007-144.
\item[19] Albers v. Comm’r, T.C. Memo. 2007-144; I.R.C. § 105(b).
\item[20] Id.
\item[21] Id.
\item[22] I.R.C. § 162(l)(1).
\item[24] I.R.C. § 162(l)(2)(B). See Reynolds v. Comm’r, T.C. Memo. 2000-20, aff’d on another issue, 296 F.2d 607 (7th Cir. 2002).\end{itemize}

\section*{CASES, REGULATIONS AND STATUTES}

\textbf{by Robert P. Achenbach, Jr}

\section*{ANIMALS}

\textbf{CATTLE.} The plaintiffs were injured when their car hit the defendant calf which had wandered on to the highway. The plaintiffs sued for negligence in failing to keep the calf off the highway and failing to promptly capture the calf after it escaped. The trial court granted summary judgment to the defendants on the basis that the plaintiffs had failed to show that the defendant owned or possessed the calf. On appeal, the appellate court reversed, holding that there was sufficient evidence to raise a factual issue as to the ownership of the calf. The court noted that an employee of the defendant had told police that a calf was missing. \textbf{Lindsey v. Chillicothe Livestock Market, Inc., 2007 Mo. App. LEXIS 857 (Mo. Ct. App. 2007).}