

# IRS Clarifies Health Policies



There has been some discussion regarding some recent Tax Court cases on HRA's or Section 105 Plans. These cases concerned plans for Schedule F farmers who employed their spouses and established Plans for the spouse/employee's benefit. Questions have arisen about whose name the health insurance policy was in and exactly what the requirements are so that these benefit plan expenses are truly deductible on the Schedule C or F saving employment taxes in addition to income taxes. We will discuss these cases and clarify the issues.

## The two cases we analyzed are:

T.C. Memo 2007-144: Darwin J. Albers & Peggy L. Albers, Petitioners v. IRS

T.C. Memo 2007-351: Ralph E. Frahm & Erika C. Frahm, Petitioners v. IRS

It is interesting to note that the same judge, Chiechi, ruled in both cases.

In the first case (Albers), Darwin Albers is a farmer who employed his wife, Peggy, to work on his farm. He completed the proper paperwork, including a spousal employment agreement, to establish a 105 Plan for her benefit. Peggy Albers performed the services for the farming business as provided for in the employment agreement. As medical expenses were incurred, Darwin Albers paid most of these expenses directly from the joint checking account that was also used to pay farm expenses and Peggy's wages.

Darwin Albers purchased a health insurance policy that would cover himself, his wife, and their dependent children. On the policy, Darwin Albers listed himself as the "Applicant", with Peggy Albers as "spouse". In other words, the insurance policy was in Darwin Albers' name. The premiums for this policy were paid from the joint account.

It does not appear that there was any evidence submitted to show that Darwin Albers wrote checks to Peggy Albers to reimburse her for any of these expenses. At one point, Peggy Albers charged \$854 of medical expenses on her credit card, but there was nothing to show who paid the charge or if any reimbursement was made to Peggy for the charge.

Let's now jump to the second case (Frahm) and look at the facts in that case. Ralph Frahm is a farmer who employed his wife, Erika, to work on his farm. He, too, completed the proper paperwork, including a spousal employment agreement, to establish a 105 Plan for her benefit. They kept records of the work that Erika Frahm performed in her capacity as an employee. As medical expenses were incurred, Erika Frahm paid the expenses from her individual checking account. Ralph Frahm, as employer, issued checks from a joint business checking account to Erika Frahm to reimburse her for the medical expenses that she had paid.

Ralph Frahm purchased a health insurance policy that would cover himself and his wife. On the policy, Ralph Frahm listed himself as the "Applicant", with Erika Frahm as "spouse". So just like in the Albers case, the health insurance policy was in the farmer's name. Unlike in the Albers case, Erika Frahm paid the premiums for the health insurance policy from her individual checking account. Ralph Frahm then wrote checks from the joint business account to Erika Frahm to reimburse her for the health insurance premiums paid.

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In the Albers case, the judge ruled that the Petitioners "...failed to establish that her employer Mr. Albers paid, directly or indirectly, to Ms. Albers pursuant to the .... medical reimbursement plan the claimed.....health insurance premiums and the claimed.....medical and dental expenses...." The decision also determined that the petitioners failed to establish that the expenses were ordinary and necessary – in other words, that they were legitimately paid as part of an employee benefit plan. Judge Chiechi decided in favor of the respondent (IRS).

In the Frahm case, Judge Chiechi decided in favor of the Petitioners – the Frahm's.

It is evident that the differences in the operations of the Plans determined the outcomes in these two cases. It did not matter that the insurance policy was in the Employer's name (the farmer) as that fact was the same in both cases. The determining factor was the paper trail. Since these are *reimbursement plans*, it is imperative that the Employee covered by the Plan pay the medical expenses for him or herself, their spouse, and dependents. The Employer must then write a check to his/her employee and *reimburse* him/her for that expense. By performing these transactions, the taxpayers create the evidence to show that the Plan exists as a legitimate fringe benefit plan created as part of a compensation arrangement for the benefit of the employee.

## Employee

Pays for health premiums out of an account separate from the business account.

- Policy does not have to be in spouse's name.
- Policy may cover dependents or be separate policies.

Employee  
Submits  
Claim

## Employer

Reimburses the employee for health premiums.



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