Homework Incomplete By Most Administrators Of Tax Code Section 105 For Sole Proprietors

Sole Proprietors have the opportunity to write off the cost of their family health care as a business expense, if they employ their spouses and provide health care benefits to those employees.

Taking advantage of this opportunity saves the typical sole proprietor about $2,000 annually in taxes by deducting about $6,000 in family health care expense as a business expense. Some tax professionals have this service as part of their practice; others defer to administrators who take responsibility for compliance. Where there is an administrator, the tax professional avoids the effort of compliance on this subject and also avoids having to sort out the health care expense at tax time, which saves significant effort. The administrator forwards a recap of the health care expense to the taxpayer who includes it with his other tax papers.

Many sections of the Internal Revenue Code become involved in this process, and there are over 2,000 references to be found in court cases, revenue rulings, and letter rulings. From these sources, there are over 1,300 guidelines that determine whether a taxpayer is in compliance.

For over one hundred years, it has been the declared right of taxpayers to use any legal means to reduce or even avoid paying taxes. However, an employee healthcare plan will become invalid when:

1. Either the employer or employee is <u>not</u> at risk.
   a. Retroactivity of benefits deals with known expenses and therefore there is no risk to either the employer or the employee.
   b. Unused funds contributed by the employee are refunded based on the benefit plan. Again, the employee is not at risk.
   c. The plan must be in existence when the care due to illness is received. The illness may have been incurred prior to the plan effective date, but only the care received during the plan effective period is covered. The deduction is allowed when the care payment is made which can occur even after plan expiration.
2. No documentation of the benefit plan or established practices/procedures for providing benefits exists.
3. No notification to employees exists covering plan benefits/rules.
4. Discrimination exists:
   a. No documentation for beneficiary eligibility is set.
      (Same as #2 above – plans are required.)
   b. Plan included or was for non-employee.
   c. The plan has no rules for providing benefits, which can result in after the fact decisions, which favor selected employees.

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It is worth examining the impact of having an invalid plan. In Epmeier vs. USA, it is made clear what insurance is, and the fact that an employee health insurance benefit is tax free to the employee, is deductible by the employer, and that a contract exists based upon mutual understanding on the plan's contents or rules. Both parties must act according to the rules and in the absence of rules; there is no plan or contract.

If the benefit plan is declared invalid, it effectively never existed. There is nothing automatic about an invalid plan becoming valid by doing nothing. Whatever the plans faults, they must be corrected and documented as a new plan. If a plan does not exist with all the aspects validated, then there is no new plan. The objectives of the employer cannot be accomplished nor can the employees realize the tax-free benefits. Correcting an invalid plan does not automatically apply to the original plan date.

Given no knowledge of an invalid plan, the employee, the sole proprietor, the tax professional, and the administrator assume that they have a plan that is renewing itself year after year. Thus, year after year, the tax liability rises, as does the basis for penalties and interest (which is compounded). Some simple mathematics can demonstrate the enormity to all parties.

Assumptions:

- Owner spends $6,000 annually for family health care.
- Owner "saves" $2,000 annually in taxes.
- There are 100,000 owners using the tax saving process.
- These users will be using the process for an average of 3-½ years.
- Penalties and interest are assessed at 20%.
- Interest is compounded.
- A six-year user would accumulate a tax obligation of over $28,800 in six years.
- A one-year user would have an obligation of over $2,800.
- 3-½ years of usage would be about $13,250 of liability with taxes being about $7,000 and the balance of about $6,000 in penalties and interest.

Given the 100,000 users, the total becomes $1.325 billion, with the penalties and interest being about $600 million. Certainly, this would make the administrators insolvent quickly, and then the owners would seek redress from the tax practitioners. For some tax practitioners, it would mean bankruptcy also.

How could such a collective catastrophe occur? The tax professional assumed the administrator had performed due diligence. The administrator did incomplete due diligence or perhaps neglected to ask his attorneys all the right questions. Or perhaps the administrator found the right compliance rules after years in business but had been following the wrong guideline so long that changing would have been too obvious an admission of error. It is not enough to ask a tax researcher a series of questions when the researcher does not understand the objectives or the environment into which the product is to be established.

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In the case of retroactivity, it is basic that the researcher and the administrator know that insurance can never be retroactive by the very nature of insurance. In any kind of insurance, there cannot be any retroactivity. In Section 105, which applies to all employers, there is repeated reference to insurance as such and its characteristics apply to self-insurance as well. The interpreters of tax laws in their revenue and letter rulings, and more dependably the court cases cite insurance as meaning risk; and there is no risk when the insured event is known before the insurance is in effect.

The references to court cases cited below include 14 instances where 28 federal judges have concluded that retroactive plans are invalid. Where the employer elects to pay for some health care event, which was incurred before the benefit existed, such payment was not adjudicated as being tax-free but rather was a form of added income to the employee.

According to IRS statistics, there are over 20,000,000 sole proprietors in business. Less than 1% of these use the opportunity to write off their personal family health care. Of course, some may not have a spouse or a spouse cannot or will not work in the owner's business. Even allowing for many short-lived businesses, there must be millions who could take advantage of their right to having their spouse become a legitimate employee and legally receiving an employee benefit program covering the spouse and the spouse's entire family. It is the same privilege enjoyed by working corporate owners, but they do not have to be married to get tax-free benefits because these owners are employees of a corporation.

The sole proprietor deserves a professional effort when they pay for professional services. We can agree that tax professionals expect the same level of professionalism from their sources which supply the tax professional – expecting that such people have done the research and, importantly, continue to do the research – where the changes in the tax code are measured by over 15,000 pages of material annually. The clients have the right to expect that the research for any program is complete, current, and provable.

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INVALIDATION OF BENEFIT PLANS

	No Risk When Retroactive 1a	No Risk If $ Back To Employee 1b	No Sync Of Plan With Illness 1c	No Plan Documentation 2	No Employee Plan Notification 3	Discrimination – Who Is Eligible? 4a	Plan For Non – Employees 4b	After Fact Decisions Possible 4c
American Family Mutual [TC Memo 50,025]	X	X	X	X	X	X		X
American Foundry [76-1 USTC ¶9401]	X		X	X				X
Bogene [TC Memo 68,147]	X							X
Burr [TC Memo 66,112]	X		X	X	X	X		X
Caplin [718 F.2d 544 & 1139]	X							X
Chism [322 F.2d 508]	X					X		X
Epmeier [199 F.2d 956]	X							
Epstein [TC Memo 72,053]	X							X
Harris [77-1 USTC ¶9414]				X	X	X		X
Kaufman, L. [35 TC 633]	X		X	X		X		X
Lang [41 TC 357]	X		X	X	X	X	X	
Larkin [48 TC 629]	X					X	X	X
Levine, S. [50 TC 422]				X	X	X	X	X
Seidel [TC Memo 71,238]	X		X	X		X	X	X
Smith, E. B. [TC Memo 70,243]	X			X	X			X
Smithback [76-1 USTC 9373]				X		X	X	
Sturgill [TC Memo 73,281]	X					X	X	
Wollenburg, W. W. [2000-1 USTC ¶50,156]	X							X
Letter Ruling 93-21068	X		X					
Proposed Regulations §1.125-1 Q&A-8								X
Proposed Regulations §1.125-1 Q&A-17, (1st)	X							
Proposed Regulations §1.125-1 Q&A-17, (3rd)	X		X					
Proposed Regulations §1.125-1 Q&A-21	X		X					
Proposed Regulations §1.125-1 Q&A-27	X		X					
Revenue Ruling 71-403, 2002-58	X		X					
Section 1.105	X		X		X			

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