

Some IRS RULES On Health Care Deductions

An employer (sole proprietor) cannot give himself tax-free employee benefits because he does not qualify for tax-free employee benefits. However, he can hire his/her spouse and provide this employee with accident and health care benefits as a business expense. The benefits can be established as family benefits covering the employee and employee dependents; and one of the dependents is the employer-spouse. The benefits are deductible as a business expense. In addition, the cost of the benefits is excludible from the employee's gross income.

The funding of the benefits can be done solely by the employer, solely by the employee, or some combination of the two. Where the employee funds any benefits, there should be a record or log of the employee effort to perform work and earn at least the amount of the benefit the employee has agreed to fund. Where the employee has agreed to fund the entire cost of the benefit, and has applied all earnings to the benefit, the employee's gross income becomes zero and there cannot be any taxes withheld, and no taxes are reported to the IRS, eliminating the need for a W-2.

If the employee family (including the employer) does not utilize all benefit funds set aside, the unused funds revert to the employer (the funding originated by the business was in lieu of payroll... and having not been used for payroll or benefits, they go back into the business). Another factor is that paying for health care is shifting the risk of an unknown expense... this is another way of establishing insurance. In addition, if the funds are inadequate for covering the future unknown health care expense, the amounts set aside cannot be changed. An IRS auditor can demand to examine records of employee hours and health expenses as well as documentation for the plan of benefits and its funding. Lack of proper documentation can make the plan out of compliance and void the deductions taken.

An excellent technical write-up is available from:

Commerce Clearing House
4025 W. Peterson Ave.
Chicago, IL 60646

The write-up is identified as UIL 162.35-02 dated 3/29/99. It is technically referred to as:

Reference Document
IRS Position Reports Service
Transfer Binder 1999-2000
80400 UIL 162.35-02 Dated 3/29/99