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TAX SAVINGS WITH AN EMPLOYEE-SPOUSE MEDICAL REIMBURSEMENT PLAN

Among the things that motivate business owners to start their own businesses are the tax savings that can be realized by being self-employed. Some tax saving strategies are more effective than others, but, every once in a while one surfaces that makes the search worthwhile. One of those could be an employee-spouse medical reimbursement plan.

The tax savings generated from properly setting up and operating a medical reimbursement plan for an employee-spouse can be substantial. The employee-spouse doesn't have to be a full-time worker and there is a potential opportunity to deduct family medical costs (including health insurance premiums) as employee compensation. However, there are very specific steps that **must** be taken to ensure the plan isn't set up to fail:

Have a written plan document. The medical reimbursement plan **must** be in writing. It is also critical the plan doesn't discriminate in favor of the highly compensated employees, the business owner, or his or her spouse.

Have the employee-spouse sign an employment agreement. Upon the employment of your spouse, make sure a properly **executed employment agreement exists**. This agreement should include the statement that medical expense reimbursements will constitute all or part of the employee-spouse's compensation. The agreement should detail the employed spouse's expected duties, hours and language to make sure that his or her annual compensation will not exceed what is reasonable for the duties performed and the hours worked. There should also be an annual cap on plan reimbursements to prevent excessive compensation from being paid. Lastly, make sure the employment agreement is signed by the employee-spouse.

Maintain a record of the employee-spouse's timesheets. The employee-spouse should not only turn in timesheets regularly, but the time sheets should document duties performed and actual hours worked.

Make sure the cash flow trail is proper. The employee-spouse should directly pay all insurance premiums and medical expenses that are intended to be covered by the plan and then be reimbursed for the paid expenses with checks drawn against the employer's business account. Payments should **NOT** be made out of the employer-spouse's personal account or out of a joint personal account. It is important that the flow of cash supports the existence of a legitimate medical reimbursement plan.

Take special care in titling the health policy using the proper name – namely the employee-spouse. IRS is clearly focusing on taxpayers who have the health insurance policy issued in the name of the employer-spouse. Whenever possible, put the health policy in the name of the employee-spouse and have the employee-spouse cover the employer-spouse plus the dependents (if applicable).

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All expenses must be substantiated. Copies of billing notices, invoices and cancelled checks evidencing reimbursement should be maintained by the employer. The employee-spouse should also keep records of expenses that he or she paid with personal funds before being reimbursed under the plan.

Following the above steps **carefully** will provide several benefits to the unincorporated business and business owner:

- Medical expense reimbursements are received by the employee-spouse **free of any federal income or employment taxes** because they qualify as tax-free fringe benefit payments
- The **business owner** (employer-spouse) **can deduct 100%** of the plan's medical expense **reimbursements** paid to or on behalf of the employee-spouse as either a Schedule C, E, or F business expense.
- The potential for a double federal tax break exists because this type of plan **can reduce both federal income tax and self-employment tax**.

Based on recent tax court decisions, there are several lessons to learn when dealing with the employee-spouse medical reimbursement plan. However, the benefits can be significant if these plans are properly executed. Now is the perfect time to put one of these plans in place for 2012. Contact our office for assistance on this and other tax planning strategies specifically geared for the small business owner.