



March 2017

## Blueprint for Employee-Spouse 105-HRA (Health Reimbursement Arrangement)

The Affordable Care Act does not apply to a business that has only one employee.<sup>1</sup>

This opens the door for what we are going to call the 105-HRA. We created this name from its two predecessors:

1. The Section 105 medical reimbursement plan
2. The health reimbursement arrangement

The 105-HRA gives you the best possible medical reimbursement plan—if you can qualify. The first requirement is to have one employee only. The second requirement is to operate the business as one of the following:

- Proprietorship reporting on Schedule C of IRS Form 1040
- Partnership filing IRS Form 1065
- Real estate rental business rising to the level of a business and reporting on Schedule E of Form 1040
- Farm business reporting on Schedule F of Form 1040
- C corporation filing IRS Form 1120

Before getting into the details of how you make this work for you if you are one of the taxpayers who fit this niche, let's look at an example of how this can save money.

**Example.** Using a properly designed 105-HRA, Henry reimburses his employee-spouse \$22,000 for medical expenses (health insurance, co-pays, other medical expenses not covered by insurance). Henry is in the 25 percent federal tax bracket, the 15.3 percent self-employment tax bracket,<sup>2</sup> and the 8 percent state tax bracket. With the 105-HRA, Henry saves \$10,626 in taxes this year and likely a similar amount every year he is in business.

## ***Why This Works for Henry***

Henry operates his business as a proprietorship. Tax law does not consider proprietors to be employees for purposes of medical plans.<sup>3</sup> This means there are no business deductions on the proprietorship tax return for Henry's medical expenses. To overcome this impediment, Henry hires his spouse as his one and only employee.

**Creates deduction.** The family health insurance plan is in Henry's spouse's name. This means the health insurance is not established in Henry's business, and so he does not qualify for the self-employed health insurance deduction on page 1 of his Form 1040. With the 105-HRA, Henry creates tax deductions where none existed before.

To see how the rules can disappear some or all of the self-employed health insurance deductions, check out the difficulties and slippery requirements in [Beat Sneaky Traps and Unfair Limits on the Self-Employed Health Insurance Deduction](#).

Without his spouse as his employee qualifying for the 105-HRA, Henry as a proprietor would have to put the \$22,000 of medical expenses on his tax return as itemized deductions, where they

- would suffer a 10 percent of adjusted gross income floor and
- would not qualify as business deductions that reduce self-employment taxes.

In Henry's case, his net itemized medical deduction would have been \$10,000, producing a net cash benefit of only \$3,300—a far cry from the business deduction that gives Henry a net cash benefit of \$10,626.

## ***Reimbursement Rules***

Your 105-HRA may reimburse the eligible employee for medical care expenses described in IRC Section 213(d).<sup>4</sup> You find almost all of these expenses in [IRS Publication 502](#), and that publication provides clarity on what you can and cannot reimburse.

Your 105-HRA may neither (a) reimburse a medical care expense incurred before the date the 105-HRA is in existence, nor (b) reimburse a medical care expense incurred before the date an employee first enrolls in the 105-HRA.<sup>5</sup> This means if you qualify, you want your plan in place now.

The 105-HRA plan may reimburse the employee for expenses incurred for the medical care of<sup>6</sup>

- the employee,
- 
- the employee's spouse (you),
- 
- the employee's dependents, and
- 
- any child of the employee who, as of the end of the taxable year, has not attained age 27.

## ***Documentation Strategies***

One frequent IRS attack on the 105-HRA is that the spouse is not an employee and thus is not eligible for the 105-HRA.<sup>7</sup> What does it take to prove that your spouse is an employee? Many tax pros like to use a W-2 with a small salary, say \$1,000, to help establish employment.

Regardless of whether you pay a salary, you want any part-time spousal employee to submit a weekly time sheet showing the date, work description, and time spent on that work. The weekly work record is very important documentation.<sup>8</sup>

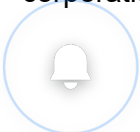
Here is a very straightforward time sheet (work record) that you can use:

- [Click here](#) for a PDF copy.
- [Click here](#) for an Excel copy.

Avoid using an employment contract. It's a trap for most taxpayers because after a month or so the tasks performed no longer match the employment contract. Further, you don't need the employment agreement to prove employment. The work-performed time record is far better proof of employment than an employment contract.

Have your spouse-employee pay all medical expenses from a separate personal checking account. If the proprietorship paid a medical expense directly, it's best for the spouse to reimburse the proprietorship. The 105-HRA audit-proof system is to have the spouse pay all the medical expenses from his or her checking account.

The 105-HRA produces business deductions. You need to handle the reimbursement of the medical expenses in a businesslike manner. The tax code requires that you make sure your employee-spouse (or you with your C corporation) substantiates the medical expenses before being reimbursed.<sup>9</sup>



To give you some guidelines for the reimbursement from your business checking account to your employee-spouse, consider using our sample 105-HRA reimbursement request form or something similar ([form in PDF](#), [form in Word](#)). Require your employee-spouse to submit expenses for reimbursement (or do so yourself through your C corporation) no less frequently than monthly.

Make sure you and your spouse sign and maintain a formal plan document.<sup>10</sup> For a sample 105-HRA plan document that you can use, [click here for the plan in Word](#) or [here for the plan in PDF](#).

The 105-HRA reimbursement is considered compensation to your spouse.<sup>11</sup> Make sure you can prove that the total compensation paid to your spouse is reasonable. For example, if Henry's spouse worked 500 hours, her hourly pay would equal \$44 an hour ( $\$22,000 \div 500$ ). That's \$91,520 for a 2,080-hour full time worker.

Is that \$44 an hour reasonable pay for the work done? If not, then either the hours worked or the amount reimbursed needs to change to ensure reasonableness.

**Gather proof.** See what pay rates apply for the type of work you have your employee-spouse doing. You can find such rates in newspaper articles, salary guides, and job postings; at LinkedIn and other sources; or by asking others who employ similar workers. Print the documents containing proof, and put them in your tax file.

Don't skimp on this documentation part.

## ***Discrimination with the 105-HRA***

Your 105-HRA plan can exclude<sup>12</sup>

- employees who have not completed three years of service,
- employees under age 25, and
- seasonal and part-time employees.

For the full scoop on 105-HRA discrimination, see [Discriminate with Your 105 Plan](#).

**Caution.** Make sure your employee-spouse qualifies for plan coverage before implementing any discrimination rules. For example, don't shoot yourself in the foot by using the part-time rule of less than 25 hours a week to exclude your new part-time employee when your spouse works 18 hours a week.

## ***How the 105-HRA Works***

**Big picture.** The Section 105 plan turns personal medical expenses into business deductions.

The plan, when designed for spouses, reimburses employee-spouses for family medical expenses, turning such reimbursements into business expenses deductible on the tax return as employee welfare benefits.

You cover your employee-spouse with family coverage, and that's how you, the employer-spouse, get your coverage.

If you are single, don't worry. You don't have to get married to get the benefits of the Section 105 plan. Instead, you can create what amounts to a no-hassle solution by simply operating your business as a C corporation. The C corporation is a separate legal entity that can provide 105-HRA benefits when it has one eligible employee only (meaning that you are the only employee).

## ***Eligible Employees***

If you have eligible employees besides yourself and your spouse, you don't qualify for the 105-HRA and should consider other plans such as the qualified small employer HRA (QSEHRA), a less-than-20-employee integrated HRA, a less-than-50-employee HRA, or the Section 125 plan (with or without a flexible spending plan).

For purposes of any Section 105 plan, your employees are far more numerous than you might think. First, you need to consider all your and your spouse's businesses. All employees found in these businesses, including your spouse's businesses, are deemed by Section 105 to be your employees.<sup>13</sup> And remember, the 105-HRA is a plan that works with one eligible employee only.

**Planning tip.** If you have more than one eligible employee, consider the QSEHRA as described in [Announcing NEW Tax-Deductible, Penalty-Free Health Plans for Small Businesses](#).

## ***Sole Source of Pay***

The 105-HRA, if fair compensation, can be the sole source of remuneration to your spouse. In a spouse-only operation, this eliminates the need for a payroll, which means no payroll tax payments or filings (see [Q&A: Proof for the IRS That No W-2 Is Needed for the 105 Plan](#)). Note that many tax pros know this rule but prefer the W-2 as added proof of employment.

## ***Takeaways***



In the right circumstances, the 105-HRA turns some or all of your personal medical expenses into business deductions. The right circumstances start with having one eligible employee only, such as

- an employee-spouse in a proprietorship, partnership, farm business, or Schedule E rental that rises to the level of a business, or
- an owner in a C corporation with no other employees.

With more than one employee and fewer than 50 employees, consider the QSEHRA as a good choice.

This article gives you the nuts and bolts of the 105-HRA, including a sample 105-HRA plan document and an employee 105-HRA medical reimbursement request for your use.

**New Feature: Client Letter on This Article for Use by Tax Pros, [Click Here.](#)**

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1 Notice 2013-54.

2 For clarity, we are using the 15.3 percent gross self-employment tax rate. When you complete a tax return, the effective tax rate is 14.13 percent (15.3 percent x 92.35 percent).

3 IRC Section 105(g); Notice 2002-45.

4 IRC Section 213(d).

5 Notice 2002-45.

6 IRC Section 105(b).

7 See Lack of a Time Sheet Kills the Section 105 Plan.

8 Ibid.

9 Notice 2002-45.

10 Reg. Section 1.105-11(b).

11 Peter F. Speltz v Commr., TC Summary Opinion 2006-25.

12 IRC Section 105(h)(3)(B); Reg. Section 1.105-11(c)(2)(iii).

13 IRC Sections 105(h)(8); 318(a); 414(b); 414(c); 414(m); 414(m)(6)(B); 1563(a); 1563(e)(5).

