**MERP Section 105 Plan for less than**

**2 Participating Employees**

Section 105 of the Internal Revenue Service (IRS) regulations allows for reimbursement of medical expenses under an employer-sponsored health plan. There are various types of Section 105 plans including: Health Reimbursement Arrangements, Medical Expense Reimbursement Plans, Accident and Health Plans, and more.

In this section, we discuss the portion of a Section 105 Plan as it pertains to an Accident and Health Plan which will be for a Medical Expense Reimbursement Plan (MERP) for less than 2 participating employees. You may also offer this Plan to qualifying retirees from the company who meet the requirements.

The IRS affords for an Accident and Health Plan pursuant to Section 105 of the Code. This type of plan encompasses Revenue Ruling 71-588, is supported by Letter Ruling 9409006, and meets the compliance regulations of other government agencies including the Department of Labor (DOL) and the Employee Retirement Income Security Act (ERISA).

The concepts surrounding both the rulings and the Code allow for a self-employed individual to employ his/her spouse who is active in the business, and to offer that employed-spouse a medical benefits package. The benefits offered cover the employee, the employee's spouse, and the employee's dependents.

In reality, this allows the self-employed individual to deduct 100% of his/her family's health costs from federal, state, and FICA/Medicare taxes. Standard tax law allows healthcare premiums to be deducted at 100% from federal and state taxes, leaving a substantial amount of potential tax savings on the table.

**Benefits of the Plan**

A Section 105 Plan allows a qualified business owner to deduct 100% of

* health insurance and dental insurance premiums for eligible employee(s) and family. This also includes qualified long-term care insurance.
* uninsured (out-of-pocket) medical, dental, and vision care expenses for eligible employee(s) and family.
* life, disability income, contact lens, hearing aid, Medicare Part A, Medicare Supplemental, optical/vision, and cancer insurance premiums for eligible employee(s).

**Qualified Filing Statuses**

While the above rulings specifically address family employment in a sole proprietorship, corporations and partnerships may also take advantage of a Section 105 Plan. Additionally, employers seeking to offer non-related employees a medical benefits package may also implement such a plan. Here is how a Section 105 Plan works within the various filing statuses.

**Sole Proprietorships**

Section 105 works well for sole proprietors who are able to legitimately employ a spouse who is active in the business. An employed spouse will be treated as any other employee, with the business owner offering medical benefits as part of the employee's compensation package.

**Partnerships**

A partner in a partnership will operate similarly to a sole proprietorship. The spouse of the partner must be a bona fide employee, thus receiving the benefits of the plan. However, a partnership between a husband and a wife will not qualify for the plan.

**C-Corporations**

Unlike the sole proprietorship or partnership, it is not necessary for spousal employment to occur within the corporation. The corporate entity may provide and deduct benefits for the owner-employee director. Although sometimes misunderstood, even if a business is incorporated, all the proper components must be in place in order for a Section 105 medical reimbursement plan to be in compliance with Internal Revenue Code, DOL, and ERISA.

**S-Corporations**

While S-Corporations can qualify for a Section 105 Plan, special rules (defined by Revenue Ruling 91-26 and Announcement 92-16) apply to medical benefits paid to a 2% or greater shareholder. The special rules apply to shareholders only; employees not owning stock in the corporation may realize substantial savings by participating in a Section 105 Plan. Determination of actual savings depends on the facts and circumstances of each case.

**Limited Liability Company**

Treatment of a Limited Liability Company (LLC) with respect to a Section 105 medical reimbursement plan depends upon how the entity files for purposes of its federal tax return. They may file as a partnership, a corporation, or a sole proprietorship. Once the filing status is determined, the appropriate rules for each filing status apply.

**Plan Year**

Section 105 Plans generally run on a calendar (tax) year, January-December. Tax deductions are then taken during tax filing the following year.

**Carry Over**

Revenue Ruling 2002-41 includes an option for a Section 105 Plan to manage and capitalize on future deductibility of unused portions of a medical expense account. If an employee does not use their maximum, they can carry it over to future years, insuring future deductions for "shock" years of healthcare expenses.

The Carry Over applies to all employees on the plan. The maximum amount available under this benefit will accumulate over plan years and will be managed on an employee-by-employee basis. The business owner may choose to set a maximum Carry Over amount. Meanwhile, employees who utilize the Carry Over will have the amount available to them until the business ceases to exist, the plan terminates, there are zero Carry Over dollars remaining, or the employee becomes ineligible.

**Employee Compensation Under a Section 105 Plan**

The Internal Revenue Code allows self-employed business owners to compensate employees for services rendered in various forms. The most common form of course is cash wages, subject to the appropriate withholding taxes. In addition to wages, the IRS Code clearly explains that an employer may compensate employees in the form of medical benefits for services rendered. Pursuant to the Code, eligible and qualifying paid-for benefits are tax-free to the employee.

When the business owner compensates employees in the form of cash wages and medical benefits, they must ensure that the combination of the two equal the employee's total compensation package. When establishing benefit maximums, it is vital that the business owner understands that the benefits and the cash combined may not exceed what would normally be considered reasonable compensation for the job the employed-spouse is doing. The following example illustrates how a typical compensation package is determined.

Jim owns his own business. Jim's wife, Mary, provides a valuable service to the farm by helping out in the field, running errands, and keeping the books. Jim decides to formally employ Mary and take advantage of a Section 105 medical plan (Health Reimbursement Arrangement). When establishing a compensation package for Mary, Jim evaluates her experience and the vital role she plays in the business. Jim compensates Mary $14,000 total per year in the following way:

1. Reimbursement for family health premiums: $7,000

2. Reimbursements for uninsured medical expenses: $5,000

3. W-2 Cash Wages: $2,000

TOTAL $14,000

By allowing for a **100% federal, state, and FICA tax deduction** of the $12,000 of reimbursed expenses, Jim would receive $4,200 in actual tax dollar savings by taking advantage the Section 105 Plan.

NOTE: If Jim's farm files its taxes as a corporation, he would be the employee and a similar tax savings plan could be established without hiring Mary.

**Qualified Medical Expenses**

Medical expenses included under this type of plan are those defined in Section 213 of the Internal Revenue Code. As a general rule, medical care includes amounts paid for diagnosis, cure, mitigation, treatment, or prevention of a disease. Appropriate expenses include, but are not limited to:

Health Insurance Premiums Dental Care Fees Hospital Bills

Deductibles Vision Care Fees Laboratory Fees

Physician Fees Chiropractor Care Fees Orthodontia Costs

Prescription Costs Psychiatric Care Fees Medical Supplies Costs

**Eligibility Requirements**

You can restrict participation under the terms of Section 105. You can make participants wait up to 90 days upon hire. You can further add a probationary period where the participant is ineligible for benefits from 1-36 months. You can require that the participants be at least 25 years of age. Last- you can require that they work at least 25 hours a week or more to be considered eligible.

**Tax Filing Forms**

In accordance with Section 105, the spouse is not considered a bona fide employee. The forms that are required for any non-related employees also must be completed for related employees (Spouse, children older than age 18 earning more than the Standard Deduction). They include the following:

* W-2 Form (annually)
* W-3 Form (annually)
* I-9 Form (one time)
* 941/943 Forms (quarterly or other frequency, depending on specifics)
* Form 940 for employees other than spouses

**Managing the Plan**

The most important concept surrounding a Section 105 Plan is legitimate employment between spouses or any other named employee. This issue is closely scrutinized by the IRS, and it is absolutely vital that the relationship be in existence. Fabricated relationships are absolutely discouraged. Therefore, the following items must be in place to ensure the plan operates smoothly and the tax advantages are maximized:

* A written employment agreement.
* A log of hours worked by the employee.
* An established cash (salary) compensation payment amount and schedule.

In addition, it is recommended to:

* Name the insured (it is preferred that the insurance policy be in the employee's name).
* Maintain separate checking accounts (one for business use and the second for personal use).
* Pay for medical expenses (all medical expenses for the family should be paid by the employee from her/her personal account), and document all payments.