August 16, 2012

The Need for a Plan: *DKD Enterprises, Inc. v. Commissioner*

By: Elliot Pisem and David E. Kahen

The means by which individuals acquire health insurance coverage for themselves and their families are much in the news, as the rules mandated by the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 come closer to full implementation. Health coverage provided under employer-funded arrangements seems likely to remain a significant portion of our health care system for years to come, and evolving tax rules encourage employers to pay or reimburse employees for certain health care expenses.

In some circumstances the existence of a "plan" is an essential element of achieving the desired tax treatment for an employer's payment of health care costs.[1] A recent decision of the Court of Appeals for the Eighth Circuit underscored the importance of having medical insurance coverage provided to employees pursuant to an "accident or health plan" adopted by the employer, and held that health insurance premiums paid by the corporation on behalf of its principal employee and sole shareholder, but not pursuant to an accident or health insurance plan of the employer, (i) were not deductible by the corporation, but (ii) were includible in the employee's taxable income. As a result of this decision, an apparently aggressive effort to claim costs unrelated to the principal revenue-producing activity of a corporation as business deductions backfired in several respects.

Elliot Pisem *and* ***David E. Kahen*** *are partners in the law firm of Roberts & Holland LLP.*

Background

DKD Enterprises, Inc. v. Commissioner[2] involved tax deficiencies asserted against Debra K. Dursky and her wholly owned corporation. As described in the Tax Court's lengthy memorandum decision and a shorter decision of the Court of Appeals, Dursky was an information technology ("IT") consultant. In 1997 she incorporated DKD Enterprises, Inc. ("DKD") to provide IT consulting services.

Throughout the years at issue (2003-2005), Dursky was the sole shareholder of DKD and the only individual employed by DKD to provide IT consulting services, and DKD maintained its place of operation at Dursky's residence in Iowa. During each of the years at issue, DKD reported annual gross receipts in a range between $197,000 and $234,000, and paid a salary to Dursky of approximately $80,000.

DKD also engaged in an activity of breeding, raising, and offering for sale cats and kittens of two breeds (the "cattery"). This activity was conducted by Dursky together with her personal partner, Elizabeth Watkins ("Watkins"), who resided with Dursky at the same residence and who spent more hours than Dursky on the cattery activity. This activity was conducted largely at the residence, but also involved attending numerous cat shows.

During the years at issue, Dursky and Watkins incurred various out-of-pocket expenses relating to the cattery activity (approximately $61,000-$68,000 per year) that were subsequently reimbursed to them by DKD. DKD claimed income tax deductions for these out-of-pocket expenses. In addition, DKD made and deducted payments of approximately $8,000 per year to Watkins, that were reported as wages by her and by DKD, and of $12,000 per annum to Dursky as purported rent for the use of her residence for the cattery activity.

DKD also made payments during the years at issue to two profit sharing plans, one a plan previously established by Dursky with Vanguard at a time when Dursky was self-employed, and the second a plan with Fidelity that was opened in 2001 in the name of DKD. Contributions with respect to the Fidelity plan were made in the amounts of $10,000 for 2003, $20,000 for 2004, and $5,000 for 2005. All of these contributions were made for the benefit of Dursky, and there was no indication in the evidence before the Tax Court of

payments having been made to the Fidelity plan for the benefit of Watkins.

Finally, DKD made payments of approximately $7,000 to $8,000 per year[3] on a health insurance policy purchased in Dursky's name and for her benefit, and claimed deductions relating to these expenditures on its tax returns for those two years.

The only revenue attributable to the cattery activity was from sales of three cats and kittens during 2004 for $250 and sales of eight cats and kittens during 2005 for $1,525. Dursky was informed during 2006 that the IRS intended to audit the tax returns of DKD and Dursky for prior years, and, perhaps unsurprisingly, no expenditures relating to the cattery activity were reflected on the DKD tax returns for 2006; however, Dursky and Watkins continued the cattery during that year as an unincorporated activity.

Following an audit, the IRS asserted substantial tax deficiencies against DKD and Dursky, as well as additions to tax (apparently attributable to certain tax returns' being filed late) and accuracy-related penalties, and the taxpayers sought relief in the Tax Court.

Following a trial, the Tax Court issued a memorandum decision that observed that it found the testimonies of Dursky and Watkins (the only witnesses at trial) to be "in certain material respects questionable, implausible, unpersuasive, uncorroborated, vague, and/or conclusory". The court also characterized the testimony of Dursky as in certain material respects self-serving, and the testimony of Watkins as in certain material respects serving the interests of Dursky and DKD. The court then observed that it would not rely on the testimonies of the witnesses with respect to the issues to which the testimonies pertained. The tax deficiencies asserted by the government against the petitioners were largely upheld by the Tax Court.

Analysis

The three principal issues addressed on appeal to the Court of Appeals for the Eighth Circuit were the Tax Court's agreement with the IRS's denial to DKD of deductions (i) for operational expenses of the cattery, which the Tax Court had found to be a personal hobby of Dursky, rather than a bona fide trade or business; (ii) for payments made to the Fidelity profit-sharing plan, which the Tax Court had held not to be a "qualified" plan (under relevant provisions of the Code), because Watkins was not a participant in the plan, and the plan therefore improperly discriminated in favor of Dursky, DKD's sole highly compensated employee; and (iii) for payments made with respect to the Dursky health insurance policy, for which deductions had been denied because the payments were not made pursuant to an accident or health "plan" adopted by DKD.

Dursky also challenged the Tax Court's conclusions that the expenditures in respect of the cattery, and the Fidelity profit sharing plan, resulted in constructive dividends to her and were therefore were includible in her income for those years, and that she was also liable for income taxes with respect to the payments made by DKD on her behalf for health insurance.

As to the "hobby loss" issue, the Court of Appeals appeared to agreed with the finding of the court below to the effect that there was substantial evidence that DKD engaged in the cattery activity for the personal pleasure of Dursky, rather than with a profit motive; and that DKD failed to establish that the cattery constituted a trade or business with respect to which expenditures would generally be deductible under Code section 162(a). The Court of Appeals also agreed with the Tax Court that, in light of the findings that DKD lacked a legitimate business purpose to operate the cattery and that the operation was undertaken by it for the personal pleasure of Dursky, it was appropriate to treat that operation as resulting in constructive dividends to Dursky as the sole shareholder, and to quantify those dividends by reference to the amounts expended by DKD, as opposed to the value (presumably minimal if any) of any resulting financial benefit to Dursky.

As to the contributions to the Fidelity profit sharing plan, the Court of Appeals held that the contributions made by DKD with respect to the 2003 and 2004 taxable years were deductible, and remanded to the Tax Court for further consideration the issue of the appropriate tax treatment of the contribution made with respect to the 2005 taxable year. The IRS had originally asserted on audit that the contributions to the Fidelity plan were not ordinary and necessary business expenses and therefore not deductible under section 162(a). The rationale was for that assertion, however, was not made clear, and at trial before the Tax Court the Commissioner made the additional argument that the plan was not a qualified plan because it discriminating in favor of Dursky, DKD's sole "highly compensated" employee.[4]

Because this additional argument was first raised at trial, the Commissioner bore the burden of proof on this issue. DKD and Dursky successfully argued to the Court of Appeals that the Commissioner had failed to establish a fact critical to the government's argument, namely, that Dursky was in fact the only employee of DKD enrolled in the Fidelity plan in the years at issue.

With respect to the treatment of payments by DKD of premiums on Dursky's health insurance policy, the Court of Appeals agreed with the Tax Court that the taxpayers had not established that the payments were an ordinary and necessary business expense deductible by DKD under Code section 162(a), or excludible from Dursky's income. Both courts referred to a regulation under section 162 which provides that "[a]mounts paid or accrued within the taxable year for ... a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit *plan*, are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business" (emphasis added),[5] and to Code section 106(a), which provides that the gross income of an employee "does not include employer-provided coverage under an accident or health *plan*" (emphasis again added).

Relevant regulations and case law make clear that, in order for medical benefits to be excludible from the beneficiary's income under section 106(a), there must, in fact, be an accident or health "plan,"[6] that is, a program or practice (if not a formal plan) to pay such amounts, and the employees must generally have knowledge of the plan, although the regulations do indicate that the plan need not be in writing, or enforceable against the employer.[7] There is no requirement under section 106 that the plan be applied in a "non-discriminatory" manner, with payments made in the same manner with respect to each employee.[8]

Here, there was no evidence, beyond the testimony of Dursky that DKD paid her quarterly medical insurance premiums, in support of DKD's having a "plan." Given the lack of evidence, the Court of Appeals agreed with the Tax Court that the insurance payments were not deductible by DKD, and were includible in Dursky's income.

It is not clear whether the taxpayers argued, or whether either court otherwise considered the possibility that, since the premium payments were obviously for the benefit of the employee and paid in connection with her performance of services for DKD, the premium payments should have been viewed -- notwithstanding the absence of a "plan" that would have allowed Dursky to exclude the premium payments from her individual income -- as additional compensation for services (rather than a constructive dividend) that would be deductible by DKD under section 162(a)(1) as part of a "reasonable allowance for salaries or other compensation for personal services rendered."[9]

Although the regulations governing an employer's deduction for health benefits also make reference to a "plan," a close reading of those regulations reveals a significant ambiguity (not addressed by the courts) as to whether they require an employer plan as a prerequisite to a deduction. In this case, the facts that Dursky was DKD's sole shareholder and that other payments at issue in the decision were characterized as constructive dividends rather than as compensation perhaps facilitated the court's thinking that the health insurance premiums amounts as well were not deductible as compensation.

Whether the health insurance premium issue would even have been pursued by the IRS on audit of a taxpayer that had not muddied the waters with an aggressive attempt to deduct expenses attributable to its sole shareholder's hobby is, of course, impossible to determine.

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1 Similarly, in an example well-known to tax practitioners who deal with corporate tax matters, a "plan of reorganization" is required in order to achieve the desired tax results of certain "reorganizations" described in Internal Revenue Code ("Code") section 368. See IRC §§ 354(a), 361(a) and Treas. Reg. § 1.368-1(c).

2 110 AFTR 2d 2012-5258 (8th Cir. 2012), affirming in part and reversing in part TC Memo 2011-29 (2011).

3 It appears that these health insurance premiums were paid only during two of the taxable years in issue.

4 See IRC § 401(a)(4).

5 Treas. Reg. § 1.162-10(a).

6 See Treas. Reg. § 1.105-5(a); *American Family Mutual Insurance Co. v. United States*, 71 AFTR 2d 93-945 (D. Conn. 1992); and Rev. Rul. 71-403, 1971-2 C.B. 91.

7 Treas. Reg. §1.105-5(a). The "knowledge of the plan" requirement applies if the employees' rights to benefits under the plan are not enforceable.

8 See Rev. Rul. 61-146, 1961-2 C.B. 25. Penalties under other Code provisions may be imposed with respect to health insurance plans that do not meet specified criteria, but those requirements are beyond the scope of this article.

9 The dividing line between payments to or for the benefit of employee/shareholders that should be treated as constructive dividends, and those that should be treated as compensation is ill-defined and can be difficult to discern. See generally Treas. Reg. § 1.301-1(d); *King's Court Mobile Home Park, Inc. v. Commissioner*, 98 T.C. 511 (1992); and cases cited therein.