

Employer Paid Cosmetic Surgery: Tax Consequences to the Employer and Employee

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The tax treatment of cosmetic surgery to serve a business purpose has come under IRS scrutiny. This paper looks at an employer request of an employee to undergo breast augmentation for the benefit of the employer. Tax consequences to the employee and employer need to be considered. Though a situation like this would often lead to a taxable event to the employee, there are considerations in which cosmetic surgery could be a deductible event to the employer, and not taxable to the employee. As a result of a small change within the Tax Cuts and Jobs Act (TCJA), it appears that the tax benefits to the employee are significantly improved. All identifying information of the employer and employee have been altered for discussion within this paper.

Keywords: Section 132, Section 162, Section 261, Section 262, business expense, income recognition, fringe benefits

INTRODUCTION

Nicole has had a storied career as a marketing manager at a retail chain that sells farm equipment, called *The Tractor*. Emerging from the pandemic, to regain market share, Nicole, along with ownership decided to work with a national marketing consultant to develop a new advertising strategy for the company. Upon evaluation, the consultant suggested that the chain explore using Nicole, the marketing manager as the spokesperson in a new commercial promotion both TV and print for its equipment.

During filming and review of demo footage, the consultant discussed with management that Nicole would be more effective in the commercials if she were to have breast augmentation, as this would be more attractive to the target market of product users, and also make Nicole resemble a spokesperson currently used in an advertising campaign for the number one competitor of *The Tractor* that has been highly successful. Market research conducted by the consultant also showed that the success of the advertising campaign for the competitor was attributed to the attractiveness of the model used within the campaign, specifically the breast size.

After discussion with business ownership, and legal counsel over the appropriateness of the request relative to any legal matters, *The Tractor* approached Nicole and offered to fully fund the cost of breast augmentation so she can be more effective in a long-term advertising campaign for *The Tractor*, and shared the market research data by the consultant supporting the request. Nicole was excited for the offer and agreed to have her breasts augmented for the purpose of the commercials. Nicole was instructed to obtain surgical consultations from three surgeons, select the one she felt most comfortable with, and *The Tractor*

would cover all costs of the surgery, and pay all involved medical providers directly for the cost of the surgery. Nicole was also reimbursed for all necessary recuperation costs.

Though individuals might not think of this situation on a daily basis, this true situation raises some serious tax questions that can be explored, that apply to many types of cosmetic surgery in a variety of professional careers, specifically:

1. Can *The Tractor* deduct the cost of the breast augmentation surgery, or other cosmetic surgery as a business expense?
2. Does Nicole need to include the value of the breast augmentation as compensation or any other form of income on her tax return?

ISSUE 1: IS THE COST OF BREAST AUGMENTATION A BUSINESS EXPENSE TO THE TRACTOR?

First, it is important to consider the definition of a deductible business expense. From a policy perspective, Congress designed the business taxation system to reflect only the increase in wealth from a business, specifically the net increase in wealth. In the Internal Revenue Code, the definition states there shall be allowed as a deduction all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business (§162). *Welch v Helvering* further defines that the expense be ordinary to be deductible, but at the same time the definition of ordinary does not have to be typical or repetitive in nature (*Welch*). The expense also has to be necessary, which means that the expense is helpful or conducive to the business activity, but does not need to be essential or indispensable. *Kovach (1995)* does show that there is complexity within the business taxpayer deductibility of business expenses, and has difficulties which can put burden on the employer to show how the expense does fit into loose criteria allowing the deduction. Much of the specific research and cases within this area applies to executive compensation, athletes, lobbying expenses, as well as business expenses of illegal activities.

The expense also has to be reasonable, which according to case law means that it is not extravagant or exorbitant (§162, *Lincoln Electric, US v, Haskel, Fuhrman, Edwards, South Salina*). This rule specifically applies to the arms-length cost paid for the service, which in this case would be the breast augmentation to the involved medical providers, relative to what other providers would be paid.

Based on the above definition, it would appear that the expense for Nicole to have breast augmentation would qualify as a deductible business expense for *The Tractor*. As defined in *Welch v. Helvering*, ordinary does not have to be a typical or routine expense. In this case, a professional consultant with a national reputation in advertising has stated with experience, as well as market research data to show that other individuals with breast augmentation to a certain size are more effective in commercials to a specific target market. It is necessary, as market research does show that the augmentation will help business, and does not have to be essential or indispensable to qualify as deductible. In other words, though there might be other ways to successfully market the equipment rather than pay for an employee to have breast augmentation, if market research clearly shows that the augmentation can increase the effectiveness of the marketing campaign, and net profits of the business, it should be considered ordinary and necessary.

Furthermore, Nicole was requested to obtain consultation three surgeons prior to surgery, so if the fees were consistent between medical providers, and none of the providers were related parties the reasonableness test would likely be satisfied to support the amount deducted.

The conflict here is whether or not the breast augmentation could also provide personal benefit to Nicole outside of her occupation to not justify the surgery as a business expense. The Code is clear that taxpayers may not deduct personal expenses unless there is a specific provision in the law that allows it (§262a). In legal prescience, when there is a conflict between business expense deductions under §162, and personal deduction under §262, §262 would typically take precedence (*Sharon v Commissioner*).

There is significant case law to also show that costs paid by a taxpayer to enhance one's own health or personal appearance have not held to be deductible business expenses (*Sparkman v Commissioner*). Multiple other case law exists to support that business expenses paid by taxpayers to enhance personal experiences would be not deductible and fall under §262, even when in conflict with §162.

The Hess case specifically applies to breast augmentation (*Hess v Commissioner*). In this case, the plaintiff was an exotic dancer who had implants to expand her breast size to 44FF. For tax purposes, she deducted the cost of the augmentation surgery on her Schedule C. The IRS contested the deduction, but the courts ultimately ruled with the taxpayer supporting the deduction due to the fact that the large breast size was not conducive to everyday life and served no personal; purpose and was solely for her occupation as an exotic dancer.

Despite all of the case law that would disallow deductions for cosmetic surgery such as this, the fact pattern herein is different. The employer is directly paying for the augmentation as an advertising expense directly to the physician. Nicole is not self-employed, and not paying for the surgery in any way. The case law focuses on a self-employed taxpayer deducting the cost of their own expenses to enhance appearance. When an employer pays the expense for their specific business purpose, is it deductible? Based on case law which defines a deductible business expense, and the fact pattern to support, this expense does qualify as ordinary and necessary it seems reasonable that the cost of surgery and any other related costs would qualify as a deductible business expense and be deducted as part of marketing or advertising costs for The Tractor.

The case law herein may apply to Nicole, as to whether or not the value of surgery is includable to her as income.

ISSUE 2: IS THE VALUE OF BREAST AUGMENTATION PAID BY NICOLE'S EMPLOYER TAXABLE INCOME TO HER?

Taxable income is defined as all income from *whatever source derived* (§61). This definition is so wide reaching that it even includes income from illegal activities as taxable (*Eugene James v United States*). It is also clear that a taxpayer does not have to receive cash to receive income. A taxpayer needs to receive economic benefit (something of value), and this can be in the form of money, property or services (*Eugene James v United States*). It is likely that the value of the surgery in a strict sense meets the value of services received that would be included within income.

Though the strict definition of §61 likely defines income for Nicole, there are areas of exclusion where a taxpayer can exclude specific items from income. It is unlikely that the value of the surgery would be considered *De minimis* (§132 (a)(4)). It has also been determined in prior case law that the value of reimbursed cosmetic surgery is taxable unless the employee had surgery to correct a disfigurement from accident, disease or deformity.

It is unlikely that there could also be a successful argument that the value of the surgery would be a working condition fringe benefit. Under the definition of working condition fringe benefit, to exclude from income recognition the reimbursement would have to be deductible as ordinary and necessarily had the employee had paid the expense (*Eugene James v. United States*). There is significant evidence, specifically the *Hess* case which states that Nicole would not have been allowed the deduction for this surgery had she paid the expense (*Hess v Comm*). Though there may be arguments to make that exclude this surgery from income, it is likely that a successful argument will be an uphill battle based on prior litigation prescience. The value of the surgery would likely be considered taxable compensation to Nicole. Had Nicole followed the fact pattern of *Hess* and had her breasts augmented to a size such that they would not be functional outside of her work function at the request of her employer, then there may be an argument to exclude the surgery from income. This is not the case herein based on the facts provided.

THE ACCOUNTABLE PLAN

The Tax Cuts and Jobs Act (TJCA) had many significant changes, some of them well known to the public via media attention, and others quietly signed into law with little attention. Treasury regulation 1.62-2 creates what is referred to as an accountable plan, which very well may provide opportunity for the employer and employee to benefit aside from previous law discussed. Under an accountable plan, the employee can claim a deduction for a legitimate business expense that is not included within an employee income. Under this plan, legitimate expenses are governed strictly under Section 162 of the Internal revenue

code, which as previously stated deductions are allowed for “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.” In general, to be deductible as an expense of a trade or business, the expense must-

- be ordinary and necessary, and
- be an expense of the payer’s trade or business during the taxable year.

Unlike previous case law and the previous discussion on fringe benefits, which has ruled that under the definition of working condition fringe benefit, to exclude from income recognition the reimbursement would have to be deductible as ordinary and necessary had the employee had paid the expense (*Eugene James v. United States*), Nicole might get a break for the business expense if she pays for it, and is ultimately reimbursed under a formal employer sponsored accountable plan. The workings of an accountable plan have previously been discussed by Campbell et.al. (2020).

It is clear from the previous analysis within this paper that the cost of the surgery would be a business expense for *Tractor*. Under an accountable plan, if established by *The Tractor*, it is a strong argument that if Nicole were to pay for the cost of the surgery, and request reimbursement for the cost of the surgery, it would indeed be a deductible business expense for *Tractor* and not taxable income to Nicole.

As discussed in Campbell et.al. (2020), there are considerations that *Tractor* would need to consider if setting one of these plans up for employees within the organization. The rules for this plan, as defined in Campbell et.al. (2020) are:

1. Substantiation. Each employee must furnish adequate substantiation of all reimbursed expenses. In general, the substantiation (proof) is adequate if it identifies the specific nature of each expense and confirms that the expense is attributable to the company’s business activities (i.e., detailing who, what, when, where, and why). Evidence of expenditures generally includes receipts, canceled checks, or paid bills. Certain types of expenditures, such as travel, meals, and lodging while away from home, require specific documentation.
2. Business connection. The expenses must satisfy the requirements for deduction as “ordinary and necessary” business expenses (per IRC section 162) and must be paid or incurred by the employee in connection with the performance of services as an employee. An ordinary expense is one that is common and accepted in the industry; a necessary expense is one that is appropriate and helpful to a business.
3. Return of excess payments. The plan must require the employee to return, within a reasonable period of time (typically 120 days), any amount that exceeds the employee’s properly substantiated expenses.

It is important to ensure that the accountable plan is properly structured, as the IRS has been diligent in challenging arrangements that it suspects are merely attempts to conceal compensation and, thereby, avoid taxation. If the IRS determines a plan is nonaccountable, all reimbursements will be transformed into taxable wages and will be subject to income tax for the employee, as well as to employment tax for the employee and employer, as case law prior to the TCJA suggests should be the tax treatment. If the plan is properly established, the reimbursements will not be subject to any income or employment taxes. The employer, in this case *Tractor* would have to establish this plan, and have guidelines so that it applies to all employees, which may increase expenses significantly to *Tractor*. Establishment of this plan would not be a “one off” to reimburse Nicole for this surgery, but if established could provide a sound argument for Nicole to not have to include the value of the surgery in her income, and for *Tractor* to avoid employment taxes on the value of the surgery paid.

CONCLUSION

In summary, when an employer pays for an employee to have cosmetic surgery, in a case such as this, it may be possible for the employer to deduct the cost they pay for the surgery based on the definition of a business expense. For the employee, historically, if they pay for the expense themselves they would typically not be successful deducting the cost as an unreimbursed employee business expense, and if paid by the employer will have the record the value of the surgery as income. It would be hard to argue that the

expense is considered to be *de minimis* and the facts here do not fall within the criteria of a working condition fringe benefit. Though previously, Nicole would have had an issue not recognizing income for the value of this surgery, post TCJA, through use of an employer Accountable plan, it may be possible for *Tractor* to retain the business expense deduction and the employee not be subject to taxable income for the value of the cosmetic surgery.

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