

Part I

Section 105- Amounts Received Under Accident and Health Plans (Also Section 106- Contributions by Employers to Accident and Health Plans)

Rev. Rul. 2006-36

ISSUE

Are amounts paid to an employee under a reimbursement plan excludable from the employee's gross income under § 105(b) of the Internal Revenue Code (the Code) if the plan provides that amounts may be paid as § 213(d) medical benefits to a designated beneficiary (other than the employee's spouse or dependents or an employee)?

FACTS

Employer sponsors a reimbursement plan (the Plan) that reimburses an employee solely for substantiated medical care expenses (as defined in § 213(d)). The Plan provides reimbursements up to an annual maximum dollar amount for the coverage period and reimburses medical expenses only to the extent that the expenses have not been reimbursed from any other plan. Under the Plan, each employee's unused reimbursement amount available at the end of each plan year is carried forward for use in later plan years. The Plan reimburses the substantiated medical care expenses of both current and former employees (including retired employees), their spouses and

dependents (as defined in §152, determined without regard to § 152(b)(1), (b)(2), and (d)(1)(B)). The Plan also reimburses the substantiated medical care expenses of the surviving spouse and dependents of a deceased employee. Upon the death of the deceased employee's surviving spouse and last dependent, or upon the death of the employee if there is no surviving spouse or dependents, any unused reimbursement amount is paid as reimbursement of substantiated medical care expenses of a beneficiary designated by the employee. The Plan does not include the fair market value of the coverage for the designated beneficiary in the gross income of the employee. The Plan treats the reimbursement as taxable to the designated beneficiary.

The Plan is paid for solely by Employer and is not provided pursuant to a salary-reduction election or otherwise under a § 125 cafeteria plan. Neither the employee nor any other person has the right, currently or for any future year, to receive any benefit other than the reimbursement of substantiated medical care expenses incurred by the employee, his or her spouse and dependents or the employee's designated beneficiary.

LAW AND ANALYSIS

Section 61(a)(1) provides that, except as otherwise provided in Subtitle A, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. Section 1.61-21(a)(3) and (4) of the of the Income Tax Regulations states that a fringe benefit provided in connection with the performance of services shall be

considered to have been provided as compensation to the person performing such services. Thus, a fringe benefit may be taxable to a person even though that person did not actually receive the fringe benefit. If a fringe benefit is furnished to someone other than the service provider, such benefit is considered as furnished to the service provider and use by the other person is considered use by the service provider.

Section 106 provides that the gross income of an employee does not include employer-provided coverage under an accident or health plan. Section 1.106-1 of the regulations provides that the gross income of an employee does not include contributions which the employee's employer makes to an accident or health plan for compensation (through insurance or otherwise) for personal injuries or sickness to the employee or the employee's spouse or dependents.

Section 105(a) provides that, except as otherwise provided in § 105, amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.

Section 105(b) states that except in the case of amounts attributable to (and not in excess of) deductions allowed under § 213 (relating to medical expenses) for any prior taxable year, gross income does not include amounts referred to in § 105(a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for

expenses incurred by the taxpayer for the medical care (as defined in § 213(d)) of the taxpayer or the taxpayer's spouse or dependents (as defined in § 152, determined without regard to § 152(b)(1), (b)(2), and (d)(1)(B)).

Section 1.105-2 of the Income Tax Regulations provides that only amounts that are paid specifically to reimburse the taxpayer for expenses incurred by the taxpayer, spouse or dependents for the prescribed medical care are excludable from gross income. Section 1.105-2 further provides that payments to or on behalf of the taxpayer's spouse or dependents shall constitute indirect payment to the taxpayer. Section 1.105-2 also states that “. . . section 105(b) does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether or not he incurs expenses for medical care.” Thus, if an employee has the opportunity to receive a payment irrespective of whether any medical expenses have been incurred by the employee or the employee's spouse or dependents, the payment is not excludable from gross income under § 105(b) even if the employee (or his or her spouse or dependents) incurred medical expenses during the year.

Notice 2002-45, 2002-2 C.B. 93, describes the tax treatment of health reimbursement arrangements (HRAs) excludable under § 105(b). The notice explains that an HRA is an arrangement that is paid for solely by the employer and not pursuant to a salary reduction election or otherwise under a § 125 cafeteria plan. An HRA reimburses the employee for medical care expenses (as defined in § 213(d)) incurred by the employee or by the employee's spouse or dependents, and provides reimbursements up to a

maximum dollar amount with any unused portion of that amount at the end of the coverage period carried forward to subsequent coverage periods.

Notice 2002-45 also states that to qualify for the exclusion from gross income under § 105(b), an HRA may only provide benefits that reimburse expenses for medical care as defined in § 213(d). An HRA does not qualify for the exclusion under § 105(b) if any person has the right to receive cash or any other taxable or non-taxable benefit under the arrangement other than the reimbursement of medical care expenses. If any person has such a right, currently or for any future year, all payments to all persons made from the arrangement in the current year are included in gross income, even amounts paid to reimburse medical care expenses of the employee, spouse or dependents.

Situation 3 of Rev. Rul. 2005-24, 2005-16 I.R.B. 892, describes a plan that, after the death of an employee and the employee's surviving spouse and dependents, pays all or a portion of the unused reimbursement amount in cash to a beneficiary or beneficiaries designated by the employee, and if no beneficiary is designated, to the deceased employee's estate. Rev. Rul. 2005-24 holds that an amount (including an amount paid to reimburse medical expenses) paid from a plan that provides for the payment of the unused reimbursement amount in cash or other benefits is not excludable from the employee's gross income under §105(b). Rev. Rul. 2005-24 does not specifically address reimbursement of § 213(d) medical expenses incurred by a non-spouse or non-dependent. Nevertheless, the ruling also states that it applies to any purported employer-provided medical reimbursement arrangement that provides for the receipt by

the employee or any other person of cash or any other taxable or non-taxable benefit other than the reimbursement of medical care expenses of employees and their spouses and dependents. This principle applies to amounts paid for reimbursement of medical expenses to designated beneficiaries other than the employee's spouse or dependents.

The Plan described in this ruling does not meet the requirements of § 105(b) and § 1.105-2. Because a beneficiary who is not the employee's spouse or dependent may receive some or all of the medical reimbursements under the Plan, amounts paid under the Plan are not excludable under § 105(b) even if those amounts are paid to reimburse the medical expenses of the employee or the employee's spouse or dependents. Because the benefit is provided in connection with the performance of services by the employee, the benefit is considered provided to the employee and must be included in the employee's gross income. See § 1.61-21(a)(3) and (4).

HOLDING

Amounts paid to an employee under a reimbursement plan are not excludable from gross income under § 105(b) if the plan permits amounts to be paid as § 213(d) medical benefits to a designated beneficiary (other than the employee's spouse or dependents of the employee). None of the payments made from the reimbursement plan during the plan year to any person, including amounts paid to reimburse the medical expenses of an employee or the employee's spouse or dependents, is excludable from the gross

income.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 2005-24, 2005-16 I.R.B. 892, Rev. Rul. 2002-41, 2002- 2 C.B. 75, and Notice 2002-45, 2002-2 C.B. 93 are amplified.

EFFECTIVE DATE

For reimbursement plans containing a provision on or before August 14, 2006 stating that upon the death of a deceased employee's surviving spouse and last dependent, or upon the death of the employee, if there is no surviving spouse or dependents, any unused reimbursement amount will be paid as a reimbursement of substantiated medical care expenses of a beneficiary designated by the employee, this revenue ruling is effective with respect to that provision for plan years beginning after December 31, 2008.

DRAFTING INFORMATION

The principal author of this revenue ruling is Shoshanna Tanner of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact Elizabeth Purcell at (202) 622-6080 (not a toll-free call).