

DEPARTMENT: Administrative Rulings; IRS Revenue Rulings

HEALTH CARE LOANS OR ADVANCE REIMBURSEMENTS INCLUDED IN GROSS INCOME. (Section 105 -- Accident and Health Plans) (Rev. Rul. 2002-80; 2002-49 IRB 925)

ABSTRACT: The Service has clarified that amounts paid as medical reimbursements or loans to an employee without regard to the employee's actual medical status are not excludable from the employee's gross income under *section 105(b)* or employment taxes.

SUMMARY: The Service has clarified (*Rev. Rul. 2002-80*) that amounts paid as medical reimbursements or loans to an employee without regard to the employee's actual medical status are not excludable from the employee's gross income under *section 105(b)* or employment taxes.

The IRS reviewed two fact patterns. In the first, an employer provides health coverage to its employees. The employer has a payroll arrangement under which employees' salaries are reduced to pay for the health insurance premiums. In addition to the health coverage, the employer also provides advance reimbursement payments to employees for uninsured medical expenses. To the extent that the employee submitted claims for uninsured medical expenses, the employer excludes the advance reimbursement amounts from the employee's gross incomes and does not treat the amount as wages for FICA or FUTA purposes. Moreover, when uninsured medical expenses do not exceed the advance reimbursement payments, the employer frequently forgives the outstanding amounts. In the second situation, the employer reimburses its employees' health care premiums through purported loans.

Clarifying and expanding on *Rev. Rul. 2002-3, 2002-3 IRB 316*, the Service explained that the exclusion from gross income under *section 105(b)* does not apply to amounts that an employer pays to an employee as advance reimbursements or loans, whether or not the employee incurs uninsured medical expenses. Further, the Service ruled that in the second situation the amounts paid to the employee as loans aren't loans and should also be included in gross income and are subject to FICA and FUTA taxes.

AUTHOR: Internal Revenue Service

ISSUE: [1] Whether, under the facts described, amounts an employer pays to an employee as "advance reimbursements" or "loans" are excluded from gross income under *section 105(b)* and from employment taxes under *sections 3401(a), 3121(a), and 3306(b) of the Internal Revenue Code*.

#### FACTS

[2] Situation (1). Employer M provides health coverage for its employees through a group health insurance policy. The coverage constitutes accident or health coverage for purposes of the exclusion for employer-provided accident or health coverage under *section 106(a)*.

[3] M has a payroll arrangement under which an employee's salary is reduced and M applies the salary reduction amounts to the payment of the premiums for the group health insurance policy for the employee during the year. The salary reduction used to pay for the premiums is mandatory for M's highly compensated employees. All other employees elect whether to purchase the group health insurance policy through salary reduction. Thus, under M's plan, all employees have a lower salary in exchange for employer-provided group health insurance coverage.

[4] In addition to the group health insurance policy, M has a plan under which M reimburses the uninsured medical expenses of employees. To ameliorate the salary reduction for the group health insurance policy, M makes payments to an employee in amounts that cause the employee's after-tax pay from M to be the same or approximately the same as what it would have been if there were no salary reduction to pay premiums for the group health insurance policy. M characterizes these payments as "advance reimbursements" of the uninsured medical expenses.

[5] During the year, the employee submits to M claims for uninsured medical expenses incurred by the employee, the employee's spouse, or the employee's dependents. To the extent the employee submits claims for uninsured medical expenses during the year, M excludes that amount of the "advance reimbursement" payments from the employee's gross income under *section 105(b)* and does not withhold income tax or treat the amount as wages for Federal Insurance Contribution Act (FICA) or Federal Unemployment Tax Act (FUTA) purposes. To the extent an employee does not have uninsured medical expenses equal to the "advance reimbursements" made to the employee by the end of the year or upon the employee's termination of employment, M will often treat excess "advance reimbursements" above uninsured medical expenses as forgiven and as additional compensation includible in the employee's gross income.

[6] Situation (2). The facts are the same as in Situation (1), except that the Employer, N, reimburses an employee's health insurance premiums through purported "loans" rather than "advance reimbursements." N implements the plan by making "loans" to the employee sufficient to cause the employee's after-tax pay to remain essentially unchanged. The "loans," which may or may not bear market rates of interest, only become due and payable at the time and to the extent that the employee submits to N claims for uninsured medical expenses. Upon receipt of a medical expense claim, N "reimburses" the medical expense and simultaneously offsets the "loan" by retaining the amount of the "reimbursement." The "reimbursements" and "loan" offsets are made through bookkeeping entries. Thus, to the extent the employee submits claims for uninsured medical expenses during the year, N excludes that amount of the "loans" from the employee's gross income under *section 105(b)* and from the employment taxes. To the extent an employee does not have uninsured medical expenses equal to the "loans," N forgives the "loans."

## LAW AND ANALYSIS

[7] In general, *section 106(a)* provides that gross income of an employee does not include employer-provided coverage under an accident or health plan. Under *section 106(a)*, an employee may exclude premiums for accident or health insurance coverage

that are paid by an employer. Also, under *section 105(b)*, an employee may exclude amounts received through employer-provided accident or health insurance if those amounts are paid to reimburse expenses incurred by the employee for medical care (of the employee, the employee's spouse, or the employee's dependents) for personal injuries or sickness.

[8] *Section 105(e)* provides that amounts received under an accident or health plan for employees are treated as amounts received through accident or health insurance for purposes of *section 105(b)*. *Section 1.105-5(a) of the Income Tax Regulations* defines an accident or health plan as an arrangement for the payment of amounts to employees in the event of personal injuries or sickness.

[9] *Section 1.105-2* provides that only amounts that are paid specifically to reimburse the taxpayer for expenses incurred by the taxpayer for the prescribed medical care are excludable from gross income under *section 105(b)*. Accordingly, *section 105(b)* does not apply to amounts that the taxpayer would be entitled to receive irrespective of whether or not the taxpayer incurs expenses for medical care.

[10] Amounts excluded from gross income under *section 105(b)* are also excluded from income tax withholding under *section 3401(a)*. In addition, amounts paid under a plan established by an employer on account of expenses incurred by the employee for medical care (of the employee, the employee's spouse, or the employee's dependents) are excluded from FICA and FUTA taxes under *sections 3121(a)* and *3306(b)*.

[11] Under *section 125*, an employer may establish a cafeteria plan that permits an employee to choose among two or more benefits, consisting of cash (generally, salary) and qualified benefits, including accident or health coverage. Pursuant to *section 125*, the amount of an employee's salary reduction applied to purchase such coverage is not included in gross income, even though it is available to the employee and the employee could have chosen to receive cash instead. If an employee elects salary reduction pursuant to *section 125*, the accident and health coverage is excludable from gross income under *section 106* as employer-provided accident or health coverage.

[12] In *Rev. Rul. 2002-3, 2002-3 I.R.B. 316*, an employer applies salary reduction amounts to the payment of health insurance premiums for employees and then "reimburses" amounts to employees so that employees' after-tax pay remains unchanged. The ruling concludes that although the salary reduction amounts used to pay the premiums are excludable from the employees' gross income under *section 106* because employer-paid, there are no employee-paid premiums for the employer to "reimburse." Thus, the reimbursements that the employer makes to employees are not excludable from gross income under *section 105(b)* because they do not reimburse employees for expenses incurred by the employees. In addition, the reimbursements are not excluded from income tax withholding, FICA taxes, or FUTA taxes. The ruling also states that the same conclusion results when the salary reduction used to pay for the health insurance premiums is done without employee elections.

[13] In Situation (1), although M purports to treat the "advance reimbursements" as payments for uninsured medical expenses, those amounts are paid to the employee regardless of whether the employee incurs expenses for medical care or suffers a

personal injury or sickness during the year. Under section 1.105-5(a), M's "advance reimbursement" plan is therefore not an accident or health plan because it is not an arrangement for the payment of amounts to employees in the event of personal injuries or sickness. In addition, under section 1.105-2, the exclusion from gross income under *section 105(b)* applies only to amounts paid specifically to reimburse medical care expenses and does not apply to amounts that the employee would be entitled to receive irrespective of whether the employee incurs expenses for medical care. Because an M employee is not paid specifically to reimburse medical care expenses but is entitled to receive the "advance reimbursements" irrespective of whether any medical expenses have been incurred, none of those payments are excludable from gross income under *section 105(b)* or from income tax withholding under *section 3401 (a)* whether or not the employee has actually incurred uninsured medical expenses during the year. Finally, because "advance reimbursements" under M's plan are not made on account of expenses incurred by the employee for medical care, the payments are subject to FICA taxes under *section 3121(a)* and FUTA taxes under *section 3306(b)*.

[14] In Situation (2), although N characterizes the payments to the employee as "loans," it is understood that the employee will never become obligated to repay any of the purported "loans" to N. Under N's plan, when the employee submits uninsured medical claims, N treats the reimbursements as an offset against that amount of the "loans." However, if the employee does not submit claims, the outstanding amounts of the "loans" never become due and payable to N. (In addition, N may not notify or obtain the employee's consent for the purported loan arrangement, in which event, the "loans" may be unenforceable under applicable law.)

[15] Accordingly, under the specific facts described in Situation (2), the arrangement does not constitute a loan and is, in substance, the same as Situation (1). Like the transaction in Situation (1), the arrangement in Situation (2) is neither an accident or health plan under section 1.105-5(a) nor excludable from gross income under *section 105(b)* by reason of *section 105-2* (either when paid to the employee or when offset against claims for uninsured medical expenses).

#### HOLDING

[16] Under the facts described in Situations (1) and (2), the exclusion from gross income under *section 105(b)* does not apply to amounts that an employer pays to an employee as "advance reimbursements" or "loans," whether or not the employee incurs uninsured medical expenses during the year. Moreover, in Situation (2), the amounts paid to the employee do not constitute loans. Accordingly, all of the "advance reimbursements" or "loans" are included in the employee's gross income under *section 61* and are subject to employment taxes under *sections 3401(a)*, *3121(a)*, and *3306(b)*.

#### EFFECT ON OTHER REVENUE RULINGS

[17] *Rev. Rul. 2002-3* is amplified.

#### DRAFTING INFORMATION

[18] The principal author of this Revenue Ruling is Felix Zech of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this Revenue Ruling, contact him at (202) 622-6080 (not a toll-free call).