Revenue Ruling 2005-24

ISSUE

Are amounts paid to an employee under a reimbursement plan that provides for the payment of unused reimbursement amounts in cash or other benefits excludable from gross income under *§ 105(b) of the Internal Revenue Code* (the Code)?

FACTS

Situation 1

Employer sponsors a reimbursement plan (the Plan) that reimburses an employee solely for medical care expenses (as defined in *§ 213(d)*) that are substantiated before the reimbursements are made. The Plan reimburses the 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 medical care expenses of the surviving spouse and dependents of a deceased employee. No other person may receive reimbursements from the Plan. 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 forfeited.

The Plan [*2] is paid for solely by Employer and is not provided pursuant to a salary-reduction election or otherwise under a *§ 125* cafeteria plan. The Plan provides reimbursements up to an annual maximum dollar amount for the coverage period, which is the plan year. The Plan reimburses medical care expenses only to the extent that the employee or the employee's spouse or dependents have not been reimbursed for the expense from any other plan.

Under the Plan, a portion of each employee's reimbursement amount available at the end of each plan year is forfeited if not used to reimburse medical expenses. The remaining unused reimbursement amount is carried forward for use in subsequent plan years. Neither the employee nor any other person has the right, currently or for any future year, to receive cash or any taxable or nontaxable benefit other than the reimbursement of medical care expenses incurred by the employee and his or her spouse and dependents.

When an employee retires, Employer automatically and on a mandatory basis (as determined under the Plan) contributes an amount to the reimbursement plan equal to the value of all or a portion of the retired employee's accumulated unused vacation and sick [*3] leave. Under no circumstances may the retired employee or the retired employee's spouse or dependents receive any of the designated amount in cash or other benefits.

The Plan satisfies the nondiscrimination requirements of *§ 105(h)* for a self-insured medical expense reimbursement plan.

Situation 2

Same facts as in *Situation 1*, except the Plan provides that the employee will receive a cash payment equal to all or a portion of the unused reimbursement amount available to that employee

at the end of the plan year or upon termination of employment, if earlier. Employer treats the cash payment as taxable compensation to the employee.

Situation 3

Same facts as in *Situation 1*, except the Plan provides that upon the death of an employee all or a portion of the unused reimbursement amount is paid in cash to a beneficiary or beneficiaries designated by the employee, and if no beneficiary is designated, to the deceased employee's estate.

Situation 4

Same facts as in *Situation 1*, except the Employer has an "option plan" which purports to be separate and apart from the reimbursement plan. Under the "option plan," an employee elects, prior to the beginning of the plan year, to participate in the "option [*4] plan." If an employee elects to participate in the "option plan," any unused reimbursement amount available at the end of the plan year is "forfeited." However, the "option plan" provides that the employee may elect to transfer all or a portion of the "forfeited" amount to one of several retirement plans or to receive the amount as a cash payment. If an employee does not elect to participate in the "option plan," any reimbursement amount unused at the end of the plan year is carried forward for use in future plan years.

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 state 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.

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 [*5] 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(e) states that amounts received under an accident or health plan for employees are treated as amounts received through accident or health insurance for purposes of *§ 105*. *Section 1.105-5(a) of the regulations* states that an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness.

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 [*6] 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 regulations 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. *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. Accordingly, if an employee is not paid specifically to reimburse medical care expenses but is entitled to receive the payment irrespective of whether any medical expenses have been incurred, none of the payments are excludable from gross income under *§ 105(b)* whether or not the employee has incurred medical expenses during the year.

Part I of *Notice 2002-45, 2002-2 C.B. 93* describes the tax treatment of health reimbursement arrangements (HRAs). The notice explains that [*7] a tax-favored 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, reimburses the employee for medical care expenses (as defined in *§ 213(d)*) incurred by the employee and by the employee's spouse and 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.

Part II of *Notice 2002-45* states that to qualify for the exclusion from gross income, 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 distributions to all persons made from the arrangement in the current year are included in gross income, even amounts paid to reimburse medical care expenses. The notice specifically states that arrangements providing for the payment [*8] of a death benefit, a bonus, or a separation payment without regard to medical care expenses do not qualify for tax-favored treatment.

Notice 2002-45 notes that arrangements formally outside the HRA that provide for the adjustment of an employee's compensation or an employee's receipt of any other benefit will be considered in determining whether the arrangement is an HRA and whether the benefits are eligible for the exclusion from gross income.

Rev. Rul. 75-539, 1975-2 C.B. 45, describes two labor contracts. Contract A provides that upon retirement, an employee will receive a portion of accumulated unused sick leave credits as a cash payment or, at the election of the employee, the payment may be applied to continue the employee's participation in the employer's health plan. Contract B provides that the value of a portion of the accumulated unused sick leave credits will be used to pay for continued participation in the employer's health plan. Under no circumstances under Contract B may the retired employee, the retired employee's spouse or dependents receive this payment in cash.

Rev. Rul. 75-539 holds that, under Contract A, the value of unused accumulated sick leave credits [*9] used to continue health coverage is constructively received by the retired employee under *§ 451*, and therefore is includible in the retired employee's gross income. Under Contract A, the amount of premium payments is considered an employee contribution out of salary and not a contribution by the employer under *§ 106*. However, under Contract B, the value of the unused accumulated sick leave credits, which may not be received in cash, is not constructively received by the retired employee, but is a contribution by the employer to the employer's health plan that is excludable from the retired employee's gross income under *§ 106*.

The reimbursement plan described in *Situation 1* is an HRA that meets the requirements for tax-favored treatment under §§ *106* and *105(b)*. The Plan in *Situation 1* is an employer-provided

accident or health plan under *§ 106* and payments are limited solely to reimbursements of previously substantiated medical care expenses incurred by current and former employees and their spouses and dependents. No person has the right, currently or in the future, to receive cash or any other taxable or nontaxable benefit under the Plan other than the reimbursement of substantiated [*10] medical care expenses as required by § *105(b)*.

On the other hand, the reimbursement plans described in *Situations 2* through *4* do not meet the requirements for tax-favored treatment. The Plan in *Situation 2* provides for a cash payment equal to all or a portion of the unused reimbursement amount available at the end of the plan year or upon termination of employment, if earlier. The Plan in *Situation 3* provides for a death benefit upon the death of the employee of all or a portion of the unused reimbursement amount without regard to medical care expenses. The Plan in *Situation 4* permits conversion of unused reimbursement amounts to cash or other benefits regardless of whether or not medical expenses have been incurred. Although the "option plan" in *Situation 4* purports to be formally outside the reimbursement arrangement, the option plan and the reimbursement arrangement constitute one plan. Accordingly, because the Plans in *Situations 2* through *4* pay amounts "irrespective" of whether medical care expenses have been incurred, no amount paid under the Plans to any person is excludable from gross income under *§ 105(b)*. See also *Rev. Rul. 2002-80, 2002-2 C.B. 925* and *Rev. Rul. 2003-43, 2003-1 C.B. 935*.

HOLDINGS

Amounts [*11] paid to an employee under a reimbursement plan that provides for the payment of unused reimbursement amounts in cash or other benefits are not excludable from gross income under *§ 105(b)*. Thus, amounts paid from plans as described in *Situations 2* through *4* are not excludable from gross income under *§ 105(b)*. In *Situations 2* through *4*, none of the payments made from the arrangements during the plan year to any person, including amounts paid to reimburse medical expenses, are excluded from gross income. On the other hand, contributions to and amounts paid from a plan as described in *Situation 1* are excludable from the gross income of an employee under *§§ 106* and *105(b)*.

This ruling applies to any purported employer-provided medical reimbursement arrangement, regardless of how the arrangement is characterized, that provides for the receipt by the employee or any other person of cash or any other taxable or nontaxable benefit or any combination of such benefits (including, but not limited to the benefits described in *Situations 2* through *4*) other than the reimbursement of medical care expenses of employees and their spouses and dependents. Moreover, this ruling applies to employer-provided [*12] reimbursement arrangements that are limited only to retired employees, as well as to employer-provided arrangements that cover active employees or both active employees and retirees.

SCOPE

This ruling addresses only reimbursement arrangements paid for solely by an employer under the specific Code sections mentioned and not pursuant to salary reduction or otherwise under a *§ 125* cafetaria plan. No inference is intended as to *§§ 401, 403, 408, 409A,* and *457 of the Internal Revenue Code*.

EFFECT ON OTHER DOCUMENTS

Notice 2002-45, 2002-2 C.B. 93, is amplified.

EFFECTIVE DATE

For reimbursement arrangements within the SCOPE of this revenue ruling, the ruling is effective for plan years beginning after December 31, 2005.

DRAFTING INFORMATION

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