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Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:TEGE:EB:HW
PLR-160677-04
Date:
May 27, 2005

Legend

Employer:

Plan:

Dear :

This responds to your letter of October 15, 2004, and supplemental submission of May 18, 2005, requesting rulings on behalf of Employer concerning the proper Federal tax treatment of a medical reimbursement plan.

You state that Employer has established the Plan, which reimburses eligible employees for medical care expenses (as defined in § 213 of the Internal Revenue Code (Code)), incurred by the employee and the employee's spouse and dependents (as defined in § 152 of the Code). The Plan reimburses medical 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. Employer requires employees to substantiate medical expenses before reimbursements or payments are made. Employees have no right to receive cash or other benefits under the Plan other than the reimbursement of medical care expenses.

Employer also sponsors a group health plan under which employees can elect from various health insurance coverage options. Participation is limited to full time employees who are enrolled in certain coverage option through Employer's group health plan. Under the group health plan, Employer pays a portion of the health insurance premium for participating employees and employees can elect to fund the remaining premium cost through salary reduction. You represent that no salary reduction amount will ever exceed the premium for coverage under the group health plan.

Eligible employees may elect among three coverage options under the reimbursement Plan. All Plan options are available to all employees who participate in Employer's group health plan and Employer contributions are identical for each participant who elects a particular Plan option. Under the Plan, Employer accrues a notional annual contribution amount on behalf of each Plan participant based on the Plan option in which the participant is enrolled, and whether the participant is enrolled in employee-only or family coverage under Employer's group health plan. The annual contribution amount that is not used during the plan year is carried over for use in subsequent plan years provided that the employee continues to participate in the Plan.

Benefits under the Plan are subject to a deductible provision. Once a participant has incurred a specified amount of covered expenses, additional covered expenses are reimbursed. Covered expenses are those that would otherwise be covered by the group health plan, but for which no benefits are paid due to the group health plan's deductible, co-payment, and co-insurance provisions. The maximum reimbursement amount available to a participant each Plan year and the minimum covered expenses that must be incurred prior to reimbursement from the Plan vary based upon the Plan option in which the participant is enrolled and whether an expense is incurred in- or out-of-network. Although a maximum annual contribution amount is designated at the beginning of the Plan year, only an additional pro rata portion of that maximum amount is available for reimbursement of medical expenses for each pay period.

Employer proposes to add a "spend down option" to the Plan. The spend down option will be available to all participants who retire and meet certain criteria with respect to Employer's retirement plan. Pursuant to the spend down option, the Plan would continue to reimburse all eligible retired employees for medical care until all unused accumulated amounts are exhausted. Employer also proposes to contribute to the Plan an amount equal to all or a portion of the value of a retired employee's unused sick days at retirement. Retired employees make no election with respect to the contribution of sick days and the retired employee has no right to receive the value of the designated sick days in cash or other benefits. Prior to the beginning of each Plan year, Employer will determine whether it will contribute all or a portion of the unused sick days to the Plan on behalf of employees who retire during that year.

You represent that the Plan will not discriminate in favor of highly compensated employees and the nondiscrimination rules of the Code and Income Tax Regulations will be met.

Section 61(a)(1) of the Code and section 1.61-21(a)(3) of the Income Tax Regulations provide that, except as otherwise provided in Subtitle A, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.

Section 106 provides that 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) to the employee for personal injuries or sickness incurred by the employee or the employee's spouse or dependents (as defined in § 152). The employer may contribute to an accident or health plan either by paying the premium on a policy of accident or health insurance covering one or more of the employees, or by contributing to a separate trust or fund which provides accident or health benefits directly or through insurance to one or more of the employees. However, if the insurance policy, trust or fund provides other benefits in addition to accident or health, § 106 applies only to the portion of the contributions allocable to accident or health benefits.

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 subsection (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 section 213(d)) of the taxpayer or the taxpayer's spouse or dependents (as defined in § 152). 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. Thus, § 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.

In Rev. Rul. 2002-41, 2002-2 C.B. 75, an employer sponsors a reimbursement arrangement (HRA) that is paid for solely by the employer and not through salary reduction contributions. The HRA reimburses substantiated medical care expenses (as defined in § 213(d)) of participating employees and their spouses and dependents (as defined in § 152) up to a maximum annual reimbursement amount. Unused amounts from one coverage period are carried forward to subsequent coverage periods. Participating employees have no right to receive cash or any other benefit in lieu of medical expense reimbursements. In Situation 2 of Rev. Rul. 2002-41, the maximum reimbursement amount under the HRA that is not applied to reimburse medical care expenses before an employee retires or otherwise terminates employment continues to be available after retirement or termination for any medical care expense under § 213(d) incurred by the former employee or the former employee's spouse and dependents. The ruling concludes that coverage and reimbursements made under the

HRA are excludable from the gross income of participating employees and retired employees under §§ 106 and 105. See also Notice 2002-45, 2002-2 C.B. 93.

In Situation 1 of Rev. Rul. 2005-24, 2005-16 I.R.B. 892, an employer sponsors a reimbursement plan that reimburses the substantiated medical care expenses of both current and former employees (including retired employees), their spouses and dependents. Under no circumstances may an employee receive taxable or nontaxable benefits under the plan, other the reimbursement of medical care expenses incurred by the employee and his or her spouse and dependents. When an employee retires, the 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 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 ruling concludes that coverage and reimbursements made under the plan described in Situation 1 are excludable from gross income under §§ 106 and 105.

The Plan is an employer-provided accident and health plan that is paid for solely by the Employer and amounts are used exclusively to reimburse employees (including retired employees) for expenses incurred for the medical care (as defined in § 213(d)) of the employee and the employee's spouse or dependents (as defined in § 152). No benefits other than reimbursements for medical care expenses are available at any time to employees or retired employees either in the form of cash or other nontaxable or taxable benefits. Accordingly, the Plan meets the requirements as set forth in Rev. Rul. 2002-41, Notice 2002-45 and Rev. Rul. 2005-24.

Based on the information submitted and the representations made, we conclude as follows: (1) Contributions, including non-elective contributions equal to the value of a a retiring employee's unused sick leave, and coverage under the Plan are excludable from the gross income of employees and retired employees under § 106 of the Code; and (2) Payment or reimbursement of medical care expenses of employees and retired employees under the Plan are excludable from gross income under § 105(b) of the Code.

No opinion is expressed concerning whether the Plan satisfies the nondiscrimination requirements of § 105(h) of the Code and § 1.105-11 of the regulations. In addition, no opinion is expressed concerning the Federal tax consequences of the Plan under any other provision of the Code other than those specifically stated herein.

This ruling is directed only to the Taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Harry Beker, Chief
Health and Welfare Branch
Office of Division Counsel/Associate
Chief Counsel (Tax Exempt &
Government Entities)