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Publications

Proposed Rule Has Serious Implications on the Taxation of Fixed Indemnity and Other Similar Coverages

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On July 7, the Departments of Labor, Treasury, and Health and Human Services published a proposed rule ("Proposed Rule") regarding, among other things, the requirements for fixed and hospital indemnity insurance to be excepted benefits (see our alert here). Notably and surprisingly, the Proposed Rule also contains proposed changes to the Code section 105(b) regulations that would "clarify" the taxation of amounts received through employment-based accident or health insurance that are paid without regard to the amount of incurred medical expenses. The Proposed Rule also addresses the substantiation requirements for the 105(b) exclusion.

Consistent with a series of IRS Chief Counsel Advices ("CCAs") (see our prior alert here), the Proposed Rule is directed at addressing the taxation of the wellness indemnity arrangements that the IRS has been concerned with for years. However, the Proposed Rule goes much farther than previous CCAs and has serious implications for all group fixed indemnity and other similar types of insurance where premiums are paid on a pre-tax basis.

Tax Treatment of Benefits

As background, Code section 105(a) provides that amounts received by an employee through accident or health insurance for personal injuries or sickness are included in gross income, except as otherwise provided under Code section 105(b). Code section 105(b) excludes from gross income amounts received by an employee to reimburse the employee's expenses for medical care (as defined in Code section 213(d)). The current Code section 105(b) regulations provide that the exclusion only applies to amounts that are paid specifically to reimburse the employee for expenses incurred by the employee for the prescribed medical care and does not apply to amounts the employee would be entitled to receive irrespective of whether or not the employee incurs expenses for medical care. The current

regulations go on to state that the exclusion is not applicable to the extent that such amounts exceed the actual expenses for such medical care.

The preamble to the Proposed Rule states that the current regulatory language has caused confusion amongst taxpayers about how the Code section 105(b) exclusion applies when the benefits are not directly related to a medical expense incurred by an employee. The preamble states that, in particular, certain individuals have taken the position that:

- benefits provided to a taxpayer through an accident or health insurance policy that provides benefits without regard to the amount of medical expenses incurred, such as fixed indemnity or specified disease excepted benefit coverage, are excluded from a taxpayer's gross income because they are paid upon the occurrence of a health-related event; and/or
- benefits can be excluded from gross income as long as the amount received does not exceed the amount of medical expenses arising from the occurrence of a health-related event.

GROOM INSIGHT: In a footnote to this statement, Treasury/IRS refers to Rev. Rul. 69-154 and appears to take the position that the Rev. Rul. only applies to a medical expense reimbursed by multiple coverages, with neither coverage paying the entire expense, but the combination of coverages paying more than the amount of the medical expense. The footnote states that Treasury/IRS is aware that some individuals have relied on the Rev. Rul. to support their claims that Code section 105(b) allows for an exclusion for all benefits provided by accident or health insurance up to the amount of medical expenses with only the excess indemnification included in gross income, even when the taxpayer is enrolled in only one accident or health plan. This footnote is the first time Treasury/IRS has specifically said that the Rev. Rul. only applies in the context of multiple coverages and seems at odds with the IRS' previous statements regarding the application of the Rev. Rul. 69-154. For example, in CCA 201719025, the IRS cites to Rev. Rul. 69-154 to distinguish a 2016 CCA that implied the entire amount of benefits paid under a fixed indemnity policy were taxable ("[the 2016 CCA] was intended to address situations in which no medical expenses were incurred or reimbursed, and should not be read to modify the analysis or result in Rev. Rul. 69-154"). CCA 201719025 describes the holding of Rev. Rul. 69-154 as:

> excess indemnification received under a medical insurance policy or plan that is attributable to an employer's contribution is includable in the employee's gross income. Under the ruling, if the employer paid the entire premium on a policy, section 104(a)(3) does not apply and thus to the extent an employee received indemnification in excess of the medical expenses incurred by the employee, the excess is included in the employee's gross income because the exclusion under section 105(b) only applies to the reimbursement of the amount of the medical expense.
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> Also, CCA 201719025 contains an example that does not appear to require that the employee be covered under multiple policies. In the example, a "traditional fixed indemnity health plan" pays fixed amounts on unpredictable health events, such as a medical office visit or a hospital stay. The employee pays premiums on a pre-tax basis. If the plan pays an individual $200 for a medical office visit and the covered individual's unreimbursed medical costs as the result of the visit were $30, $30 would be excluded from gross income under section 105(b) and the excess amount of $170 would be included in gross income.

The preamble to the Proposed Rule states that Treasury/IRS interprets Code section 105(b) to not apply to benefits paid without regard to the actual amount of incurred and otherwise unreimbursed Code section 213(d) medical expenses, and thus payments made without regard to the actual amount of incurred and unreimbursed Code section 213(d) medical expenses are includible in a taxpayer's gross income. Thus, the Treasury/IRS proposes to amend the regulations to "clarify" this. Specifically, the Proposed Rule states that:

Any amounts received under a fixed indemnity plan treated as an excepted benefit under section 9832(c)(3), or any plan that pays amounts regardless of the amount of section 213(d) medical expenses actually incurred, are not payments for medical care under section 105(b) and are included in the employee's gross income under section 105(a).

The preamble states that "even if a benefit payment under [an] arrangement is *used* to reimburse an employee's medical expenses, if the amount of the payment is not tied to the amount of the expense incurred and the employee is entitled to keep any amounts by which the benefit payment exceeds the incurred expenses, that would indicate that the benefit is not actually a reimbursement for medical expenses." (emphasis in original).

GROOM INSIGHT: This position is different than the IRS' conclusion in CCA 202323006 (released June 8, 2023), where the IRS said "[t]he exclusion from income in § 105(b) does not apply to payments when the employee has no unreimbursed medical expense either because the activity that triggers the payment does not cost the employee anything or because the cost of the activity is reimbursed by other coverage." The Proposed Rule goes one step further to take the position that, even if the activity that triggers the payment does cost the employee something (e.g., a hospitalization) and is not reimbursed by other coverage, the Code section 105(b) exclusion does not apply unless the benefit payment is based on the actual amount of incurred and unreimbursed medical expenses.

The excepted benefit section of the Proposed Rule provides that, to be an excepted benefit, a fixed or hospital indemnity policy must pay benefits without regard to services or items received or actual or estimated amount of medical expenses incurred. Thus, it appears that Treasury/IRS is taking the position that the benefits paid under a fixed indemnity plan that is an excepted benefit paid on a pre-tax basis will not qualify for the Code section 105(b) exclusion, even if the plan substantiates the amount of medical expenses incurred related to the triggering event.

Treasury/IRS requests comments on whether additional clarification is needed regarding how these rules would apply to the types of benefits provided through employment-based accident or health insurance other than fixed indemnity excepted benefits coverage or specified disease excepted benefits coverage, including incentives offered through wellness programs, where the insurance, those programs, or both provide benefits without regard to the amount of medical expenses incurred and where the premiums are paid on a pre-tax basis.

Employment Tax Consequences

The preamble goes on to state that under the Proposed Rule, accident and health insurance payments that would not be excluded from employees' gross income under Code section 105(b) because the amounts were paid without regard to the actual amount of incurred or otherwise unreimbursed medical care expenses would be wages subject to FICA, FUTA, and income tax withholding. And, if the rules are finalized as proposed, "taxpayers would need to consider the impact this proposal would have on determinations of whether amounts received under accident and health plans constitute wages for employment tax and income tax withholding purposes" since they are not excluded from an employee's gross income under Code section 105(b).

GROOM INSIGHT: It is unclear why Treasury/IRS state that payments that are not excludable under Code section 105(b) are wages subject to FICA, FUTA, and income tax withholding, but then say that "taxpayers would need to consider" the impact of the Proposed Rule on determinations of whether the payments are wages for employment tax and income tax withholding purposes. Despite the latter language, the position that the payments are wages subject to withholding is consistent with the IRS' recent position in CCA 202323006.

Substantiation Requirements

The preamble quotes the language in the current Code section 105(b) regulations that states that "[i]f amounts are paid to the taxpayer solely to reimburse him for expenses which he incurred for the prescribed medical care, section 105(b) is applicable even though such amounts are paid without proof of the amount of the actual expenses incurred by the taxpayer." The preamble states that certain interested parties have interpreted this language to suggest that substantiation of incurred medical expenses is not required for the Code section 105(b) exclusion to apply.

The Proposed Rule would clarify that, for amounts to be excluded from income under Code section 105(b), the payment or reimbursement must be substantiated. The preamble states that Treasury/IRS understands that, in most circumstances, substantiation typically occurs prior to reimbursement, but is of the view that substantiation must occur at least within a reasonable period thereafter. Treasury/IRS requests comments on whether any final rules should specifically address timing requirements for substantiation.

GROOM INSIGHT: As noted above, if the Proposed Rule is finalized as proposed, it appears that benefit payments under most fixed and hospital indemnity and specified disease and illness policies will not qualify for the Code section 105(b) exclusion and thus will be includable in gross income to the extent the premiums for such policies are paid on a pre-tax basis. In that case, this substantiation rule does not appear to have an impact on those plans. However, for some indemnity-type policies, for example, a fixed indemnity policy that only pays based on the actual amount of medical expenses incurred and is not an excepted benefit, this will require substantiation of the actual amount of medical expenses incurred. Most fixed indemnity or specified disease policies do not currently have a mechanism or process for substantiating medical expenses.

Applicability Date

The Proposed Rule states that, although the proposed changes generally reflect longstanding Treasury/IRS rules and guidance, due to the fact certain plan sponsors and issuers may not have understood the rules under Code section 105(b), the proposed changes would apply as of the later of (1) the date of publication of final regulations or (2) January 1, 2024.