Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 105.—Amounts Received Under Accident and Health Plans

(Also §§ 106, 125.)

Health Reimbursement Arrangements (HRAs). This ruling describes an employer-provided medical care expense reimbursement plan called a health reimbursement arrangement (HRA), in which reimbursements for medical care expenses made from the plan are excludable from employee gross income. Among other things, the HRA described retains favorable tax treatment because it only reimburses employees or former employees for medical care expenses of the employee or former employee and their spouses and dependents; is solely employer-funded and not paid for directly or indirectly from salary reduction; and although it allows participants to carry forward unused amounts for use in later coverage periods, these amounts may never be used for anything but reimbursements for qualified medical expenses.

Rev. Rul. 2002–41

ISSUE

Whether employer-provided coverage and medical care expense reimbursements made under a reimbursement arrangement that allows unused amounts to be carried forward, as described in Situations 1 and 2 below, are excludable from gross income under §§ 106 and 105 of the Internal Revenue Code, respectively.

FACTS

Situation 1: An employer sponsors a major medical plan for all employees that provides coverage under a policy of accident and health insurance for certain medical care expenses described in § 213(d)(1)(A) and (B). The major medical plan has a $2,000 annual deductible for employee-only coverage and a $4,000 annual deductible for family coverage. However, certain preventive care benefits (*e.g.*, annual physicals and well-baby visits) are covered without regard to the plan's deductible. The major medical plan is paid for in part pursuant to salary reduction elections under the employer's cafeteria plan. The election form provides that salary reduction elections are used only to pay for the major medical plan. To participate in the major medical plan, an employee must make a $1,000 annual salary reduction election for employee-only coverage or a $3,500 annual salary reduction election for family coverage.

In addition to the major medical plan, the employer also sponsors a health reimbursement arrangement (HRA) that reimburses the medical care expenses of all participating employees and their spouses and dependents up to an annual maximum reimbursement amount that is fixed on January 1 of each year. The HRA is available only to employees who participate in the major medical plan. The HRA meets the nondiscrimination requirements of § 105(h).

The HRA is paid for by the employer and employees do not make any salary reduction election to pay for the HRA. The HRA operates on a calendar year basis. Employees have no right to receive cash or any benefit other than reimbursement for medical care expenses under the HRA.

The expenses reimbursable under the HRA are any medical care expenses that would be covered by the major medical plan but for the major medical plan's deductible, limitation to expenses that are "usual, customary and reasonable," or any other similar dollar limitation imposed by the major medical plan. Only expenses that are substantiated are reimbursed.

The maximum reimbursement amount for the first year in which an employee participates in the HRA is $1,000 for an employee who has employee-only coverage under the major medical plan and $2,000 for an employee who has family coverage under the major medical plan. Unused reimbursement amounts from one year are carried forward for use in later years. Therefore, in each year after the first year, the maximum reimbursement amount under the HRA equals $1,000 for an employee who has employee-only coverage under the major medical plan and $2,000 for an employee who has family coverage under the major medical plan, increased by the unused amount from the previous year. If an employee retires or otherwise terminates employment, any unused reimbursement amount remaining in the HRA is unavailable thereafter.

Under the terms of the plans, a qualified beneficiary who chooses to elect COBRA continuation coverage may only elect the HRA in conjunction with the major medical plan. However, a qualified beneficiary may choose to elect COBRA continuation coverage for only the major medical plan. The COBRA applicable premium for continuation of the major medical plan is $1,800 for employee-only coverage and $4,500 for family coverage.

Situation 2: The facts are the same as Situation 1, except that any portion of 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)(1)(A), (B), and (D) incurred by the former employee or the former employee's spouse and dependents. However, after the employee retires or otherwise terminates employment, the maximum reimbursement amount is not increased unless COBRA continuation coverage is elected.

LAW AND ANALYSIS

Section 61(a)(1) and § 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 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).

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 (and § 104 relating to compensation for injuries and sickness). Section 1.105–5(a) provides 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 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 § 213(d)) of the taxpayer or the taxpayer's spouse or dependents (as defined in § 152).

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. 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.

Section 105(h)(1) provides that, unless the plan satisfies the nondiscrimination requirements of § 105(h)(2), amounts paid under a self-insured medical expense reimbursement plan to a highly compensated individual will not be excludable from that individual's gross income under § 105(b) to the extent they constitute excess reimbursements.

Coverage provided under an accident and health plan to former employees and their spouses and dependents are excludable from gross income under § 106. See, Rev. Rul. 82–196, 1982–2 C.B. 53; Rev. Rul. 85–121, 1985–2 C.B. 57.

Under the facts described above, the HRA is an employer-provided accident and health plan used exclusively to reimburse expenses incurred for medical care as defined under § 213(d). Under the HRA, no benefits other than reimbursements for medical care expenses are available either in the form of cash or other non-taxable or taxable benefits at any time.

For purposes of determining whether any part of the salary reduction for the major medical plan is attributable to the HRA, under the facts and circumstances, the applicable premium for COBRA continuation coverage may be used as the actual cost of the major medical plan. Under the facts described above, the actual cost of the major medical plan for one year is $1,800 for employee-only coverage and $4,500 for family coverage. The amount of salary reduction election for employee-only coverage ($1,000) is less than $1,800 and the amount of salary reduction election for family coverage ($3,500) is less than $4,500. Also, the cafeteria plan election form states that salary reduction elections are used only to pay for the major medical plan. Under these facts and circumstances, the HRA reimbursement amounts are not attributable to the salary reduction contributions made to pay for the major medical plan.

In Situation 2, the employer provides accident and health coverage under the HRA for former employees. This coverage is provided based on the former employee's prior employment relationship with the employer. The HRA is used to reimburse the former employee only for medical care expenses of the former employee or the former employee's spouse or dependents. Neither the former employee nor the former employee's spouse or dependents receive any other benefits from the HRA at any time.

HOLDING

Employer-provided coverage and medical care expense reimbursements made under the reimbursement arrangement that allows unused amounts to be carried forward, as described in Situations 1 and 2, are excludable from gross income under §§ 106 and 105, respectively.

See Notice 2002–45 published elsewhere in this Internal Revenue Bulletin for further information and guidance concerning HRAs.

DRAFTING INFORMATION

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

Section 401.—Qualified Pension, Profit-Sharing, and Stock Bonus Plans

(Also, §§ 411, 4980F; 26 CFR 1.411(d)–2.)

Rev. Rul. 2002–42

Merger or conversion; partial termination; notice. This ruling describes a situation where a merger or conversion of a money purchase pension plan into a profit-sharing plan is not a partial termination of the money purchase pension plan and also describes the type of notice that must be given to affected plan participants.

ISSUES

1. Whether, in the absence of other facts indicating a partial termination, the merger or conversion of a money purchase pension plan into a profit-sharing plan results in a partial termination of the money purchase pension plan under § 411(d)(3) of the Internal Revenue Code (the Code).

2. Whether the notice required by § 4980F of the Code and section 204(h) of the Employee Retirement Income Security Act of 1974, as amended (ERISA) must be provided to affected individuals in a money purchase pension plan that is merged or converted into a profit-sharing plan.