Documents for Podcast 008
What's Up Doc? Medical Reimbursement Plans
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Medical Reimbursement Plans represent one of the two methods provided for in Section 105 for allowing an employer to provide a benefit to the employees of the organization that is not taxable to the employee, but is deductible to the employer when paid, the other method being employer paid insurance.

Medical reimbursement plans have some quirks that make them less popular than other options, but in the right situation they are a very powerful tool. As such, they are a tool all tax practitioners who work with closely held businesses should be aware of. This presentation will concentrate on the planning opportunities these plans offer for small businesses.

The IRS highlighted such plans under a new name (Health Reimbursement Arrangements) in a 2002 notice.[1] They are a close relative of flexible spending accounts in cafeteria plans, except that the types of plans we will discuss today are provided under an entirely employer funded plan rather than via employee elective deferrals into a cafeteria plan.

Basic Requirements

Section 105(a) provides that benefits received attributable to employer contributions to

1 IRS Notice 2002-45, amplified by Revenue Ruling 2005-24

accident and health plans are not included in an employee's income. An important initial issue is that those that are self-employed (proprietors and partners) are not considered employees for this purpose[2] and neither are greater than 2% owners of an S corporation (or those deemed to be greater than 2% shareholders by attribution under §318, such as spouses of the shareholder).[3]

However, §105(h) imposes special conditions on *self-insured* medical expense reimbursement plans. A plan is considered self insured unless reimbursement is provided under an individual or group health insurance policy of a licensed insurance company or under a prepaid medical care arrangement that is regulated under federal or state law in a manner similar to the regulation of insurance companies.[4] The plan must involve a shifting of risk[5] and cannot be underwritten by a captive insurance company.[6] If the plan is partially underwritten by insurance, then these rules apply only to the part not covered by insurance.[7] Such a situation would be one where the employer provided a group insurance policy but also reimbursed employees for the amount of the deductible they incurred.

A self-insured plan is subject to two specific sets of rules that impact the highly compensated employees. A highly compensated employee falls into one of the following three classes:

- One of the 5 highest paid officers;
- A greater than 10% shareholder of the employer (including stock deemed owned under the attribution rules of §318); or
- Among the highest paid 25 percent of all employees of the employer (other than employees allowed to be excluded under §105(h)(3)(B) who are actually excluded from participation, a category we'll consider later).[8]

The plan must meet two tests with regard to this group. First, the plan must show it does not discriminate in favor of the highly compensated in terms of eligibility to participate.[9] Second, if it passes that test, it must also show that the actual benefits provided do not discriminate in favor of the highly compensated participants.[10] If the plan fails either of these tests, some or all of the reimbursement may be taxable to the participant.

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2 IRC §105(g)
3 IRC §1372
4 IRC §105(h)(Regulation §1.105-11(b)(1)(i)
5 Regulation §1.105-11(b)(1)(ii)
6 Regulation §1.105-11(b)(1)(iii)
7 Regulation §1.105-11(b)(2)
8 IRC §105(h)(5)
9 IRC §105(h)(2)(A)
10 IRC §105(h)(2)(B)

Discrimination as to Eligibility

There are two mechanical tests for discrimination, and then a facts and circumstances test if the plan fails that. The mechanical test provides that if a plan actually benefits either

- 70% or more of all employees of the employer or
- 80% or more of all employees eligibile to benefit under the plan if 70% or more of a employees are eligible to benefit under the plan

Then the plan is deemed to be nondiscriminatory as to eligibility.[11]

Alternatively, a plan can be held to be nondiscriminatory if employees qualify under a classification found by the IRS to not be discriminatory in favor of highly compensated employees.[12] Regulation §1.105-11(c)(2)(ii) provides that such a determination will be based on facts and circumstances, using the same standards as are applied under §410(b)(1)(B) without regard to the special rules under §401(a)(5) considering eligibility to participate.

However, an important set of exceptions exist here in determining which employees can be excluded from coverage without causing the plan to be deemed discriminatory.[13] The plan can exclude:

- Employees who have not completed three years of service with the employer;[14]
- Employees who have not attained age 25 prior to the beginning of the plan year;
- Part time or seasonal employees.

  Part time employees are subject to a special set of testing rules based on their customary hours. Basically employees that work less than 25 hours a week can be excluded from coverage without any additional testing, those with more than 35 hours cannot be excluded, and those that fall in between can be excluded if other employees in a similar position with the employer work substantially more hours or, if there are no other employees of the employer who do similar work, then other similar employees in the same industry and location work substantially more hours.

  Seasonal employees are subject to a similar set of three groups. Those that work less than 7 months are year can be treated as season regardless of other facts. Those who work more than 9 months a year are not to be treated as seasonal. And those that work between 7 and 9 months are subject to a similar "other employees doing similar work" test as are the part time employees.

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11 IRC §105(h)(3)(A)(i)
12 IRC §105(h)(3)(A)(ii)
13 IRC §105(h)(3)(B)
14 See Regulation §1.105-11(c)(2)(iii)(A) for details on how years of service are to be computed. Generally it's a facts and circumstances test, but the regulation references qualified plan rules as a guide in this area.

- Employees covered by a collective bargaining agreement or;
- Nonresident aliens who receive no income from the employer that constitutes income from sources within the United States (as defined at §861(a)(3)).

Note that generally the excluded classes are broader than those generally allowed to be excluded for testing purposes from qualified retirement plans.

Quite often these plans will be considered in cases where all of the employees except for the highly compensated fall into one of these classes or where there are no employees other than the owners of the business. Tax professionals should recognize cases where, in fact, there are no employees who would need to be covered under the plan to recognize when such a plan needs to be considered.

Discrimination as to Benefits

Benefits provided cannot discriminate in favor of the highly compensated individuals. If a benefit is available only to highly compensated individuals, the entire value of that benefit is considered taxable to the highly compensated employee.[15] As well, a benefit that varies based on the level of compensation is considered to discriminate in terms of benefits offered.[16]

If the plan fails the discrimination test noted above but does cover some eligible nonhighly compensated employees, then a portion of the benefit is deemed to offered in a discriminatory fashion, a proportion of the benefits paid to each highly compensated employee that didn't fail the first test is subjected to tax.[17] That proportion looks at total benefits paid on behalf of the highly compensated as compared to total benefits paid for all participants. So if the highly compensated received 50% of the benefits, then 50% of their reimbursement will be considered taxable income.

Covered Benefits

The plan can pay for and exclude any expense defined by IRC Section 213(a). As the IRS has pointed out, such items *includes* nonprescription drugs, since those items are treated as nondeductible by IRC Section 213(b), which is not the provision referenced in IRC Section 105(f). However, the employer must account for such payments, and amounts incurred prior to the effective date of the plan are not treated as properly reimbursable under the plan.

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15 Regulation §1.105-11(e)(2)
16 Regulation §1.105-11(c)(3)(i)
17 Note that if a plan has no nonhighly compensated employees who would have to be counted, it is considered to benefit the proper proportion of nonhighly compensated employees (that is 70% of zero is zero) and so doesn't have a problem. However, if one nonhighly compensated employee now falls outside the excluded classes, the plan can become a fully taxable to the nonhighly compensated employees if that nonhighly compensated employee does not participate under the plan.

Planning Issues

The existence of these plans presents a couple of planning issues that need to be considered. An employer considering such a plan needs to be aware of the discrimination issues and the potential exposure to liability for benefits under the plan. For instance, while it might make sense to have a plan that reimburses employees for all medical expenses in a case where the entity only has now and only will have a single employee (the owner), that type of open ended arrangement likely doesn't make sense for a plan covering more than one employee—even if all employees are owners and/or highly compensated. In the absence of a cap on benefits (which is allowed so long as it is the same for all), an employer could be on the hook for an unlimited amount of medical expense.

Impact on Entity Selection

Presuming it appears that such a plan might make sense for a client, the professional needs to consider the impact on entity selection for the business. The simplest entity to implement this plan in is a C corporation—that is the one entity where the owner(s) of the entity can be directly covered under the plan as employees. For other entities, the owner is not going to be eligible to be covered under the plan—if it's possible, it will be via being covered under dependent coverage for another employee.

The other employee's dependent option is generally used in proprietorships when the spouse of the proprietor is hired as an employee and then the business overs coverage for employees and their dependents. Thus, the owner is "bootstrapped" into the plan as his/her spouse's spouse—and thus eligible for dependent coverage. The IRS has "blessed" such an arrangement, but only if the spouse is truly an employee. Remember that Section 105 only applies to plans covering employees—so if the spouse doesn't do anything of substance in the business, payments of medical care on behalf of that person won't be considered paid under such a plan. As well, the benefit being offered must be considered in light of the reasonable compensation requirement found in Section 162—a spouse who does one hour's worth of filing in the business during the year likely does not justify receiving a benefit expected to be worth thousands of dollars.

As well, remember that an S corporation represents a special problem—the spouse of the shareholder is deemed to be a shareholder under Section 1372 via the attribution rules of Section 318. So the "hire a spouse" fix doesn't work for an S corporation regardless of how much work the spouse does for the business.

Finally, it is important that the client understand that the choice of entity will have an impact on issues other than the ability to set up a medical reimbursement plan. The potential for double taxation of C corporation earnings needs to be carefully considered, especially if it appears an appreciating asset might end up being trapped in the corporation if it is formed. As well, C corporations generally require more detailed tax

planning (and expense) to insure that a situation doesn't arise where excess income is trapped in the C corporation—pass through entities tend to be effectively "self-correcting" in that matter.

Other Options

Medical insurance is the obvious other choice, as medical insurance provided under §106 and the benefit received under the insured plan are not subject to the discrimination rules noted above. One potential downside, though, is that except for C corporations the ability to deduct the medical insurance in computing adjusted gross income is going to depend on meeting the requirements of §162(l), specifically not being eligible for coverage (even if not taken advantage of) that disqualifies the taxpayer from claiming the self-employed health insurance deduction. Again C corporations are in better shape here, since a C corporation can deduct, and the employee exclude from income, employer provided health insurance regardless of whether the employee is eligible for (or even is covered by) another policy.

Cafeteria plans and flexible spending accounts are another option to be considered if the goal is to provide this benefit to rank and file employees. Such plans are more expensive to maintain, but do shift the risk to the employees who have to decide how much to contribute.

Health savings accounts are another option. They don't have the discrimination problems if the contribution is made by the employee—and since the owner is going to be in a very similar tax position either way, it seems to make sense to go this route. However, they do require special insurance policies that have terms some clients may object to, as well as simply the need to deal with additional reporting issues.