

Section 106.—Contributions by Employer to Accident and Health Plans

(Also Section 125 — Cafeteria Plans and Section 105 — Amounts Received Under Accident and Health Plans).

Application of sections 106(a) and 105(b) to reimbursements of employees for salary reduction amounts previously excluded from gross income under section 106(a).

Rev. Rul. 2002-3

ISSUE

Whether, under the facts described, the exclusions from gross income under §§106(a) or 105(b) of the Internal Revenue Code apply to reimbursements by an employer to employees for salary reduction amounts used to pay for health insurance premiums.

FACTS

Employer M provides health coverage for its employees through a group health insurance policy. The coverage constitutes accident or health coverage for purposes of the exclusion for employer-provided accident or health coverage under §106(a).

M has a payroll arrangement under which employees' salaries are reduced, and M applies the salary reduction amounts to the payment of the health insurance premiums for the employees. Thus, employees receive lower salaries in exchange for employer-provided health coverage. In addition, M makes "reimbursement" payments to employees with respect to the health insurance premiums in amounts that cause employees' after-tax pay from M to be the same as what it would have been if there were no salary reduction and no "reimbursement" payments. M takes the position that both the salary reduction and the "reimbursement" payments are excluded from gross income of employees and are not subject to Federal Insurance Contributions Act (FICA) or Federal Unemployment Tax Act (FUTA) taxes.

The salary reduction used to pay for health insurance premiums under M's payroll arrangement could be done with or without employee elections. For example, M could make a unilateral decision to reduce employees' salaries and use those amounts to provide health insurance to the employees. Alternatively, M could offer employees the choice under a §125 cafeteria plan to reduce their salaries in order to receive employer-provided health insurance.

LAW AND ANALYSIS

In general, §106(a) provides that gross income of an employee does not include employer-provided coverage under an accident or health plan. Under §106(a), an employee may exclude premiums for accident or health insurance coverage that are paid by an employer. Also, under §105(b), an employee may exclude amounts received through employer-provided accident or health insurance if those amounts are paid to reimburse expenses incurred by the employee for medical care (of the employee, the employee's spouse, or the employee's dependents) for personal injuries or sickness. To the extent amounts are excluded from gross income under §105(b) or 106(a), they are also excluded from income tax withholding under §3401. In addition, amounts paid to reimburse

expenses incurred by the employee for medical care (of the employee, the employee's spouse, or the employee's dependents) for personal injuries or sickness are also excluded from FICA and FUTA taxes under §§3121(a) and 3306(b).

Under §125, an employer may establish a cafeteria plan that permits an employee to choose among two or more benefits, consisting of cash (generally, salary) and qualified benefits, including accident or health coverage. Pursuant to §125, the amount of an employee's salary reduction applied to purchase such coverage is not included in gross income, even though it is available to the employee and the employee could have chosen to receive cash instead. If an employee elects salary reduction pursuant to §125, the coverage is excludable from gross income under §106 as employer-provided accident or health coverage.

Rev. Rul. 61-146 (1961-2 C.B. 25) provides that the §106 exclusion applies to an employer's reimbursement of an employee for individual accident and health insurance premiums paid by the employee to an insurer if (1) the employer has an accident and health plan under which it permits such reimbursements and (2) any reimbursement is of premiums actually paid by the employee.

Under the rationale of Rev. Rul. 61-146, §106 allows an employee to exclude employer reimbursements for health insurance premiums, but only if those premiums are actually paid by the employee. Under both alternative arrangements described above, when M applies the amount of employees' salary reduction to pay health insurance premiums, the premium payments are paid by M, not the employees, and are excludable from the employees' gross income under §106 because they are paid by M. Although the §106 exclusion applies to the health insurance premiums paid by M, there is no employee-paid premium for M to "reimburse", and therefore the reimbursement payments that M makes to employees are not excluded from gross income under §106. Similarly, the reimbursement payments are not excluded from gross income under §105 because they do not reimburse employees for

expenses incurred for medical care. Accordingly, the reimbursement payments are not excluded from income tax withholding under §3401. In addition, because the reimbursement payments are not reimbursements of expenses incurred for medical care, they are not excluded from FICA taxes under §3121(a) or FUTA taxes under §3306(b).

If the premium payments were instead actually paid by the employees out of the employees' salaries, the salary amounts from which the payments were made would not be excludable from the employees' gross income, but any payments by M to reimburse the employees for the premium payments would be excludable under section 106.

HOLDING

The exclusions from gross income under §§106(a) and 105(b) do not apply to amounts that an employer pays to employees to reimburse the employees for amounts paid by an employer for health insurance coverage that are excluded from gross income under §106(a) (including salary reduction amounts pursuant to a cafeteria plan under §125 that are applied to pay for such coverage). Accordingly, the reimbursement amounts that the employer pays to the employees are included in the employees' gross income under §61 and are subject to employment taxes under §§3401, 3121(a), and 3306(b).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 61-146 is distinguished.

DRAFTING INFORMATION

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