
The Cafeteria Plan Bulletin

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TOO GOOD TO BE TRUE.....IRS REV. RULING 2002-3

What has been viewed by many benefit specialists as a sham transaction has been attacked by the IRS in Rev. Ruling 2002-3. The so called “double dipping” of health insurance premiums by some employers has finally been held invalid by the IRS.

This practice was purported to give the employer two deductions with the same benefit dollar. A welcome respite in the last round of benefit cost increases; however, if it sounds too good to be true it's because it usually is.

The scheme was to reduce an employee's taxable pay by the amount of the premium they were paying for their share of the group insurance premium. Then the employee was reimbursed in a like amount. The reimbursement was supposed to be tax-free to the employee as medical reimbursement.

In Rev. Ruling 2002-3 the IRS has ruled the reimbursement is a taxable transaction. This effectively taxes the monies to the employee and stops the double deduction.

An example would be as follows. Assume that an employer pays Fred

“If it sounds too good to be true.....”



\$800 per week in W-2 wages and gives him free health insurance worth \$200. Assume Fred pays taxes (Fed & FICA) of 20% or \$160, leaving him \$640 to take home. Now the employer implements the “double dip”. It tells Fred that his W-2 pay is being reduced to \$600. (it does this unilaterally or tells Fred that it is a condition to participate in the group insurance plan) but promises him that his take-home pay will not be affected as he will

receive a tax-free reimbursement in an amount that will restore his take-home pay to what it was before. Under the “double dip”, Fred's W-2 pay is \$600 (\$800 - \$200) and his taxes are \$120 (20% x \$600), leaving him \$480 in take-home pay. But Fred also gets a \$160 reimbursement that is purportedly tax-free, bringing his take-home pay to \$640, just like it was before the “double dip” was implemented. Why would an employer do this? To pocket the \$40 in tax savings (\$160-\$120) plus save its share of the FICA taxes. *However, the IRS says you can't do this!!* Under the rationale of the Rev. Ruling, the \$160 reimbursement must be included on Fred's W-2 pay, so his W-2 pay is \$760 (\$600 + \$160). The result for Fred is he is actually **worse off** than before. Because of the tax avoidance program, Fred's take-home pay drops from \$640 to \$608 (\$760 - (20% x \$760)).

In Rev. Ruling 2002-3, the IRS goes on to explain that an employer can reimburse employees on a tax-free basis for health insurance premiums that are actually paid by the employee on an after-tax basis, provided certain conditions are met as outlined in Rev. Ruling 61-146. However, under this tax avoidance program, the premiums are paid by the employer (either unilaterally or by pre-tax salary reductions) and are already excluded from gross income under Code Section 106 (“gross income of an employee does not include employer-provided coverage under an accident or health plan”), so the rationale of Rev. Ruling 61-146 does not apply. There can be no double dipping. There is no “employee paid” premium to reimburse. Also, the reimbursements are not excluded from gross income under

Code Section 105 because they do not reimburse employees for expenses incurred for medical care.

Employers that may have adopted the tax avoidance program should consider consulting their attorneys or other advisors regarding how to unwind the program.

Rev. Ruling 2002-3 is important for another reason. It reaffirms the continuing validity of Rev. Rul. 61-16 which allows for individually owned health insurance policies by the employee to be paid pre-tax through the Cafeteria Plan. Following this Rev. Ruling many employers have designed their Cafeteria Plans to add insurance premium reimbursement accounts to their Plans. For the pros and cons of such a practice give us a call.

DEATH BENEFITS IN CAFETERIA PLANS?

Of course, one of the "Qualified Benefits" under a Cafeteria Plan can be group term insurance. Under this benefit, there are certain limitations on the amount of premiums that can be pre-taxed, according to the face amount of coverage and other rules.

However, consider the following situation. An employee dies mid plan year leaving a balance in his *Health Care Flexible Spending Account*. Is there any way to get that money out to his family members?

Fortunately, the answer is "yes". If they are beneficiaries of the employee's estate, they would benefit from reimbursements obtained by the estate for their own and the employee's expenses incurred **prior to** the employee's death. In certain circumstances, they may also elect COBRA and obtain reimbursement as COBRA beneficiaries for their own medical expenses **incurred after** the

employee's death. Generally, it is the deceased's executor or personal representative, acting on behalf of the participant, that requests reimbursement for eligible expenses incurred by the employee, spouse and dependents before the employee's death. The executor or personal representative would be required (as would the employee, if living) to submit the claim form and satisfy the plan's substantiation requirements. The claims would have to be presented before the end of the plan run-out period specified in the plan document.

The administrator would issue a reimbursement check to the estate as instructed by the court, on behalf of the employee. So a family member would "benefit" only indirectly to the extent that he or she is an estate beneficiary.

This is **important for the human resource professional to know** because estate administration can take many months. Consider reminding the family or the personal representative of the date that the Cafeteria Plan run-out period expires.



PROOF THAT A TREATMENT WORKS IS NOT A PREREQUISITE FOR IT TO QUALIFY AS MEDICAL CARE UNDER A HEALTH CARE SPENDING ACCOUNT

We present the following synopsis of recent IRS information letters only as an interesting event. We in no way recommend that our clients push the envelope with submitting medical expenses of this nature.

In IRS Information Letter 2001-0116, to prove that successful treatment is neither a requirement nor a guarantee that medical expenses will be deductible under Code Section 213, the Service noted that the Tax Court had in one case allowed some of the expenses of the traditional Navajo sing without requiring proof that it cured cancer. Yet in a different case, the Tax Court had disallowed expenses for medical care, despite "accepting the undisputed fact that diseases have been healed by miracles occurring at the shrine of Lourdes." The IRS noted that the Tax Court did not directly challenge the view that religiously-based treatments could qualify as medical care under the appropriate circumstances.

Lastly, it is interesting to note that both of the information letters that addressed the deductibility of non-traditional healing in the last year (2001) came as a response to inquiries from members of Congress. Obviously, this area has captured attention at high levels.

Editors Note:

Experimental surgeries and other treatments for cancer and other dread diseases generally are reimbursable under your Cafeteria Plan, even though not covered by your medical plan. Always check first, however, before committing dollars to a Spending Account for these items.