

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-100141-08

July 23, 2008

Taxpayer's Name:
Taxpayer's Address:
Taxpayer's Identification No.:
Year(s) Involved:
Date of Conference:

LEGEND: TAXPAYER =

ISSUE:

If an accrual method Taxpayer provides medical and dental services to employees under self-insured medical and dental plans as described below, and the Taxpayer pays the service providers more than 2 ½ months after the end of the taxable year in which services are provided, in what year are the payments for those medical and dental services deductible by Taxpayer?

CONCLUSION:

Taxpayer may deduct the payments in its taxable year during which the medical and dental services are provided to Taxpayer's employees.

FACTS:

Taxpayer is an accrual method taxpayer that maintains self-insured medical and dental plans (collectively, the “Plans”) for its eligible employees. The Taxpayer operates on a 52/53 week taxable year ending in December. The plan year of the Plans is the calendar year. Eligible employees are assumed to be calendar year taxpayers. Taxpayer represents that benefits under the Plans are not provided through a welfare benefit fund within the meaning of section 419(e) of the Internal Revenue Code (the “Code”).

The Summary Plan Description (the “SPD”) states that Taxpayer “has adopted the Plan[s] in order to provide health care benefits for its eligible employees and dependents... [who] are permitted to participate in [the] plan options.” The SPD further provides that Plan benefits will be provided for “Covered Expenses,” unless limited or excluded in the Exclusion and Limitations section. The SPD states, “A covered expense is incurred on the date the medical service is received.” The SPD further provides that expenses for services are reimbursable under the Plan only if they are provided while the individual is a participant covered under the Plan.

Upon meeting eligibility requirements, employees may receive medical and dental services covered by the Plans. When an eligible employee requires services, the employee arranges for the necessary appointment with the medical service provider selected by the employee. The service provider procures the billing information from the employee and then bills a third-party administrator for any services provided. Under the Plans, except in rare cases, claims are filed by the service provider rather than the employee. Employees are never liable to Taxpayer for the costs of the medical services provided.

Pursuant to a contract with Taxpayer, the third-party administrator reviews the bills to determine whether the services are covered under the Plans. The third-party administrator pays the service providers to the extent the services are covered, paying with its funds, for which Taxpayer reimburses the administrator, or from a bank account funded by Taxpayer. Taxpayer pays these expenses from its general assets. Taxpayer’s employees are liable to the service provider for any amounts not covered by the Plans such as co-payments.

The third-party administrator generally pays claims within 30 days of receiving a bill from a service provider. In certain circumstances, there is a delay by the service provider in billing the third-party administrator and the third-party administrator pays the service provider more than 2 ½ months after the end of the taxable year in which the services are provided.

Taxpayer deducted expenses for services in the taxable year in which the services are provided to the employees, including instances in which a claim is paid more than 2 ½ months after the end of the taxable year.

LAW AND ANALYSIS:

Section 105(a) of the Code provides that 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(b) of the Code provides an exception to section 105(a). Section 105(b) provides that except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 for any prior taxable year, gross income does not include amounts referred to in section 105(a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by him for the medical care (as defined in section 213(d) of the Code) of the taxpayer, his spouse, and his dependents (as defined in section 152 of the Code).

Section 105(h) of the Code generally provides that amounts paid to highly compensated individuals under a discriminatory self-insured medical expense reimbursement plan are not excludable from gross income under section 105(b) to the extent the amounts constitute an excess reimbursement.

Section 105(h)(10) provides that any amount paid for a plan year that is included in income by reason of section 105(h) shall be treated as received or accrued in the taxable year of the participant in which the plan year ends.

Section 1.105-11(h) of the Income Tax Regulations provides that excess reimbursements (determined under § 1.105-11(e)) paid to a highly compensated individual for a plan year will be considered as received in the taxable year of the individual in which the plan year ends. The particular plan year to which reimbursements relate shall be determined under the plan provisions. In the absence of plan provisions, reimbursements shall be attributed to the plan year in which payment is made. For example, the regulations provide that under a calendar year plan an excess reimbursement paid to A in 1981 on account of an expense incurred and subject to reimbursement for the 1980 plan year under the terms of the plan will be considered as received in 1980 by A.

Thus, with respect to the inclusion in income of excess reimbursements for highly compensated individuals under a discriminatory plan that would otherwise be excluded

from income, the inclusion occurs in the year the services are provided if the plan provides that such reimbursements relate to such year.

Section 461(a) of the Code provides that the amount of any deduction shall be taken in the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.446-1(c)(1)(ii) of the regulations provides that under the accrual method of accounting, a liability is incurred, and is generally taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. The first two requirements are commonly referred to as the all events test and the third requirement is called the economic performance requirement.

Section 1.446-1(c)(ii)(B) of the regulations defines a liability as including any item allowable as a deduction, cost, or expense for Federal income tax purposes.

Section 1.461-4(a) of the regulations provides that for purposes of determining whether an accrual basis taxpayer can treat the amount of any liability (as defined in section 1.446-1(c)(ii) of the regulations) as incurred, the all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability.

Section 1.461-4(d)(2)(i) of the regulations provides the general rule that economic performance for a liability arising from services provided to the taxpayer occurs as the services are provided.

Section 1.461-4(d)(2)(iii) of the regulations provides a specific rule that economic performance for certain employee benefits occurs when the amount is otherwise deductible under sections 404, 404A, or 419 of the Code, as appropriate.

In general, liability for self-insured medical expenses is incurred in the taxable year in which all events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability in accordance with section 1.461-1(a)(2) of the regulations. Generally, the fact of liability and the amount of the liability are established in the taxable year the services are provided, so the liability for the medical expenses is incurred in the taxable year in which medical services are provided to Taxpayer's employees by the medical service provider because that is the time economic performance occurs.

However, if payments are made more than 2 ½ months after the end of the taxable year in which the services are provided, the benefits may constitute deferred

compensation. In that case, section 1.461-4(d)(2)(iii) of the regulations provides an exception to the general rule, under which the timing of economic performance of (and thus the employer's deduction for) the liability for the expense of certain employee benefits is governed by section 404 of the Code.

Section 404(a) of the Code provides that if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, the compensation is not deductible under Chapter 1 of Subtitle A of the Code when accrued. However, if the compensation would otherwise be deductible under Chapter 1 of Subtitle A of the Code, it is deductible under section 404 of the Code, subject to the limitations imposed by section 404.

Section 404(a)(5) of the Code generally provides that compensation paid under a nonqualified plan (i.e., a plan for which contributions are not deductible under section 404(a)(1), (2), or (3) of the Code) of deferred compensation is deductible in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan.

Section 404(b)(1)(A) of the Code provides that, in the absence of a plan deferring the receipt of compensation, any method or arrangement having the effect of such a plan is subject to section 404(a) of the Code.

Section 1.404(b)-1T of the regulations provides that a plan that defers the receipt of compensation or benefits for more than 2.5 months following the end of the employer's tax year is treated as a plan deferring the receipt of compensation for purposes of sections 404(a) and (b) of the Code.

Section 404(b)(2)(A) of the Code provides that any plan providing for deferred benefits (other than compensation) for employees, their spouses, or their dependents is treated as a plan deferring the receipt of compensation. Section 404(b)(2)(A) further provides that in the case of such a plan, the determination of when an amount is includible in gross income must be made without regard to any provisions (in Chapter 1 of the Code) that exclude the benefits from gross income.

Section 404(b)(2)(B) of the Code provides that section 404(b)(2)(A) does not apply to any benefit provided through a welfare benefit fund as defined in section 419(e).

The timing of the deduction for payments Taxpayer makes more than 2 ½ months following the close of its taxable year, therefore, depends on (1) whether the payments are made through a welfare benefit fund as defined in section 419(e) and (2) when the medical and dental reimbursement amounts paid under the Plans would be included in the income of employees participating in such Plans if such amounts were not excludible from income. With respect to the first issue, Taxpayer represents that the

Plans do not involve a welfare benefit fund within the meaning of section 419(e) of the Code. Regarding the second issue, the Plan terms provide that whether benefits are eligible for reimbursement is determined by whether the individual is a participant on the date that services are provided. Accordingly, the eligible employees are considered to receive the reimbursements in the calendar year during which they receive the medical and dental services under the self-insured Plans. See Reg. § 1.105-11(h).

Based on the foregoing analysis, under the particular facts presented in this case, it is unnecessary to determine whether section 404 governs the timing of Taxpayer's deduction. If section 404 applies, section 404(b)(2) provides that the determination of when an amount is includible in gross income is made without regard to provisions that exclude the benefit from gross income. As set out above, the payments Taxpayer makes for medical and dental services would be includible in the employees' gross incomes in the calendar year during which the services are provided. Taxpayer could claim the deduction (if the payments would otherwise be deductible) for the same year under section 404(a)(5).¹ If section 404 does not apply, the deductibility of the payments made more than 2½ months after the end of the taxable year is subject to the general economic performance rules under section 1.461-4(d)(2)(i) of the regulations. Applying the provisions of section 461, the liability for medical and dental expenses is incurred in the taxable year in which medical and dental services are provided to Taxpayer's employees because that is the time economic performance occurs. In either case, the expenses are deductible by Taxpayer in the taxable year in which the medical and dental services are provided.

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

¹ Although Taxpayer has a 52/53 week taxable year ending in December, rather than a calendar year taxable year, see Treas. Reg. § 1.441-2(d).