

Section 105: Unraveling the Mystery of Medical Reimbursement Plans

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Medical reimbursement plans repay insured employees for many out-of-pocket medical expenses not covered by their underlying health plan. The most common question asked about medical reimbursement plans relates to whether a plan is insured or uninsured, and what rules apply to each. The objective of this article is to clarify these issues.

If payments are made from the general fund of the business to reimburse the employee for his or her medical expenses, the plan is called uninsured or self-insured. However, when a corporation pays a premium to an insurance company and thereby shifts the risk to an "unrelated third party," it is called an insured plan. Non-discrimination rules do not apply to insured plans. [See Treasury Regulations 1.105-11(B)(1)(ii).]

The general definition of a self-insured medical reimbursement plan is a plan written for the benefit of employees that provides for reimbursement of employee medical expenses referred to in Section 105. This means the employee is reimbursed from employer funds. The reimbursement dollars are paid by the employer from corporate revenues or retained earnings. When the employee receives reimbursement, the company receives a deduction and the employee must include the payment as taxable income.

A plan is self-insured unless it meets one of the following requirements:

- 1) Reimbursement is provided under an individual or group policy of accident or health insurance issued by a licensed insurance company or

- 2) Reimbursement is provided under an arrangement in the nature of a prepaid health plan that is regulated under federal or state law in a manner similar to the regulation of insurance companies.

An insured plan can avoid income inclusion to the employee while retaining the deduction to the employer. To qualify as an insured plan, it must satisfy the requirements of Section 105(h) and Section 105(b).

A plan underwritten by a policy of insurance or a prepaid healthcare plan that does not involve "shifting of

risk" to an unrelated third party, such as a cost-plus policy, is considered self-insured. This type of policy merely provides administration or bookkeeping services. However, a plan is not considered self-insured merely because "experience" is one factor the insurer uses in determining the premium.

There are very few insurance companies that currently offer an insured medical reimbursement plan and each utilizes a slightly different approach. SML Select, a medical reimbursement plan offered by Security Financial Life, avoids this argument by providing reimbursement above a certain level at no cost to the insured.

There are several benefits associated with an insured medical reimbursement plan. There is no "use it or lose it" provision. The employer can pick and choose who participates. Reimbursement plans have lower administration costs because there are typically fewer participants (the benefit is not provided to all employees).

Business owners may look upon this type of plan as a "golden handcuff" to retain key employees. Premium payments are designed to be tax-deductible under Section 105 of the Internal Revenue Code. C-corporations can fully deduct the cost of the insured plan. For other business entities (S-corporations, LLCs and partnerships), the deduction is limited to 60% through 2001, 70% in 2002 and 100% in year 2003 and thereafter.

An insured plan does not have to meet the non-discrimination requirements in order to secure the tax benefits for covered employees, assuming the employer includes all individuals of a specified class.

Medical reimbursement plans can be used to reward long-term employees, attract new employees or enhance a benefit package for current employees. ■



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