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Via Electronic Submission: www.regulations.gov

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Mr. William M. Paul
Principal Deputy Chief Counsel and Deputy Chief Counsel (Technical)
IRS Office of Chief Counsel
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RE: Comments on Proposed Rule on the Taxation and Substantiation Requirements for Fixed Indemnity and Certain Other Accident and Health Insurance Policies (REG–120730–21)

Dear Ms. Batchelder and Mr. Paul:

The American Council of Life Insurers ("ACLI") appreciates the opportunity to provide comments on the proposed rule on the taxation and substantiation requirements for fixed indemnity and certain other accident and health insurance policies ("fixed indemnity policies").[1] Fixed indemnity policies provide vital consumer protections by helping to pay for out-of-pocket expenses associated with

[1] While we use the term "fixed indemnity insurance" throughout our comments, the Proposed Rule refers to all policies for which a fixed benefit on the occurrence of a medical event. Many kinds of supplemental benefits including fixed indemnity, hospital indemnity, specified disease, and accident only insurance meet that definition. See IRC Section 9832(c)(1)(A);(c)(3); IRC Section 54.9831-1(c)(2)(i),(c)(4). Unless otherwise specified, all references are to the Internal Revenue Code or the regulations promulgated thereunder.

The American Council of Life Insurers (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States.

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medical events that are not covered by primary medical insurance. Fixed indemnity coverage helps to bridge the financial gap between what a customer's comprehensive health plan pays and the total costs they face when they experience a health event and require medical treatment and/or services. For example, even an individual covered by comprehensive medical insurance may have expenses such as copays, deductibles, coinsurance, travel costs, special clothing, wigs, household modifications, and access to out of network providers.

In fact, 57% of Americans cannot afford a $1,000 emergency expense[2] and 41% of Americans have some sort of debt created by medical or dental expenses. [3] A survey found that 100 million Americans experience health care debt.[4] Medical debt can negatively affect health by causing an individual to delay or avoid medical care because of the cost, and can force people to sacrifice essentials like groceries, and deplete savings.[5] Another study found that private health insurance leaves a lot of costs uncovered and can offer little protection against high bills.[6] Middle income earners have the highest rate of medical debt at 23.5%.[7] Furthermore, of those middle income earners, people of color experience a higher level of medical debt.[8]

On July 12, 2023, the U.S. Department of the Treasury ("Treasury"), Department of Labor, and Department of Health and Human Services published a proposed rule in the Federal Register on the tax treatment of fixed indemnity insurance (the "Proposed Rule").[9] The Proposed Rule would make the full amount of any benefit a fixed indemnity policy pays taxable and subject to payroll tax if the premiums for the policy were paid on a pre-tax basis through employer contributions or a cafeteria plan. Unfortunately, these changes would significantly undermine individuals' ability to protect themselves and their families.

We respectfully request that Treasury and the Internal Revenue Service ("IRS") withdraw the Proposed Rule's amendments to Section 1.105-2 and reexamine their conclusion that fixed benefits that insurance policies pay on the occurrence of a health-related event ("fixed indemnity benefits") are wages for Federal tax purposes. Treasury and the IRS state that the Proposed Rule is a clarification of current law. In fact, it is a drastic change that imposes a tax increase on policyholders who need the benefits to pay medical expenses. Such a drastic departure from current law could only be effected by an act of Congress. Moreover, the preamble to the Proposed Rule incorrectly presumes that fixed indemnity benefits are wages, without citing valid authority and without proposing any change to the underlying payroll tax regulations.

Additionally, the proposed effective date is unworkable given the impacts to current policies, the necessary administrative changes for insurance companies, and the lack of an appropriate way in which to report to the IRS the payment of fixed indemnity benefits.

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[2] Bankrate, *Bankrate's 2023 annual emergency savings report*, June 23, 2023.
[3] Lunna Lopez, Audrey Kearney, Alex Montero, Liz Hamel and Mollyann Brodie, *Health Care Debt In The U.S.: The Broad Consequences Of Medical And Dental Bills*, KFF, June 16, 2022.
[4] Lopes, Lunna and Audrey Kearny, Alex Montero, Liza Hamel, and Mollyann Brodie, "Health Care Debt in the U.S.: The Broad Consequences of Medical and Dental Bills," (June 2022) available at: Health Care Debt In The U.S.: The Broad Consequences Of Medical And Dental Bills | KFF.
[5] Himmelstein, David and Samuel Dickman, Danny McCormick, et. al., "Prevalence and Risk Factors for Medical Debt and Subsequent Changes in Social Determinants of Health in the US," (September 2022) available at: Prevalence and Risk Factors for Medical Debt and Subsequent Changes in Social Determinants of Health in the US | Health Policy | JAMA Network Open | JAMA Network.
[6] *Id.*
[7] Murdock, Kylie and Joshua Kendall, David Kendall, "Medical Debt Hits the Heart of the Middle Class," (August 2023) available at: Medical Debt Hits the Heart of the Middle Class – Third Way.
[8] *Id.*
[9] See 88 FR 44596.

Below is a brief summary of the information provided in greater detail in the appendix to our letter:

The Proposed Rule Would Impose a Tax Increase on Individuals who have Recently Experienced a Serious Health-Related Event

The changes in the Proposed Rule are a drastic departure from current law, resulting in a tax increase on individuals receiving fixed indemnity benefits. Currently, policyholders are taxed only on fixed indemnity benefits to the extent they exceed their unreimbursed medical expenses (the “excess benefit rule”) and fixed indemnity benefits are not wages for payroll tax purposes. The Proposed Rule would recharacterize the full amount of fixed indemnity benefits as wages subject to income and payroll taxes. Individuals receiving fixed indemnity benefits will have recently experienced a serious health-related event and should not have an increased tax liability imposed on funds they need to pay expenses resulting from medical related costs. Additionally, if fixed indemnity benefits are subject to payroll taxes, employers will be less likely to offer fixed indemnity coverage. (For more information, see the Appendix page 1.)

Fixed Indemnity Benefits Help Pay for Real Medical Expenses and Should not be Confused with Tax Avoidance Schemes or Disability Insurance

Fixed Indemnity Insurance Benefits are Used to Pay for Medical Expenses and Qualify for the Exclusion Under Section 105(b)

The Proposed Rule states that 100% of any fixed indemnity benefit is taxable because fixed indemnity insurance is not reimbursement for medical expenses. This is an inaccurate view. While fixed indemnity policies do not require that policyholders use benefits to pay for medical expenses and may not base payment of benefits on expenses incurred for medical care, the health-related events covered by fixed indemnity insurance, such as cancer, heart attacks, and hospitalizations, invariably give rise to medical expenses that are not covered by comprehensive medical insurance, such as co-pays, travel costs, special clothing, household modifications, out of network providers, and experimental or investigative medical treatments. Further, any policy benefits that are not used to pay medical expenses are subject to income tax. (For more information, see the Appendix page 2.)

Tax Avoidance Schemes are not Used to Pay for Medical Expenses and Should be Addressed Directly

The life insurance industry shares the concerns of Treasury and the IRS regarding arrangements that are marketed as supplemental coverage and purport to avoid reporting and imposition of income and payroll taxes. Fixed indemnity insurance, however, is very different from the product used in recent tax avoidance schemes, yet would be subject to the Proposed Rule. The IRS should continue to address abusive arrangements through targeted guidance, public outreach, and enforcement action, not through an overly broad regulation with far-reaching consequences for millions of Americans who rely on fixed indemnity insurance to protect them from the unexpected costs of medical emergencies. (For more information, see the Appendix page 3.)

Fixed Indemnity Benefits are not Disability Payments

Benefits under disability policies are triggered by an absence from and inability to work and are a replacement for earned income. In contrast, fixed indemnity benefits are not income replacement. The policies pay based on specific health-related events, such as a hospital stay or a diagnosis of a specified disease (such as cancer). Fixed indemnity benefits cover individuals who may not be employed and pay benefits even if a policyholder continues working after a health-related medical event or has disability coverage. This is because medical-related out-of-pocket expenses that

fixed indemnity policies may help cover are unrelated to an individual's employment or earnings status. (For more information, see the Appendix page 5.)

The Excess Benefit Rule is a Longstanding Regulatory Interpretation that Cannot be Changed without Legislation

Treasury and the IRS have consistently applied the excess benefit rule for more than 60 years

The Proposed Rule is a departure from more than 60 years of law and formal and informal guidance. The IRS and Treasury have repeatedly affirmed the "excess benefit rule," in regulations, revenue rulings, private letter rulings, IRS publications, and Presidential budget proposals. The Proposed Rule would arbitrarily eliminate the excess benefit rule for fixed indemnity insurance, increasing taxes on policyholders who have recently suffered an unplanned health-related event, and incurred out-of-pocket expenses that are not covered by comprehensive medical insurance. (For more information, see the Appendix page 6.)

The Proposed Rule is Contrary to Congressional Intent

Over the past 60 years, Congress has repeatedly revisited the rules applicable to employer-paid health insurance without making changes that would make fixed indemnity benefits fully taxable. Treasury and the IRS propose to change this decades long tax treatment, where Congress has clearly left the longstanding rule for the taxation of excess reimbursements for medical expenses intact. Such a fundamental change to the rule that would impact an entire market should only be effected legislatively. (For more information, see the Appendix page 8.)

Fixed Indemnity Benefits are not Wages for Purposes of Income Tax Withholding or the Federal Insurance Contributions Act ("FICA") or Federal Unemployment Tax Act ("FUTA") Tax

The Proposed Rule presumes that fixed indemnity benefits are subject to payroll taxes without proposing underlying regulatory changes to impose wage treatment on fixed indemnity benefits. Payments made on account of medical expenses paid by third-party insurance companies in the event of a triggering medical condition are not wages within the plain meaning of the term. Furthermore, there is a longstanding distinction between insured and uninsured employer health plans that is reflected in the Internal Revenue Code, Treasury Regulations, and the applicable legislative history. Additionally, Temporary Treasury Regulation Section 32.1, which the Proposed Rule cites as authority, was promulgated without notice and comment with the intention that it apply to disability payments and is not valid as applied to fixed indemnity benefits. (See the Appendix page 10.)

Information Reporting Guidance on Fixed Indemnity Benefits would be Helpful

If Treasury and the IRS agree that long-standing guidance on fixed indemnity benefits should not be changed, insurance companies would benefit from direction as to how fixed indemnity benefits should be reported. There is no form available that permits insurance companies to indicate that a fixed indemnity payment may not be taxable, subject to the excess benefits rule. Additionally, if Treasury and the IRS impose wage treatment on fixed indemnity benefits, a framework for shifting of FICA/FUTA tax liability will need to be established to report fixed-indemnity benefits. (For more information, see the Appendix page 13.)

The Proposed Applicability Date is Unworkable and would Impermissibly Impact the Taxation of Insurance Contracts Already in Force

The proposed applicability date of these significant tax changes is unworkable because it would

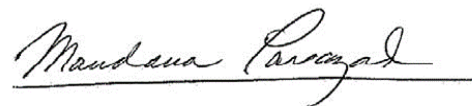
impact policies that were purchased with the expectation that benefits paid by a policy purchased on a pre-tax basis would be taxable only to the extent they exceed a policyholder's unreimbursed medical expenses. Additionally, many employers have already made decisions about plan offerings for 2024, based on the assumption that benefits under the policies would not be subject to FICA or FUTA tax or payroll withholding and reporting.

Furthermore, if the Proposed Rule is finalized contrary to our recommendations, insurance companies and employers will need time to implement systems and administrative changes. With 2024 only three months away, the necessary changes cannot be implemented in the time frame proposed. (For more information, see the Appendix page 14.)

We appreciate the opportunity to provide feedback on the Proposed Rule, especially given the vital consumer protections fixed indemnity insurance provides. We would be happy to provide more information on these and any other issues that may come up in the course of developing proposed regulations.

Sincerely,

Regina Y. Rose



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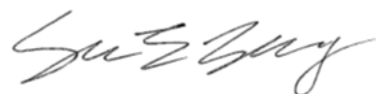

Sarah Lashley

Cc:

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ACLI
Financial Security for Life

Appendix

Proposed Rule on the Taxation and Substantiation Requirements for Fixed Indemnity and Certain Other Accident and Health Insurance Policies

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I. Introduction

On July 12, 2023, the U.S. Department of the Treasury ("Treasury"), Department of Labor, and Department of Health and Human Services published a proposed rule in the Federal Register on the tax treatment of fixed indemnity insurance (the "Proposed Rule").[1] Treasury and the IRS state that the Proposed Rule is a clarification of current law. In fact, it is a drastic change that imposes a tax increase on policyholders who need the benefits to pay medical expenses. Such a drastic departure from current law could only be effected by an act of Congress. Moreover, the preamble to the Proposed Rule incorrectly presumes that fixed indemnity benefits are wages, without citing valid authority and without proposing any change to the underlying payroll tax regulations.

Additionally, the proposed effective date is unworkable given the impacts to current policies, the necessary administrative changes for insurance companies, and the lack of an appropriate way in which to report to the IRS the payment of fixed indemnity benefits.

II. The Proposed Rule Would Impose a Tax Increase on Individuals who have Recently Experienced a Serious Health-Related Event

Policyholders relied on current and long-standing rules that only benefits in excess of their unreimbursed medical expenses would be subject to tax. If the Proposed Rule is finalized, 100% of their benefits would be subject to tax regardless of the amount of their unreimbursed expenses. Further, Treasury and the IRS indicate that FICA and FUTA taxes would apply, when FICA and FUTA taxes have never previously applied to these amounts and there is no valid rule subjecting the benefits to FICA or FUTA tax.

Example: A policyholder has cancer and has had many cancer-related doctor visits, hospital visits, and cancer treatments. She has ACA primary medical insurance, but as with any reliable medical coverage, she will have out-of-pocket expenses in the form of deductibles and co-insurance—items not covered by her major medical plan. In a single year, these out-of-pocket expenses amounted to $6,000. She is insured by a fixed indemnity excepted benefit plan for which her employer paid the premium. This coverage provides a fixed indemnity benefit that covers the same health-related medical events covered under her major medical plan. Her maximum benefit from the fixed indemnity plan for these same health-related medical events is $5,000.

Under current law: The entire $5,000 from the fixed indemnity plan is not subject to tax, because there is no "excess benefit." The policyholder is left with only $1,000 of unreimbursed medical expenses.

Under the proposal: The policyholder would owe taxes on the $5,000 in fixed indemnity benefits (even though that is less than her unreimbursed medical expenses). Further, the Proposed Rule would appear to subject this payment to FICA and FUTA taxes on this benefit, payable by both the employer and the policyholder (in the case of FICA taxes).

As a result, if the policyholder is in the 22% tax bracket her benefit is reduced as follows:

Fixed Indemnity Benefit	$ 5,000.00
Income Tax (22%)	$(1,100.00)
OASDI (6.2%)	$ (310.00)
HI (1.4%)	$ (70.00)
Remaining Benefit	$ 3,520.00

[1] See 88 FR 44596-44658.

The policyholder's employer also now owes $380 in FICA tax.

Moreover, depending on whether the state in which the policyholder resides conforms to the Federal tax rules, her benefits could be even further reduced by state income tax.

If the Proposed Rule were finalized, employers may reconsider how and whether to offer fixed indemnity insurance to their employees. Faced with this decision, some employers will continue to offer these benefits but on an after-tax basis, which will avoid tax implications on any benefit payments. Employers and employees will have increased FICA and FUTA taxes when premiums are paid post-tax because they will pay tax on the portion of premiums that would have been exempt if paid on a pre-tax basis. Unfortunately, with the tax increase under the Proposed Rule, some (likely smaller) employers may choose not to offer these employer-paid benefits at all. Currently, both the premium and benefits (up to the amount of unreimbursed medical expenses) are not subject to income tax and both the premium and benefits are completely exempt from FICA and FUTA tax. If changed, the harm in this situation would be felt by employees, who would lose the opportunity to have cost-effective additional financial protection.

III. Fixed Indemnity Benefits Help Pay for Real Medical Expenses and Should not be Confused with Tax Avoidance Schemes or Disability Insurance

Fixed Indemnity Insurance Benefits are Used to Pay for Medical Expenses and Qualify for the Exclusion Under Section 105(b)

The Internal Revenue Code does not distinguish between fixed indemnity insurance and primary medical insurance; tax treatment is the same for all reimbursements for medical expenses. Treasury and the IRS are proposing to change this rule, referring to it as a "clarification," and applying the rule designed for disability benefits to this sector of the health insurance market.

As is the case with accident and health coverage generally, if the premium for fixed indemnity insurance is paid on an after-tax basis, Section 104(a)(3) establishes that the benefits are not subject to tax. This is also the case with health coverage generally, if the premium for fixed indemnity insurance is paid for on a pre-tax basis (including both employer funds and employee salary reduction, referred to in this document as "employer-paid"), Section 105(b) provides that such benefits are not subject to tax to the extent the benefits reimburse the employee for medical expenses (as defined in Section 213(d)).[2]

No direct correlation is required between the amount of benefits payable and the amount of medical expenses incurred, for the exclusion under Section 105(b) to apply, as long as benefits are payable exclusively upon the occurrence of a triggering medical event.

The Proposed Rule would amend Section 1.105-2 arbitrarily to state that no portion of a fixed indemnity benefit is reimbursement for medical expenses under section 105(b):

> *Any amounts received under a fixed indemnity plan* treated as an excepted benefit under Section 9832(c)(3), or any plan that pays amounts regardless of the amount of Section 213(d) medical care expenses actually incurred, are not payments for medical care under Section 105(b) and are included in the employee's gross income under Section 105(a).

In practice, the statement that fixed indemnity benefits are divorced from expenses for medical care is untrue. A policy may pay a lump-sum benefit upon the diagnosis of a specified disease, such as cancer, without explicitly stating that the insured must incur medical expenses. However, fixed indemnity insurance is intended to protect policyholders from potentially financially devastating costs incurred as a result of certain health events. The kinds of health-related medical events insurance companies cover are the type that will undoubtedly result in the policyholder

[2] See the discussion of the "excess benefit" rule starting on Appendix page 6.

incurring medical expenses. Additionally, while a policyholder purchases the policy as financial protection, they are undoubtedly thinking of the out-of-pocket expenses that will result from the health-related event if it occurs. Moreover, while a policyholder can use the policy proceeds for something other than medical expenses, it is unlikely that they purchase a fixed indemnity policy for that purpose or with the idea that they would not need the policy to pay for any out-of-pocket medical expenses since they cannot access the benefits of the policy without the occurrence of a health-related event. Following settled law, long-standing regulations and guidance, the IRS has up until now recognized these realities and the role these policies play protecting vulnerable consumers and allowed exclusion of these benefits when they are used to cover qualifying, out-of-pocket medical expenses.

Additionally, the preamble to the Proposed Rule appears to take a more restrictive view than the language proposed in the regulation itself. The preamble states that an insurer must not only pay the benefit with regard to the amount of medical expenses the policyholder incurs, but must also determine that an insured is not reimbursed through other insurance for a benefit payment to qualify as reimbursement for medical expenses under Section 105(b):

> The Treasury Department and the IRS interpret Section 105(b) of the Code to not apply to benefits paid without regard to the actual amount of incurred and otherwise ***unreimbursed*** Section 213(d) medical expenses. Because payment of these amounts is not a reimbursement of Section 213(d) medical expenses, the amount of reimbursement is immaterial, with the result that the payment is not excluded from gross income under Section 105(b) of the Code.[3]

Under this interpretation, the Proposed Rule would preclude any benefit paid by an employer-paid health plan that did not coordinate benefits from being considered reimbursement for medical expenses. Even policies that coordinate benefits could be considered to pay benefits “without regard to unreimbursed medical expenses” because they do not know if an individual owns another policy that does not coordinate.[4]

Moreover, the Greenbooks recognized that at least some portion of fixed indemnity benefit payments could be excluded as reimbursements for medical expenses. In fact, the Greenbooks implied that a statutory change to the law would be necessary for fixed indemnity benefits not to be reimbursements for medical expenses.

Additionally, for Treasury and the IRS to determine that all fixed indemnity insurance is not a reimbursement of Section 213(d) medical expenses is contrary to the plain language of Section 105(b) and could be considered arbitrary and capricious, which would render the Proposed Rule invalid. In making such a determination, Treasury and the IRS would not be considering all of the relevant factors relating to whether fixed indemnity insurance reimburses medical expenses.[5]

Tax Avoidance Schemes Should be Addressed Directly

The preamble refers to certain arrangements that purport to avoid income and employment taxes through the use of schemes that pay benefits—often on a monthly basis—based on “health-related” medical events or activities.[6] The industry is aware of these sham schemes, which are very different from fixed indemnity insurance policies. Treasury and the IRS have been working to

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[3] See *supra* footnote 1 at 44635.

[4] Individuals may participate in a group health plan and also own a privately purchased individual medical policy – which typically does not coordinate.

[5] *Natural Resources Defense Council, Inc. v. United States EPA*, 526 F.3d 591 (9th.Cir. 2008) (holding EPA’s changed interpretation of “contamination” in storm water discharge rule was arbitrary and capricious and an impermissible construction of governing statute)*:* 5 U.S.C. Section 706(2)(A); Motor *Vehicle Manufacturers Association v. State Farm Auto Mutual Insurance Co*, 463 U.S. 29 (1983).

[6] See *supra* footnote 1 at 44634.

address a variety of such arrangements which impermissibly use the favorable tax treatment for employer-provided health benefits as a means of avoiding taxes through sham schemes.[7] While these schemes have variations, their core element is that the employee reduces a large portion of their salary (often $1,000 or more per pay period in excess of the cost of major medical premium) through a Section 125 cafeteria plan and receives almost the entire amount of the reduced salary (usually less the major medical coverage premium) back purportedly tax-free. The schemes' alleged "tax benefits" are triggered by completely volitional actions that apply each pay period to the entire salary reduced amount (less the major medical premium) for all participants for the entire plan year. The participant employees do not and need not suffer a medical event to receive a benefit. Activities that trigger the payment of "benefits" under these abusive schemes include activities such as watching a video regarding general health or checking in with a health coach, but do not involve a participant's medical event that gives rise to medical expenses as defined in Section 213(d).

These tax avoidance schemes do not use defined Health Insurance Portability and Accountability Act of 1996 ("HIPAA") excepted benefits like fixed indemnity insurance. Instead, the Section 125 cafeteria plan alone is used to perpetrate the tax avoidance scheme by pre-tax contributions to the cafeteria plan followed by return of a large portion of those contributions as cash. The contributions and benefits under these tax schemes are completely different than fixed indemnity insurance.

Contributions for fixed indemnity insurance are small relative to major medical coverage premiums and much smaller than the contributions made to the Section 125 cafeteria plan under these tax schemes. All benefits paid under fixed indemnity insurance are based on a specific medical event such as cancer or inpatient hospital stays. Any wellness benefits paid on a fixed indemnity basis are a small part of a larger policy and pay small amounts (generally, $50-$100) for preventative health screenings, such as a colonoscopy or mammogram. Unlike the tax schemes' large "reimbursement" paid in the same amount to each participant every pay period, fixed indemnity insurance benefits pay only at the time of specified narrowly defined medical events of the participant. Further, unlike the tax avoidance schemes – which often make payments automatically, or base payments merely on an employee certification that a health-related event occurred, traditional indemnity benefits require proof. This proof is typically in the form of a provider statement, receipt of payment, or even an EOB. And although the indemnity benefit amount is not based on the medical expenses, the specific expense delineates the medical event generating medical expenses which is used to determine the specific benefits that apply under the insurance coverage. So, unlike the tax schemes, fixed indemnity benefits are tied directly to specific medical events and treatment. Additionally, unlike the tax schemes' large payments each pay period, indemnity benefits are generally much smaller than actual medical expenses incurred for treatment of a participant's injury or sickness and are triggered by an unlikely unfortunate event.

The tax avoidance schemes the agencies have attempted to squash are so different from the supplemental limited benefit coverage addressed in the regulations, that supporters of these schemes will likely argue that the proposed regulations do not apply to the large tax-free payments under the schemes. In fact, the tax avoidance schemes are similar to an impermissible flexible spending arrangement defined under Section 125 and its regulations. Perhaps tightening those regulations would better address these tax schemes.

The potential for tax abuse is an unfortunate factor of every tax system. The IRS has considerable authority to enforce the federal tax laws and impose penalties, including criminal sanctions.[8]

[7] As part of these efforts, the IRS has released several Chief Counsel Advice memoranda regarding the impermissible tax schemes which help to alter taxpayers to unscrupulous activities. The most recent is CCA 202323006, released June 9, 2023, available here https://www.irs.gov/pub/irs-wd/202323006.pdf (last visited Aug. 7, 2023).

[8] See https://www.irs.gov/about-irs/criminal-investigation-ci-at-a-glance.

Further, the IRS often engages in outreach efforts to educate taxpayers about unlawful activities.[9] In the case of tax schemes involving health coverage, state insurance regulators and other federal agencies may also play a role. To date, there has been no litigation involving the tax avoidance schemes and public outreach has been limited to those within the tax community.

Fixed Indemnity Benefits are not Disability Payments

Either one or both of the changes to Section 1.105-2 in the Proposed Rule (that benefits paid under fixed indemnity plans without regard to the amount of medical expenses are taxable and/or the new "substantiation" requirement) would effectively treat fixed indemnity health plans as disability benefits. This result is contrary to the statute and congressional intent.

More generally, since well before HIPAA, the Internal Revenue Code has recognized the differences between health benefits and benefits that are payable on account of disability (meaning benefits triggered by an absence from work). The 1954 Internal Revenue Code provided different treatment for health benefits (including fixed indemnity benefits) and benefits payable on account of disability (absence from work), and Congress over time has changed the treatment for disability benefits only, and not the treatment of accident and health benefits.[10]

The legislative history with respect to the changes in tax treatment of disability benefits is further instructive with respect to the differences between accident and health benefits, including fixed indemnity benefits, and disability benefits and the separate role for each. Specifically, the House and Senate reports for the Tax Reform Act of 1964 contain the same explanation for the additional restrictions imposed at that time on the Section 105(d) exclusion for disability benefits:

> [T]his sick pay exclusion in its present form is not justified. The amounts received by the employee in this case are substitutes for regular wages or salaries which, had they been received as such, would be fully taxable. ***The wage substitutes in this case are wholly unrelated to the costs involved as a result of illness or injury.*** Amounts paid by the employer for the medical expense of the employee already are excludable by the employee under other provisions of law (Section 105(b)) and amounts paid by the employee himself for medical expenses also are deductible elsewhere under present law (Section 213 of the code) to the extent that they exceed what is considered to be the normal level of medical expenses."[11] (Emphasis added).

Congress provided a different tax treatment for disability payments, which are based on an absence from work and are "unrelated to the costs involved as a result of illness or injury." On the other hand, fixed indemnity insurance, like other types of health coverage is triggered specifically by a medical event, not absence from work.

The key issue in distinguishing health policies from disability policies is the structure and substance of the policies.[12] Disability benefits may also be described using various terms, including "sick

[9] See, for example, https://www.irs.gov/businesses/small-businesses-self-employed/anti-tax-law-evasion-schemes (last visited on Aug. 16, 2023), and IRS Publication 3995 (Rev. 3-2023) "Recognizing Illegal Tax Avoidance Schemes, available at https://www.irs.gov/pub/irs-pdf/p3995.pdf (last visited on Aug. 16, 2023).

[10] See discussion at Appendix page 10.

[11] 1964-1 CB (Part 2) Federal Tax Laws and Committee Reports January – June 1964, page 168 (House Report No. 749, 88th Cong., 1st Sess. (Sept. 13, 1963), Committee on Ways and Means); page 553-54 (Senate Report No. 830, 88th Cong., 2d Sess. (Jan. 28, 1964), Committee on Finance).

[12] As justification for changes in the Proposed Rule, the Treasury and the IRS refer to fixed indemnity health coverage various times as "income replacement"." While it may be that sometimes in the marketplace this coverage is referred to as "cash replacement", "income protection", "financial protection", or even "income replacement" (because these terms may help to distinguish fixed indemnity excepted benefits from major medical or primary coverage), these descriptions are not the core issue. Expense-based major medical coverage could also be considered to be "cash replacement" or "income replacement" because the benefits

pay," "wage continuation," "income replacement," and the like. The key issue is how benefits are structured. Benefits under disability policies are triggered by an ***absence from and inability to work***. Such policies typically pay a set amount on a periodic basis (e.g., monthly) as long as a person is incapacitated due to an event or condition specified in the policy, i.e., the covered disabling condition that prevents the person from working. In contrast, ***fixed indemnity excepted benefits pay based on specific health-related events***, such as a hospital stay or a diagnosis of a specified disease (such as cancer). While the payment of the benefit may be linked to a period, such as $200 per day of hospitalization, the benefit is not intended to provide a periodic stream of income and is not triggered by an absence from and inability to work.

IV. The Excess Benefit Rule is a Longstanding Regulatory Interpretation that Cannot be Changed without Legislation

Treasury and the IRS have consistently applied the excess benefit rule for more than 60 years

For more than 60 years Treasury and the IRS have consistently applied the excess benefit rule to excess reimbursements. The rule has been applied not only in binding guidance, such as regulations and revenue rulings, but also in publications instructing taxpayers to apply the rule, Private Letter Rulings, Chief Counsel Advice Memoranda, and revenue proposals.

Treasury regulations that have been in effect since 1956 establish that only reimbursements in excess of unreimbursed medical expenses are taxable

The current Treasury regulations were adopted in 1956[13] and have not been changed since then. Consistent with the statute, Treasury regulations provide:

> Section105(b) applies only to amounts which are paid specifically to reimburse the taxpayer for expenses incurred by him for the prescribed medical care. *Thus, Section 105(b) does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether or not he incurs expenses for medical care.*.. If the amounts are paid to the taxpayer solely to reimburse him for expenses which he incurred for the prescribed medical care, *Section 105(b) is applicable* even though such amounts are paid without proof of the *amount of the actual expenses incurred by the taxpaye*r, but Section 105(b) is not applicable to the extent that such amounts exceed the amount of the actual expenses for such medical care."[14] (Emphasis added).

When these regulations were promulgated, the majority of typical health plans paid a primary medical benefit (often a fixed amount of health indemnity).[15] Sometimes individuals also had

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replace the cash or income that the individual would have had to pay for the covered medical expense if they were not covered by insurance. Rev. Rul. 69-154 already provided a rule for determining how much of a payment made under a fixed indemnity insurance plan is used to pay medical expenses and how much is for something else (i.e., pro-ration).

[13] 1956-1 CB 63, 70; T.D. 6169.

[14] Section 1.105-2.

[15] For example, the National Academy of Medicine (formerly known as the Institute of Medicine) describes the growth of commercial insurance after World War II as including "a reliance on indemnity products that paid cash to the individual and were not linked to contracts for payment or other arrangements that involved health care practitioners and institutions directly." Further, the National Academy notes that when the Federal Employees Health Benefits Program ("FEHBP") was established in the 1950's, it included "both a service benefit plan (Blue Cross and Blue Shield) and an indemnity plan." (Emphasis added) Institute of Medicine, 1993. Employment and Health Benefits: A Connection at Risk. Washington, DC: The National Academies Press, available at https://www.ncbi.nlm.nih.gov/books/NBK235989/ (last visited on Aug. 17, 2023). A history of insurance in the U.S. describes the early Blue Shield plans as having two key features. "First, they required free choice of physician, and second, they were indemnity rather than service benefit plans. This meant that the plans paid the patient a dollar amount for each covered event; the patient, in turn,

optional supplemental coverage available either privately or through their employer. Thus, today's fixed indemnity coverage is exactly the type of coverage contemplated by the regulations when they state that benefits payable to reimburse a taxpayer for medical expenses incurred are excludable from income "even if such amounts are paid without proof of the amount of the actual expenses incurred."[16] The payment triggers in fixed indemnity policies, although not requiring proof of the ***amount*** of actual expenses incurred, are such that the incurring of medical expenses is required.

Revenue Ruling 69-154 illustrates the excess benefit rule

Revenue Ruling 69-154[17] specifically addresses how to apply the excess benefit rule and determine the taxable amount with respect to fixed indemnity insurance. In that ruling, an employee was covered by an employer-paid general health insurance policy and a supplemental employer-paid health policy. The benefits received under both policies were greater than the amount of the medical expenses the employee incurred. Nevertheless, the IRS determined that the supplemental health policy was "reimbursement" for the medical care expenses and was excludable up to the amount of the otherwise unreimbursed portion of the medical expenses.

In the preamble to the Proposed Rule, Treasury and the IRS state that the application of Revenue Ruling 69-154 is limited to situations in which the policyholder receives payments from more than one insurance policy.[18] It is not clear why there is a distinction between an excess reimbursement when paid by a fixed indemnity policy or when paid by multiple policies as is the case in Revenue Ruling 69-154. In both cases, the benefit is paid without regard to the otherwise unreimbursed medical expenses of the policyholder. Otherwise, there would be no excess reimbursement.

Publication 502 instructs taxpayers to follow the excess benefit rule

The IRS has also affirmed the excess benefit rule in its publications instructing taxpayers as to the amount of excess reimbursements for medical expenses to include on their tax returns. Since at least 1994, Publication 502 has included instructions for calculating the taxable amount of an excess medical reimbursement along with examples.[19] The examples clearly state that if a taxpayer's, "reimbursements are more than [their] total medical expenses for the year, [they] have ***excess reimbursement***." (Emphasis in original.) It includes instructions for calculating the taxable amount of an excess reimbursement under several different circumstances.

The publication also contradicts the assertion in the preamble to the Proposed Rule that the excess benefit rule does not apply to excess reimbursements attributable to a single policy. One of the circumstances included is a situation in which the employee is insured by a single plan for which the premiums were paid with pre-tax employer contributions.[20]

PLR 9546016

In PLR 9546016 (Nov. 17, 1995), the IRS recognized the excess benefit rule. The letter ruling states that all or a portion of a benefit paid by an employer-paid fixed indemnity policy could be taxable, depending on the portion of the benefit that was exempt from tax under Section 105(b).

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was responsible for paying the physician." Morrisey, Michael, "Health Insurance," Health Administration Press, Chicago, IL, and AUPHA Press, Washington, DC (2008), at 7.

[16] See Section 1.105-2.

[17] 1969-1 CB 46.

[18] See *supra* footnote 1 at 44635, footnote 215. Additionally, Publication 502 includes a worksheet for taxpayers to determine the excess benefit attributable to reimbursements for medical expenses. At p. 18.

[19] Available at: https://www.irs.gov/pub/irs-prior/p502--1994.pdf at pp. 15-16.

[20] See the heading "Premiums paid by your employer," at p. 18.

The IRS recently confirmed the application of the excess benefit rule to fixed indemnity plans in CCA 201719025

CCA 201719025 (May 12, 2017) does not address the taxation of benefits paid by an employer-paid fixed indemnity plan as in Revenue Ruling 69-154. However, it includes a discussion of the potential legal implications for circumstances in which a self-funded fixed indemnity plan is paid for on a pre-tax basis. The IRS cited Revenue Ruling 69-154 and applied the excess benefit rule, stating that benefits paid under such a plan are taxable to the extent they exceed medical expenses.

Additionally, in a footnote in CCA 201719025, the IRS also clarified its earlier analysis in CCA 201703013 (Jan. 20, 2017) of benefits paid by an employer-paid plan. In CCA 201703013, Situations 2 and 3, employees, who may have had other comprehensive health coverage were permitted to enroll in an employer-paid fixed indemnity plan. The fixed indemnity plan paid a fixed benefit for certain health-related events without regard to the amount of medical expenses otherwise incurred by the employee. In CCA 201703013, the IRS stated that the full amount paid by the plan was taxable. However, in CCA 201719025, the IRS clarified its conclusion in the earlier CCA. It explained that the determinations in Situations 2 and 3 of CCA 201703013 was not intended to modify the analysis or result in Revenue Ruling 69-154.

The "Greenbooks"

Treasury's General Explanations of the Administration's Fiscal Year 2023 and 2024 Revenue Proposals ("Greenbooks") contain a proposed legislative clarification of the tax rules applicable to fixed indemnity policies.[21] In its explanation of current law, Treasury acknowledges the excess benefit rule:

> Under these types of policies, the amount paid is neither based upon the amount of any medical expense incurred related to the event or illness that triggered payment nor coordinated with other health coverage. Under certain circumstances, the payment may be excluded from the employee's gross income and wages to the extent that the payment does not exceed the employee's actual medical care expenses.

What Treasury and the IRS describe as a clarification is a reversal of longstanding tax treatment that has been in effect for more than 60 years

While Courts have recognized agencies' right to change an interpretation or regulation, the agency must provide a reasoned analysis in doing so.[22] Treasury and the IRS have not done so here. The Proposed Rule refers to the changes to Section 1.105-2 as a clarification, but in fact they are a drastic change that would eliminate the excess benefit rule for fixed indemnity. Under the Proposed Rule, employer-paid policies that are excepted benefits under Section 9832(c)(3) and that pay benefits without regard to the amount of a policyholder's medical expenses, 100% of the benefit would be taxable income. The rule would apply regardless of the amount of the individual's related unreimbursed medical expenses (e.g., even when the total accident and health benefits received by an individual are far less than the individual's related medical expenses). Additionally, Treasury and the IRS have provided no evidence that the Proposed Rule is needed.

The Proposed Rule is Contrary to Congressional Intent

Furthermore, even if Treasury and the IRS were to provide a reasoned analysis for the Proposed

[21] General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals, Department of the Treasury (March 9, 2023) p. 204; General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals, Department of the Treasury (March 2022), p. 104.

[22] *Motor Vehicle Manufacturers Association v. State Farm Auto Mutual Insurance Co*, 463 U.S. 29 at 57 (1983).

Rule, the rule is contrary to congressional intent and can only be effected through legislation. Courts have noted that "It is well established that when Congress revisits a statute giving rise to a longstanding administrative interpretation without pertinent change, the 'congressional failure to revise or repeal the agency's interpretation is persuasive evidence that the interpretation is the one intended by Congress.'"[23]

Treasury and the IRS have repeatedly publicly affirmed the excess benefit rule and Congress has not acted to change it.[24] Congress has had ample time and many occasions since the current Section 105(b) regulations were adopted in 1956 to change the taxation of health benefits in the manner Treasury now proposes yet has chosen not to do.

For example, Congress has amended Section 105 to change the tax treatment of *disability* benefits under Section 105(d), but left the tax treatment of benefits under health plans (including fixed indemnity insurance) intact.[25] Congress could easily have considered similar changes to the taxation of health insurance (including fixed indemnity insurance) under Section 105 at any of these times, but chose not to. Nor did Congress make changes to the taxation of health insurance when Congress revisited the entire tax code in the Tax Reform Act of 1986.

The tax treatment of benefits provided under the Code for employer-provided health care has frequently caught the attention of Congress.[26] Various proposals investigated by Congress have included elimination of the favorable tax treatment, imposing income limits on favorable tax treatment, and replacing the current treatment with an income-based deduction. Yet, none of these proposals have been adopted and the tax treatment of health benefits (including fixed indemnity benefits) remain intact.

Congress also considered changing the tax treatment of employer-provided health care as part of deliberations on the Affordable Care Act. What resulted was the excise tax on high-cost health plans, which was added to the Code as Section 4980I (also commonly referred to as the "Cadillac Plan" tax).[27]

In the Greenbooks, Treasury and the IRS have acknowledged that congressional action is needed to make the change now proposed, having twice made budget proposals to "amend Section 105(b)." For more than 60 years the public has relied on numerous public statements by Treasury and the IRS relating to the application of the excess benefit rule to fixed indemnity policies. Treasury and the IRS do not have the authority to change the law through regulations where

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[23] *Commodity Futures Trading Com v. Schor*, 478 U.S. 833, 846 (1986) *citing NLRB v. Bell Aerospace Co.,* 416 U.S. 267, 274-275 (1974) (footnotes omitted).
[24] See Rev. Rul. 69-154, Publication 502, PLR 9546016, CCA 201719205, and the 2023 and 2024 Greenbooks.
[25] See Pub. L. 88-272, the "Revenue Act of 1964" (HR 8363); Pub. L. 94-455, the "Tax Reform Act of 1976" (HR 10612); and Pub. L. 98-21, the "Social Security Amendments Act of 1983."
[26] Congressional activity regarding examination of the tax benefits for employer-provided accident and health coverage, including such things as hearings and substantial legislation, are a matter of public record. The following are a very few examples of this activity: Joint Committee on Taxation, *Present Law and Background on Federal Tax Provisions Relating to Health Care* (JCX-26-98), April 22, 1998 (prepared for a public hearing scheduled for April 23, 1998, by the Subcommittee on Oversight of the House Ways and Means Committee on federal tax-related provisions affecting heath care); Joint Committee on Taxation, *Exclusion for Employer-Provided Health Benefits and Other Health-Related Provisions of the Internal Revenue Code: Present Law and Selected Estimates,* (JCX-25-16), April 12, 2016 (prepared for a public hearing scheduled for April 14, 2016, by the House Committee on Ways and Means on the tax treatment of health care); possible revisions to the tax treatment of employer-provided health care are a perennial feature of the Congressional Budget Office (CBO) options for reducing the deficit (the most recent option may be found here https://www.cbo.gov/budget-options/58627 (last visited Aug. 6, 2023)).
[27] The Cadillac Plan tax has since been repealed. Pub. L. 116-94 (Dec. 20, 2019), Further Consolidated Appropriations Act, 2020.

Congress has purposefully chosen not to and any attempt to do so by Federal regulations would be a violation of the Administrative Procedures Act.[28]

V. Fixed Indemnity Benefits are not Wages for Purposes of Income Tax Withholding or FICA/FUTA tax

Perhaps the most unsettling aspect of the Proposed Rule is the presumption in the preamble that employer-paid fixed indemnity insurance benefits are wages for purposes of income tax withholding and FICA/FUTA taxes. This conclusion is incorrect.

Excess benefits attributable to fixed-indemnity insurance are not wages within the plain meaning of the term

In general, "wages" for withholding purposes means "remuneration for services … performed by an employee for his employer (including benefits paid in any medium other than cash)." Section 3401(a).

Wages for purposes of FICA/FUTA are defined in Sections 3121(a) and 3306(b) respectively. Both Code sections define wages as "all remuneration for employment."

The definitions of wages for FICA/FUTA purposes and income tax withholding purposes are similar, albeit not identical in all cases. However, the Supreme Court has held that "simplicity of administration and consistency of statutory interpretation instruct that the meaning of 'wages' should be in general the same for income-tax withholding and for FICA [and FUTA] calculations." [29] Thus, unless specifically altered by statute, wages for federal income tax, FICA, and FUTA fit within the plain meaning of "remuneration for employment."

Until the IRS issued CCA 201703013, there had been no guidance stating that fixed indemnity payments or excess reimbursements made by an insurance company are wages. In fact, PLR 9546016 and Publication 502[30] both treat excess reimbursements as nonwage income.

Fixed indemnity payments do not fit within the plain meaning of remuneration for employment. They are not based on performance of services, which are measured in increments of hours worked, tasks completed, and quality of services. Rather, fixed indemnity benefits are triggered by a health-related medical event.

Benefits paid by third-party insurers are not remuneration for employment

The benefits paid by the insurer under a fixed indemnity insurance policy are not made as a result of any employee/employer relationship or as payment for services by an employee. There is no explicit exception because none is needed. Rather, as discussed in detail below, these payments are not "wages" under the plain meaning of the statute. It is the value of the insurance coverage that is part of the policyholder's wages rather than the benefits. Accordingly, while employer paid *premiums* for health insurance coverage would be subject to income and payroll tax withholding, absent the specific statutory exclusion, the benefits paid by such insurance are not.

Section 3401(d) states that a third-party can be an employer, but insurance companies are not employers for payroll tax purposes. Income tax reporting and withholding obligations fall on an "employer" making payments of "wages" to an employee.[31] An "employer" is defined for this

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[28] *FDA v. Brown & Williamson Tobacco Corp*., 529 U.S. 120 (2000).

[29] *U.S. v. Quality Stores, Inc.*, 134 S. Ct. 1395 1405 (2014), *citing Rowan Companies, Inc. v U.S.*, 452 U.S. 247 (1981).

[30] In pages 15-19 of Publication 502, the IRS states that excess reimbursements should be recorded on for 1040 as "other income."

[31] Section 3402(a).

purpose in Section 3401(d) as a person for whom an individual performs any services as an employee. Section 3401(d) also provides that, if someone other than the employer controls the payment of wages, that person is considered the employer for income tax withholding purposes.

The third-party issuer of an insurance policy, subject to insurance risk, does not fit within this definition. Cases involving Section 3401(d)(1) statutory employers generally involve persons stepping into the shoes of the employer to pay what would traditionally be considered wages. For example, in two cases involving bankruptcy trustees, courts held that because the employees provided services to bankrupt companies, the bankruptcy trustees were liable for employment taxes.[32] In *Winstead v. United States*, 109 F.3d 989 (4th Cir.1997), the Fourth Circuit decided that the plaintiff, who paid the employees from his own accounts, rather than the sharecroppers for whom the employees worked, was the employer for tax purposes.

Unlike Section 3401(d) employers, insurance companies do not make payments in direct relationship to services performed, but for an independent fortuitous occurrence. The payment of benefits by an insurance company that has assumed an insurance risk is therefore fundamentally different than payments that are “wages” for “employment.” This concept is reflected in the Code and Treasury Regulations under the income tax withholding rules, which provide that third-party payments of sick pay that are subject to insurance risk are not categorized as wages, while sick pay payments made by an employer or the employer’s agent are wages.[33]

The legislative history helps explain the difference between the Code’s treatment of payments made directly by an employer and payments made by a third-party insurance company.[34] When Congress established wage withholding for Federal income tax purposes in 1942, the definition of wages was based on the existing definition used for wages for FICA and FUTA tax purposes—“all remuneration for employment.”[35] At the time, before the enactment of the 1954 Code, the exemption that is under Section 105 today fell under Section 22(b)(5), which exempted from income, “amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness.” Additionally, amounts received by employees through an insured employer accident and health plan were not subject to income tax, but payments from an uninsured employer accident and health plan were subject to tax. Section 105(b) extended the exclusion for reimbursements for medical expenses to uninsured accident and health plans.[36] No change was made to payroll tax provisions to include payments made by insurance companies until Section 3402(o)(1)(C) was modified to include third-party sick pay as a payment “other than wages” for which policyholders could request withholding.[37] After which, Sections 3121(a) and 3306(b) were modified to include third-party sick pay as wages. Accordingly, while excess reimbursements paid by insurance companies may be subject to income tax, they are not wages for income tax, FICA, or FUTA tax purposes.

Additionally, Sections 3121(a)(2)(B) and 3306(b)(2)(B) explicitly exclude from wages for FICA and FUTA, respectively, “the amount of any payment …*made on account of* … medical or hospitalization expenses in connection with sickness or accident disability.” (Emphasis added). This exclusion applies equally to all medical or sickness payments triggered by a medical event including fixed indemnity benefits. Benefits payable under fixed indemnity policies, which are conditioned on a medical event, such as hospitalization, or a diagnosis of a particular disease, fall

[32] Otte v. United States, 419 U.S. 43 (1974); In re Armadillo Corp., 561 F.2d 1382 (10th Cir.1977).
[33] Section 3402(o)(1)(C); Treas. Reg. 1.3401(a)-1(b)(8).
[34] FICA provisions were originally enacted in 1935 in Title VIII of the Social Security Act, 49 Stat. 636. In 1939, Title VIII was transferred to the Internal Revenue Code and became FICA. 53 Stat. 1387. Title VIII contained definitions of “wages” and “employment” substantially identical to those FICA now provides. See Sections 811(a) and (b), 49 Stat. 639. Federal Unemployment Tax Act (FUTA) was the bill passed in 1939 that established a payroll tax to fund unemployment benefits.
[35] S. Rep. No. 1631, 77th Cong., 2d Sess., 165 (1942) (Revenue Act of 1942).
[36] 83 Conf. Rep. 2543 at 24.
[37] Pub. L. 96-601, Section 4(b) and P.L. 97-123.

within this definition.

Temporary Treasury Regulations Section 32.1 does not apply to excess benefits or is as applied to benefits other than disability benefits

In the preamble to the Proposed Rule, Treasury and the IRS refer to Temporary Treasury Regulations ("Temp. Treas. Reg.")[38] Section 32.1 as support for the idea that fixed indemnity benefits that are taxable income under Section 105(a) are always subject to FICA. Temp. Treas. Reg. Section 32.1(d) provides that "payments on account of sickness or accident disability" subject to FICA include "any payment for personal injuries or sickness includible in gross income under Section 105(a) and the regulations thereunder" and do not include any payments under accident or health insurance that are expended for medical care as described in Section 105(b) and the regulations thereunder. In recent guidance[39], and in the preamble to the Proposed Rule, Treasury and the IRS have stated that, excess reimbursements attributable to fixed indemnity benefits are subject to FICA because they are not exempt from tax under Section 105(b) and taxable under Section 105(a)

In making this statement, Treasury and the IRS conflate the two separate and distinct provisions for disability and medical expenses. Provisions applicable to "amounts paid on account of sickness or accident ***disability***" payments are set forth in Sections 3121(a)(2)(A) and 3306(b)(2)(A). Provisions applicable to "amounts paid on account of ***medical or hospitalization expenses*** *in connection with sickness or accident disability"* are set forth in Sections 3121(a)(2)(B) and 3306(b)(2)(B).

The employment tax withholding rules relating to sick pay payments, which are a form of disability, provide an instructive contrast with the rules for withholding for payments made on account of medical or hospitalization expenses. In the case of sick pay (i.e., payments for absence from work), the flush language of Sections 3121(a) and 3306(b) provides that disability payments described in Sections 3121(a)(2)(A) and 3306(b)(2)(A) made by a third-party insurance company are wages unless they are paid pursuant to workers compensation laws and that third-party insurers are required to withhold on such wages.[40] The statute does not apply this third-party withholding in the case of payments on account of medical or hospitalization expenses.[41] The legislative history further confirms that Congress intended to limit such withholding to "sick pay" (i.e., payments for absence from work) and makes no mention of applying this rule on account of medical or hospitalization expenses.[42] Congress could have applied this sort of rule to medical expenses subject to insurance risk but chose not to. Treasury and the IRS may not through regulation come to a different result than the one prescribed by Congress.

Treasury and the IRS did not characterize excess reimbursements as wages until the IRS issued CCA 201719025. Even in the current version of Publication 502, taxpayers are instructed to record excess reimbursements attributable to employer-paid insurance as "other income" on their tax returns.[43] PLR 9546016 also states that fixed indemnity benefits attributable to an employer-

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[38] Section 7805(e)(2) provides that any temporary regulation shall expire within 3 years after the date of issuance. The IRS has previously stated that this provision is effective only for temporary regulations issued after Nov. 20, 1998, and thus does not apply to this temporary regulation issued in 1982. The IRS has also stated that the continuing authority of the temporary regulation was confirmed in 2005 by Treasury Decision (TD) 9233, 70 FR 74198, 2006-1 CB 303. See CCA 201719025, released May 12, 2017, available at https://www.irs.gov/pub/irs-wd/201719025.pdf (last visited Aug. 4, 2023). Note, however, that the provision of the temporary regulation relied on in the Proposed Rule was not amended by TD 9233. Whether this temporary regulation has the force of a final rule is not clear.

[39] CCA 201719025; CCA 201703013; and CCA 202323006.

[40] Sections 3121(a)(2)(A) and 3306(b)(2)(A), and flush sentence following Sections 3121(a) and 3306(b).

[41] Sections 3121(a)(2)(B) and 3306(b)(2)(B).

[42] H.R. Conf. Rep. 97-409 (relating to P.L. 97-123), 12-15, 1981 USCCAN 2681, 2688-2687.

[43] Available at https://www.irs.gov/pub/irs-pdf/p502.pdf at pp. 18-19.

paid policy should be reported under Section 6041, which does not apply to wages.

Further, Temp. Treas. Reg. Section 32.1 was not subject to notice and comment and was clearly intended to apply to disability payments.[44] The temporary regulation was promulgated in response to the change to the employment tax rules that made payments of third-party sick pay subject to wage treatment. For example, the preamble to the temporary regulation states that it was not intended to apply to amounts attributable to a temporary absence from work. The preamble to the temporary regulation contains no discussion about the applicability of Temp. Treas. Reg. Section 32.1 to fixed indemnity insurance benefits or any excess reimbursement. Additionally, considering that the rule's broad application goes far beyond the statutory language, its validity as applicable to anything other than disability payments is questionable.

VI. Information Reporting Guidance on Fixed Indemnity Benefits would be Helpful

If at least some portion of fixed indemnity benefits attributable to employer-paid policies remains exempt from tax, there is no current IRS form or means that is truly appropriate for reporting fixed indemnity benefits. Issuers of fixed indemnity insurance are generally not in a position to calculate the taxable amount, if any, of benefits under fixed indemnity policies. As with any medical based policy, the issuer of a supplemental fixed indemnity policy does not have the necessary information. For example, the insurer lacks information regarding any other medical coverage the individual may have (e.g., through a spouse's employer or a former employer or individually purchased) and/or the insured's total medical expenses, nor does the insurer have any reasonable means of obtaining this information. While more traditional "expense incurred" health insurers are permitted (or even required) to share payment information for benefits coordination purposes, this sharing of information generally does not occur with respect to individual market coverage and supplemental, fixed indemnity coverage. This is in part because such insurance is prohibited from coordinating payments with other employer sponsored plans. In addition, privacy rules may limit the ability of the health care provider, employer, or insurer to obtain or share information under other coverage that would be needed to determine the taxable amount. Thus, because the insurer does not know the amount that is "fixed or determinable," the entire amount of the benefit is the only information the insurer is able to report for tax purposes.

Currently, Form 1099-MISC is used to report certain miscellaneous items of income. Box 3 of Form 1099-MISC is used to report "other income." The instructions to the recipient direct the taxpayer, in general, "to report this amount [in Box 3] on the 'Other income' line of Schedule 1 (Form 1040)." Thus, based on Form 1099-MISC, the total amount in Box 3 would seem to be taxable income; yet that would not be the case with respect to fixed indemnity payments under the "excess benefit" rule

This outcome is unfair to policyholders. While they can contest the taxable amount of the fixed indemnity benefit they receive on their return, most individuals receiving fixed indemnity benefits are unwell and the process would be overwhelming. As a result, they end up being taxed on the entire amount of the benefit.

The simplest way to avoid this outcome is to not require reporting by the insurer and instead have the insured include the taxable portion of the fixed indemnity benefit in "Other Income" as Publication 502 currently directs them. Reporting on a Form 1099-MISC is not always required. Section 6041(a) provides that all persons:

> [E]ngaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations,

[44] See 47 FR 29225. Additionally, the portion of the 2005 amendment relating to Temp. Treas. Reg. Section 32.1 Treasury and the IRS cite as ratifying Temp. Treas. Reg. Section 32.1 was not subject to notice and comment. It was not included in the Proposed Rule, but was part of the final rule. See 70 FR 12164 (the Proposed Rule) and 70 FR 74198 (the final rule).

> remunerations, emoluments, or other fixed or determinable gains, profits, and income … of $600 or more in any taxable year, … shall render a true and accurate return to the Secretary … setting forth the amount of such gains, profits, and income." (Emphasis added.)

The IRS addressed the issue of what constitutes fixed or determinable income in Rev. Rul. 80-22. The IRS ruled that payors of hail crop insurance did not have to report insurance proceeds to beneficiary farmers where they were informed by the individual farmers that pre-production expenses had been capitalized. The IRS explained that,"[b]ecause the insurance company cannot require a farmer to disclose the basis in the destroyed crops, the amount of 'gains, profits, or income,' if any, resulting from the payment of the hail crop insurance proceeds is not fixed or determinable by the company."

Alternatively, if insurers must report fixed indemnity payments, any form for reporting fixed indemnity payments would need to be clear that the amount reported is not necessarily income as well as information as to when the payments may be income.

The idea that a reported amount does not represent the full taxable amount is recognized in other situations. For example, Form 1099-R is used to report pension and retirement distributions. There is a box on the form to indicate that the taxable amount is not determined. As another example, Form 1099-G is used by state and local governments to report refunds of state and local taxes. The instructions for the recipient indicate that the amount reported "may be taxable to you if you deducted the state or local income tax."

We note that, if fixed indemnity benefits were wages, the difficulty in reporting payments would drastically increase. The same issue with accurately reporting the taxable amount arises when benefits are reported on a Form 1099. However, wages also require withholding of FICA and FUTA tax. There are procedures currently in place that allow insurance companies to shift the liability for the employer's share of FICA or FUTA owed and information reporting obligation for third-party sick pay to the employer, rather than the insurance company.[45] It is not clear how insurance companies would be required to report fixed indemnity benefits as wages or whether the insurance company would have a means of transferring the FICA/FUTA tax liability to the employer.

VII. The Proposed Applicability Date is Unworkable and would Impermissibly Impact the Taxation of Insurance Contracts Already in Force

If, contrary to our recommendations, Treasury and the IRS decide to finalize the Proposed Rule, then the effective date should be pushed back to prevent currently existing policy holders from experiencing a large tax increase. Additionally, insurance companies will need more than the time allotted to make any changes to administrative systems.

The proposed applicability date is the later of the date of publication of a final rule or January 1, 2024. For the reasons set forth below, we believe that the current tax treatment should be retained for all in force policies, and that any more restrictive rule should be prospectively effective for newly issued policies with sufficient time to allow for needed planning and adjustments necessitated by the tax changes.

Taxing fixed indemnity benefit payments on existing policies is a retroactive tax increase on taxpayers who relied on current law, regulations, and other guidance[46] when purchasing this coverage through pre-tax salary elections or enrolling in employer-funded plans. As explained in detail above, the new taxes imposed by the Proposed Rule are a change, rather than a clarification, in the tax treatment of benefit payments for employer funded fixed indemnity insurance

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[45] See Sections 3121(a), 3306(b) and Temp. Treas. Reg. Section 31.2(e) (FICA/FUTA). See Section 6051(f) (reporting).

[46] Other guidance includes, e.g., Rev. Rul. 69-154 and CCA 201719025.

or for insurance purchased through pre-tax salary reduction. Consistent with long-standing tax policy, such dramatic changes to the tax treatment of these policies should be applied prospectively only to new policy purchasers.[47]

The taxation of fixed indemnity insurance benefit payments under the Proposed Rule arises when such premiums are paid for by the employer or by the employee with pre-tax dollars. Currently, the benefits from such policies can be used on a dollar-for- dollar basis to offset unreimbursed medical expenses. Making such benefits taxable in all cases will cause many employers to revisit whether to offer such coverage in the first instance, causing a potential ripple effect in overall benefits provided and a likely overall reduction in coverage for employees.

In most cases, benefit decisions are made well in advance (typically in the spring) for the following plan year. An immediate applicability date (or even a plan year 2024 applicability date) gives no time for employers to plan for open enrollment. Preparing for annual open enrollment requires months of lead time for employers to design their benefit offerings and effectively communicate these offerings to their employees. The Proposed Rule will require prudent employers to re-evaluate the cost of providing these benefits and update enrollment materials to accurately communicate the benefits to employees. Employers who pay for some or all of the premiums for fixed indemnity insurance will need to decide whether imputing income on the value of the employer-paid portion is preferable to subjecting the employee to tax on the payment of the benefit. Employers also need to consider the administrative burden and practicality of the withholding issues associated with a taxable benefit. Weighing these factors takes time and consideration that a January 1, 2024, or later but immediate applicability date would not allow.

Additionally, insurance companies will need time to implement systems changes. Systems that have existed for many years will need to be redesigned to account for the new wages and reporting components and tested prior to implementation. The administrative systems on which policy information is stored are complex and companies may administer different blocks of fixed indemnity policies on different administrative systems as a result of the acquisition of new business or upgrading to a newer administrative system for a new product. If systems changes cannot be implemented in time before the rule takes effect, companies will be forced to comply with the rule through manual procedures, increasing the potential for human error.

Accordingly, if, contrary to our recommendations, the proposed changes to the tax treatment of fixed indemnity insurance benefits are finalized, more time will be needed before the final rule applies. For this reason, we propose a bifurcated applicability date; whereby existing policyholders will continue coverage under the current tax treatment, and only new policies will be subject to the new restrictive tax treatment. For new policies, assuming that a final rule is adopted in 2023, we recommend an applicability date that is not earlier than plan years beginning on or after January 1, 2025. If the rule were to be finalized in 2024, then it should be applied no earlier than tax years beginning on or after January 1, 2026.

Further, at the very least, a transition period affording penalty relief for failures to correctly apply

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[47] Retroactive tax increases have an aura of patent unfairness. Congress has limited the ability of the Department to impose retroactive tax regulations in Section 7805 because it was Congress's view that "it is generally inappropriate for Treasury to issue retroactive regulations." H.R. Rep. No. 104-506, at 44 (1996). None of the specific circumstances in Section 7805 that allow retroactive tax regulations apply here. The only rationale put forward by the Department for the effective date of the Proposed Rule is that the proposal is a "clarification." However, as discussed in detail in this memorandum, that is simply not the case, this is a clear change in the law. Thus, there is no basis for any retroactivity and the effective date should recognize the interests of taxpayers who have taken actions (i.e., purchased fixed indemnity insurance on a pre-tax through salary reduction) before this proposal (even though benefits may be payable after issuance of the regulations). Further, employees should not be impacted by actions previously taken by a completely different taxpayer, i.e., the employer. Some pre-tax contributions are made directly by the employers; employees do not control employer actions.

reporting requirements under Section 6724(a) and late payments of withholding under Section 6656(a) should be provided.

We want to emphasize that any changes to the applicability date, including those we suggest here, would not serve to address the underlying issues we have raised with respect to the provisions of the Proposed Rule. We continue to oppose the Proposed Rule for the reasons addressed here and recommend that it be withdrawn.

VIII. Conclusion

Treasury and the IRS state that the Proposed Rule is a clarification of current law. In fact, it is a drastic change that imposes a tax increase on policyholders who need benefits to pay medical expenses that are not covered by comprehensive medical insurance. Such a drastic departure from current law could only be effected by an act of Congress. Additionally, the Proposed Rule would arbitrarily disqualify from the exemption from tax under Section 105(b), excepted benefits under Section 9832(c)(3) and any other health benefit that is paid regardless of the amount of expenses a policyholder incurs. It also incorrectly labels fixed indemnity insurance as income replacement when these policies are not disability insurance. Moreover, the preamble to the Proposed Rule presumes that fixed indemnity benefits are wages without valid authority and without proposing any change to payroll regulations. Additionally, the proposed effective date is unworkable given the impacts to current policies and necessary administrative changes for insurance companies and there is no appropriate way in which to report the payment of fixed indemnity benefits to the IRS.

We respectfully request that Treasury and the IRS withdraw their proposed amendments to Section 1.105-2 as well as the assertion that fixed indemnity benefits are wages for Federal tax purposes.