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INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

District Director
Southwest District

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's EIN

Years Involved:

Date of Conference

ISSUES

(1) Whether the Cancer insurance policies, the Hospitalization policies and waiver of premiums constitute accident and health benefits for purposes of section 106 of the Internal Revenue Code (Code)?

(2) Whether the progressive diagnosis feature, guaranteed renewability feature or any other feature of the Cancer insurance policies under Taxpayer's cafeteria plan result in prohibited deferral of compensation under section 125 of the Code?

FACTS

For the year in question, Taxpayer maintained a cafeteria plan as described in section 125 of the Code under which insurance coverage was provided to employees of Taxpayer and related entities.

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In addition to basic group health insurance coverage, beginning January 1, 1996, supplemental coverage was made available to employees through an insurance company. The supplemental coverage was offered in the form of a selection of individual policies. The premiums for the supplemental policies were paid by pretax salary reduction under Taxpayer's cafeteria plan.

The following supplemental policies were offered to employees of Taxpayer through the cafeteria plan: Cancer, Cancer Screening and Other Specific Diseases Coverage; Hospital Confinement Indemnity Coverage A; Hospital Confinement Indemnity Coverage B; Hospital Intensive Care Indemnity Coverage; Hospital Intensive and Sub-Acute Intensive Care; Accident-Only Policy A; Accident-Only Policy B.

These insurance policies are all level premium, individual policies. Most of the policies are guaranteed renewable, and no individual can be singled out for cancellation or rate increase. Once insured, each individual is guaranteed the right to continue the coverage provided under the policy without further evidence of insurability even if the individual ceases to be employed by his or her employer so long as premiums are paid within the terms of the policy. Premiums are paid monthly, and coverage ceases if premiums are not paid when due or within the defined grace period. Premium increases can be made no more than once in a 12 month period and only for all policies of its kind in force in the state where the insured individuals reside. None of the policies accumulate investment or cash surrender value or provide for return of any part of premiums paid.

The Cancer insurance policies and Hospitalization policies contain a waiver of premium benefit if the insured becomes disabled under the terms set forth in the policies. In that event, premiums are waived during the period of disability. Under the Cancer insurance policies, the premium is waived if the named insured is (1) unable to work at any job for which he or she is qualified by reason of education, training or experience; (2) not, in fact, working at any job for pay or benefits; and (3) under the care of a doctor for treatment of cancer for longer than three continuous months (91 days) after the effective date of the policy. Under the Hospitalization policies, the premium is waived if the named insured is continuously confined to a hospital for a specified number of days because of injuries received in a covered accident or because of a covered sickness.

Among other benefits, the Cancer insurance policies offer a lump-sum cash benefit payable upon an initial diagnosis of cancer (also referred to as the first diagnosis benefit). The benefit has two parts: an initial payment of $1,000.00 and a progressive payment of $40.00 for each month (progressive diagnosis benefit) the policy has been in force prior to the insured's sixty-fifth birthday. The benefits are paid only if the policy is in force at the time of the diagnosis.

Under the policies, benefits are paid on an indemnity basis upon the occurrence of a specified accidental injury or sickness (e.g. cancer) or occurrence of an accident or

illness and use of some type of medical service. Payment of benefits requires either: (1) diagnosis or treatment by a physician; or (2) use of some other medical service, such as hospitalization, within a reasonable period of time after the occurrence of the particular accident or illness. The policies permit assignment of benefits to a physician or hospital.

The guaranteed renewability feature of the policies offers the opportunity to continue the insurance in future years; there is no guarantee of premium. No coverage automatically carries over by virtue of prior premium payments and insurance company retains the right to change the premium rates by class.

The Taxpayer makes the following representations: The progressive diagnosis benefit does not involve payments in a current year which are accumulated and used in subsequent years to fund insurance coverage. The Cancer insurance policies have no savings or investment feature whether related to the diagnostic benefit or otherwise. No part of the contributions in one plan year "purchases" a benefit that will be provided in a subsequent plan year. The cancer policies remain in force only so long as premiums are timely paid on a current basis. No matter how many premiums have been paid in previous plan years, if the current premium is not paid, the coverage, including the progressive diagnosis benefit, lapses. There is no investment fund, cash value, or "build up" to fall back on and no part of the premium is held in a separate account for the policyholder or otherwise segregated from the general asset accounts of the insurance company.

The Taxpayer further states that the progressive diagnosis benefit clearly has an actuarial cost which is paid as part of each premium and is attributable to a benefit which will be provided, if at all, in the future. According to the Taxpayer, upon the payment of each monthly premium, the insured is entitled (upon appropriate diagnosis) to the contracted-for benefit as of that month and no more. The only way any benefit will be provided in the future is if premiums continue to be timely paid and if the insured is diagnosed with cancer while maintaining current coverage. In addition, the Taxpayer represents that the premiums paid with respect to the Cancer policies are not advance premiums (i.e., prepayment for coverage in future policy periods).

LAW AND ANALYSIS

ISSUE 1

Section 106(a) of the Code provides that, with certain exceptions, gross income of an employee does not include employer-provided coverage under an accident or health plan.

Section 1.105-5(a) of the Income Tax Regulations provides that an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness.

Section 1.106-1 of the regulations provides that the employer may contribute to an accident or health plan either by paying the premium (or a portion of the premium) on a policy of accident or health insurance covering one or more of his employees. However, if such insurance policy provides other benefits in addition to accident or health benefits, section 106 applies only to the portion of the employer's contribution which is allocable to the accident or health benefits.

Thus, the term "accident and health benefits" as used in section 1.106-1 of the regulations means benefits payable under an accident and health plan (i.e., in the event of personal injuries or sickness).

Under the Hospitalization policies, the insured must suffer losses resulting from injuries received in covered accidents or covered sickness. In addition, the premiums are waived if the named insured is confined to a hospital because of injuries received in a covered accident or because of a covered sickness. Under the Cancer insurance policies, the insured must be diagnosed with cancer. To receive a waiver of premiums under the Cancer insurance policies, the insured must be under the care of a doctor for the treatment of cancer for longer than three continuous months (91 days) after the effective date of the policies.

The Cancer insurance policies, the Hospitalization policies and the waiver of premiums are accident and health benefits.[1]

ISSUE 2

Section 125(d)(2) of the Code provides that, except for section 401(k) plans and certain plans maintained by educational institutions described in section 170(b)(1)(A)(ii), "[t]he term 'cafeteria plan' does not include any plan which provides for deferred compensation."

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[1]The excludability of accident and health insurance coverage is governed by section 106 of the Code. The materials submitted by Taxpayer discuss section 105 of the Code in substantial detail. However, section 105 applies only to determine the taxability of the proceeds of the insurance policies. Although it is possible that a portion of the proceeds of the insurance policies under discussion may be taxable to the employees under section 105(a) (e.g. in the event that the proceeds exceed the taxpayer's medical expenses, See Rev. Rul. 69-154, 1969-1 CB 46), such inclusion would have no bearing on the application of section 106.

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Q&A-7 of section 1.125-1 of the Proposed Income Tax Regulations, published on May 7, 1984, states,

> A cafeteria plan does not include any plan that offers a benefit that defers the receipt of compensation, with the exception of the opportunity for participants to make elective contributions under a qualified cash or deferred arrangement defined in section 401(k). ... In addition, a cafeteria plan does not include a plan that operates in a manner that enables participants to defer the receipt of compensation. Generally, a plan that permits participants to carry over unused benefits or contributions from one plan year to a subsequent plan year operates to enable participants to defer the receipt of compensation. This is the case regardless of whether the plan permits participants to convert the unused contributions or benefits into another benefit in the subsequent plan year.

The Preamble to the 1.125-1 proposed regulations as well as all subsequent proposed regulations under section 125 make it clear that the guidance provided may be relied upon by taxpayers in complying with the provisions of section 125 and will be applied by the Internal Revenue Service in resolving issues arising under cafeteria plans and related Code sections. 1984-1 C.B. 563.

Congress, as part of the Deficit Reduction Act of 1984, reviewed the section 1.125-1 proposed regulations in their entirety and, although it added certain transition relief for taxpayers, stated,

> In May 1984, the Internal Revenue Service issued proposed regulations with respect to the cafeteria plan rules and the statutory rules governing the exclusion of benefits from gross income.
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> [T]he conference agreement provides both general and special transition relief, with respect to the proposed Treasury regulations on cafeteria plans, for cafeteria plans and "flexible spending arrangements" in existence on February 10, 1984.
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> Cafeteria plans and flexible spending arrangements that were not in existence on February 10, 1984, generally do not qualify for either the general or the special transition rules under the conference agreement. <u>Thus, the conference agreement does not prevent the current</u>

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> application of the proposed Treasury regulations to such plans and arrangements. [Emphasis added].

Conf. Rept. 98-861, 98th Cong., 2d Sess. (June 23, 1984) at 1173-1176.

Under a cafeteria plan, employees may receive excludable employer-provided benefits in lieu of taxable compensation. There is no deferral of compensation inherent in a cafeteria plan because the benefits are currently received. On the other hand, if the employee receives a return of employer contributions in a subsequent year, the compensation (i.e., the salary reduction) has been impermissibly deferred from one year to the next. The question at issue in the instant case is whether the progressive diagnosis feature, the guaranteed renewability feature or any other feature of the Cancer insurance policies are paid with unused salary reduction amounts from a prior plan year.

All level premium insurance, regardless of type, must build into the premium structure a premium greater than actuarially necessary in the early years in order to pay for the higher risk in later years. In the instant case, not only are the policies level premium policies, but the insured receives an additional benefit of guaranteed renewability and increased benefits in subsequent years. At first blush, these features may appear to be inconsistent with the Taxpayer's representation that the premiums are not prepayment for coverage in future policy periods.

The fundamental characteristic of insurance is that it shifts the risk of economic loss from the insured and the insured's family to the insurance program and distributes the risk of this economic loss among all participants. Helvering v. LeGierse, 312 U.S. 531 (1941). In the instant case, each participant in the Cancer insurance policies is buying coverage which will provide for level premiums, an initial lump-sum cash payment, progressive diagnosis benefits and guaranteed renewability. Regardless of whether it is the participant's first year of coverage or the participant has been in the program for several years, he or she must pay a premium which actuarially equals his or her distributive share of the aggregate risk of loss for the entire program (including the cost of progressive diagnosis benefits and guaranteed renewability). While a first year participant may pay a premium that exceeds what would be the actuarial cost of funding his or her individual coverage, that actuarial cost does not reflect the cost of the coverage when considered in the context of the entire insurance program. The cost of any individual participant's coverage in the plan is his or her distributive share of the aggregate risk of loss for all participants including those who have additional benefits because of prior participation. Accordingly, under this view, there are no unused salary reduction amounts which are being used from a prior or current plan year to fund benefits in subsequent years. In the subsequent years, the premiums will be determined based on the actuarially determined risk of loss for that particular year including the risk that some participants diagnosed with cancer will receive a greater benefit than they would if diagnosed in a prior year. On the other hand, the risk of loss

would be reduced to the extent that long-term policy holders do not renew their coverage or a greater than anticipated number of new policies are sold. The insurance company retains the right to increase the premiums for all participants in the cancer insurance program if necessary to cover its actuarially determined risk of loss.

CONCLUSION

Issue 1:

The Cancer insurance policies, the Hospitalization policies and waiver of premiums, constitute accident and health benefits for purposes of section 106 of the Code.

Issue 2:

The progressive diagnosis feature, guaranteed renewability feature or any other feature of the Cancer insurance policies under Taxpayer's cafeteria plan do not result in prohibited deferral of compensation under section 125 of the Code.

A copy of this technical advice memorandum is to be given to the Taxpayer. Under section 6110(k)(3) of the Code, this memorandum may not be cited as precedent.

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