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BLOG

# Treasury and IRS Clarify Tax Treatment of Certain Medical Care Arrangements

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The U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) recently issued proposed regulations under Section 213 of the Internal Revenue Code of 1986, as amended (the Code), clarifying the tax treatment of Direct Primary Care Arrangements (DPCA), and Health Care Sharing Ministry (HCSM) memberships under certain medical care arrangements.

Under the proposed regulations (Proposed Rule), the IRS and Treasury propose to treat expenditures for DPCAs and membership in an HCSM as amounts paid for medical care as defined in Code Section 213(d), and that amounts paid for those arrangements may also be deductible medical expenses under Code Section 213(a). The Proposed Rule also clarifies that amounts paid for certain arrangements and programs, such as health maintenance organizations (HMOs) and certain government-sponsored health care programs, are amounts paid for medical insurance under Code Section 213(d)(1)(D). This alert focuses on how DPCAs and HCSM memberships impact employer-sponsored group health plans.

## Background

Code Section 213(d) defines medical care as amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease or for the purpose of affecting any structure or function of the body. The term "medical care" also includes transportation to obtain medical care, and insurance that covers medical care. Determining what expenses qualify as "medical care" under Code Section 213(d) is necessary in order to determine what expenses can be paid or reimbursed through certain medical plans and health care arrangements on a tax-free basis to plan participants. For example, health care flexible spending account plans under Code Sections 125 and 105, Health Savings Accounts (HSAs) under Code Section 223, and group health plans, including Health Reimbursement Arrangements (HRAs) under Code Sections 105 and 106 all refer to Code Section 213(d) in defining medical expenses eligible for reimbursement under the plans. In addition, Code Section 213 allows individuals to take an itemized deduction for expenses for medical care, including insurance for medical care, to the extent the expenses exceed 7.5% of the individual's adjusted gross income (AGI) (10% of AGI for taxable years beginning on or after January 1, 2021).

Although the Proposed Rule does address how reimbursement of DPCAs and HCSM memberships would impact coverage under an HSA and/or HRA, it does not address health care flexible spending account plans.

## Direct Primary Care Arrangements

The Proposed Rule defines a "DPCA" as a contract between an individual and one or more primary care physicians under which the physician(s) agree to provide medical care (as defined in Code Section 213(d)(1)(A)) for a fixed annual or periodic fee without billing a third party. This is similar to a capitation-type payment arrangement between a physician and an insurance company or health plan. The Proposed Rule defines a "primary care physician" as an individual who is a physician (as described in Section 1861(r)(1) of the Social Security Act (SSA)) who has a primary specialty designation of family medicine, internal medicine, geriatric medicine, or pediatric medicine. The Treasury and IRS have requested comments on these definitions and also whether to expand the definition of a DCPA to include a contract between an individual and a nurse practitioner, clinical nurse specialist, or physician assistant who provides primary care services under the contract. The Treasury and the IRS have also requested comments on how to define primary care services provided by a non-physician practitioner, including whether the definition of primary care services in Section 1833(x)(2)(B) of the SSA is appropriate.

The Proposed Rule provides that, depending on the facts, a payment for a DPCA may be either a payment for medical care under Code Section 213(d)(1)(A) or may be a payment for medical insurance under Code Section 213(d)(1)(D). However, regardless of whether the arrangement is for medical care under Code Section 213(d)(1)(A) or medical insurance under Code Section 213(d)(1)(D), the IRS and Treasury conclude amounts paid for the arrangement will qualify as an expense for medical care under Code Section 213(d).

***Winston Takeaway:*** Although the Proposed Rule provides that a DPCA can be either in the nature of medical care or medical insurance, the characterization of a DPCA as medical insurance under Code Section 213(d)(1)(D) has implications for purposes of the rules for HSAs under Code Section 223. Specifically, if an individual is covered under a DPCA, this may disqualify that individual from being an HSA-eligible individual (i.e., being able to make and receive tax-qualified contributions to an HSA). Earlier versions of the CARES Act proposed to treat DPCAs as excepted benefits, but this language was not retained in the final version of the CARES Act.

## Health Care Sharing Ministry

An HCSM is akin to a health care consortium made up of members who share a common ethical or religious belief. The members' health care costs are shared by the group. The HCSM does not purchase insurance or assume insurance risk on behalf of its members.

Since Code Section 213(d)(1)(D) does not actually define the term "insurance," Treasury and the IRS interpret "insurance" broadly under the Proposed Rule in determining that amounts paid for membership in a HCSM may be payments for medical insurance under Code Section 213(d)(1)(D).

## Interaction of DPCAs and HCSM Memberships with an HRA

The Proposed Rule provides that an HRA—including a Qualified Small Employer HRA (QSEHRA), an HRA integrated with a traditional group health plan, an HRA integrated with individual health insurance coverage or Medicare (individual coverage HRA), or an excepted benefit HRA—may provide reimbursement for DPCA fees that generally are expenses for medical care, as defined under Code Section 213(d). Thus, since a DPCA can be a payment for medical care under Code Section 213(d)(1)(A), the Proposed Rule concludes that an HRA can provide reimbursement for payments under a DPCA.

The Proposed Rule also provides that an HRA may reimburse payments for membership in an HCSM as a medical care expense under Code Section 213(d).

***Winston Takeaway:*** The conclusion that an HRA can reimburse HCSM memberships appears to be a mistake, since this guidance concluded that membership in an HCSM could be classified as the payment for medical insurance under Code Section 213(d)(1)(D), not the payment for medical care under Code Section 213(d)(1)(A). If the payment for membership in an HCSM is the payment for medical insurance under Code Section 213(d)(1)(D), then it is possible that an HRA would not be permitted to reimburse the payment for membership in an HCSM, since not all insurance is reimbursable from all HRAs.

## Interaction of DPCAs and HCSM Membership with an HSA

With respect to HSAs, the Proposed Rule provides that, generally, an individual will not be an HSA-eligible individual if that individual is also covered by a DPCA, except in limited circumstances. This is due to the fact that DPCAs typically provide for an array of primary care services and items, such as physical examinations, vaccinations, urgent care, laboratory testing, and the diagnosis and treatment of sickness or injuries, that provide coverage before the minimum annual deductible is met and that are not disregarded coverage or preventive care. However, the IRS and Treasury note that in the limited circumstances in which an individual is covered by a DPCA that does not provide coverage under a health plan or insurance (for example, the arrangement that solely provides for an anticipated course of specified treatments of an identified condition), or solely provides for disregarded coverage or preventive care (for example, it solely provides for an annual physical examination), the individual would not be precluded from being an HSA-eligible individual solely due to participation in the DPCA. Further, the preamble to the Proposed Rule notes that if the DPCA fee is paid by an employer, that payment arrangement would be a group health plan and it (rather than the DPCA) would disqualify the individual from being an HSA-eligible individual.

With respect to membership in an HCSM, the Proposed Rule concludes that an individual could not qualify as an HSA-eligible individual if that individual also is a member in an HCSM. This is because an HCSM is medical insurance under Code Section 213(d)(1)(D), which is not permitted insurance under Code Section 223; thus membership in an HCSM would disqualify an individual from being an HSA-qualified individual.

## Other Types of Medical Care Arrangements

In addition, the Proposed Rule incorporates the longstanding position of the IRS that treats amounts paid for membership in an HMO as medical insurance premiums for purposes of Code Section 213(d). In contrast, amounts paid to an HMO or a provider to cover coinsurance, copayment, or deductible obligations under an HMO's terms are payments for medical care under Code Section 213(d)(1)(A). The Proposed Rule clarifies that, regardless of the classification, both HMO amounts are eligible for deduction as a medical expense under Code Section 213(a).

Finally, the Proposed Rule clarifies that amounts paid for coverage under certain government-sponsored health care programs, such as Medicare Parts A-D, Medicaid, CHIP, TRICACE, and certain veterans' health care programs, are amounts paid for medical insurance under Code Section 213(d)(1)(D). Thus, to the extent a particular government-sponsored health program requires individuals to pay premiums or enrollment fees for coverage under the program, those amounts are eligible for deductions as medical expenses under Code Section 213.

The Proposed Rule will apply for taxable years beginning on or after the publication of a final rule in the Federal Register. Comments on the Proposed Rule will be accepted through August 10, 2020.

***Winston Takeaway:*** As noted in the footnotes to the preamble, the Proposed Rule does not address any issues under Title I of ERISA, such as whether any particular arrangement or payment constitutes, or is part of, an employee welfare benefit plan within the meaning of ERISA Section 3(1). However, the Proposed Rule highlights that an employer's funding of a benefit arrangement, in most circumstances, is sufficient to treat an arrangement that provides health benefits to employees as an ERISA-covered plan. Thus, DPCAs that are funded, in whole or part, by an employer subject to ERISA will likely be treated as employer group health plans for purposes of ERISA.

In addition, the Proposed Rule does not address whether Health Care Flexible Spending Accounts (Health Care FSAs) may reimburse expenses for DPCAs. Health Care FSAs generally may reimburse medical care expenses as

defined under Code Section 213. However, Health Care FSAs may not reimburse employee premium payments for other health coverage.

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