

**June 25, 2009**

**MEMORANDUM**

**TO: All Tax Accounting and EB Clients**

**FROM: Les Schneider  
Will Sollee**

**RE: Self-Funded Medical IBNR and the 2 ½ Month and 8 ½ Month  
Payment Rules**

A number of companies have either filed automatic accounting method changes, or have adopted the position on their tax returns, that IBNR (expenses incurred but not reported) by employees under a self-funded medical or dental reimbursement plan are deductible in the taxable year in which the medical services are provided to the employee, provided the claim for payment comes from the medical provider and not the employee. This treatment is sanctioned in Appendix Section 19.01(1) of Rev. Proc. 2008-52. In contrast, that section of Rev. Proc. 2008-52 confirms that if the reimbursement plan provides that the employee must pay the medical provider and submit a claim to the employer for reimbursement, the reimbursement expense is not deductible by the company until the reimbursement claim is submitted by the employee to the company. This latter position is based on the *General Dynamics* decision.

It has come to our attention that some clients who have taken advantage of the IRS position on medical expense reimbursements are reducing their expense deductions under either of the above approaches by limiting the amount of the deduction to reimbursement claims paid to the medical provider or employee either within the 2 ½ month payment deadline in Section 404(a)(5) or within the 8 ½ month payment deadline in Section 461(h). The justification cited for the 2 ½ month payment deadline is based on the premise that Section 404(a)(5) requires

the payment of accrued compensation within 2 ½ months after the end of the year the compensation is earned by the employee in order to avoid being treated as deferred compensation. Deferred compensation is not deductible until the compensation is paid to the employee. The 8 ½ month payment deadline is based on the premise that the expense deduction depends on the application of the recurring item exception in Section 461(h), which requires that economic performance must occur with respect to an expense within 8 ½ months after the end of the year of accrual in order for the expense to be deductible in the year of accrual.

You should be aware that in TAM 200846021, the IRS held that the 2 ½ month payment rule in Section 404(a)(5) does not apply to self-funded medical and dental reimbursement plans because it is the provision of medical and dental coverage to employees, rather than the actual payment of the medical provider (or the employee), that constitutes satisfaction of the 2 ½ month payment rule in Section 404(a)(5). Furthermore, the TAM holds that economic performance occurs when the medical and dental services are provided to the employee. The logical inference one draws from that conclusion is that the recurring item exception is irrelevant and the 8 ½ month payment rule is therefore inapplicable. In order to claim a deduction for the potential reimbursement expense, all that is necessary is that the liability for the expense must be fixed and the amount of the liability be capable of being estimated with reasonable accuracy.

Any company not deducting the entire amount of their liability for employee medical and dental reimbursements because of either the 2 ½ month rule or the 8 ½ month rule should consider filing an accounting method change request. Unfortunately, this type of accounting method change does not qualify for the automatic consent procedures in Rev. Proc. 2008-52. If you need assistance with such a filing, please contact either of the undersigned.

Les Schneider  
Will Sollee