

**Testimony of Sarah H. Ingram
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**The Taxation of Health Care Provided by
Tribal Governments to their Members**

Good afternoon, Mr. Chairman, and members of the Committee.

I appreciate the opportunity to be here this afternoon to explain the tax treatment of health care that tribal governments choose to provide to their members.

At the outset of my testimony before delving into the tax rules, I want to acknowledge that the United States has a unique legal relationship with Indian tribal governments as set forth in the Constitution of the United States, treaties, statutes, executive orders, and court decisions. Our responsibility to provide health services to American Indians and Alaska Natives derives from the government-to-government relationship between the federal government and tribal governments, as well as specific statutes, such as The Snyder Act and the Indian Health Care Improvement Act, that provide the authority for Congress to appropriate Federal funds to provide health care to our First Americans.

The Indian Health Service, a federal agency within the Department of Health and Human Services, provides clinical and public health services to American Indians and Alaska Natives often in remote, economically depressed locations with limited access to health facilities. In the face of these challenges, many tribal governments have developed innovative approaches to providing health care to their members.

I recognize that tribes and tribal members may have a variety of non-tribal health resources available to them. Depending upon location and other considerations, these may include employer provided insurance, Medicare, the Indian Health Service, and federal, state and local health programs, insurance arrangements, hospitals and clinics.

Within this health care environment, tribes, in the exercise of their sovereignty, may wish to create new health care opportunities for their members, or to expand or augment the health care presently available to their members. This afternoon, I will address the tax aspects of a number of methods tribes may have

used, or have considered using, to provide medical benefits or health insurance coverage to their members.

Allow me, Mr. Chairman, to note that the tax rules that apply to health care provided by tribal governments are the same rules that have existed for decades and that apply to such care and benefits provided by non-tribal governments, including federal, state, and local authorities.¹ There are no special tax rules that apply uniquely to tribal government health care programs.

I would also like to note that the Internal Revenue Service does not have a special program to examine tribal health programs. Nor are we emphasizing this area at the moment. That said, the issue of the taxability of medical benefits and health insurance coverage can arise from time to time in the normal course of an audit as we look at whether a tribe, or any other type of government or employer, is following appropriate information reporting and withholding practices as it administers its various programs. Moreover, the issue can arise when a government or employer comes to the IRS seeking a legal ruling about the tax treatment of a proposed plan or arrangement.

The principal questions at issue.

In considering the tax treatment of health care that a tribe might provide for its members, we need to focus principally on two types of benefits and two categories of tribal members.

The first type of benefit is health insurance coverage that the tribe provides to the tribal member. The tribe may pay the insurance carrier directly, or self-insure. I will refer to this benefit as health insurance coverage, or “up-front coverage.” The second type of benefit is funds paid out for medical services provided to the tribal members and their family members, either from a third party insurance company or directly from the tribe itself. These amounts may be paid directly to the tribal member as reimbursement, or to the health care provider who performed the medical service. In this testimony, I will refer to these medical services benefits as “back-end benefits.”

The two categories of tribal members we need to consider are tribal members who are also tribal employees, and tribal members who are not employees. The significance of this distinction will become apparent rapidly.

In this context, when a tribe provides or pays health insurance coverage or medical services for its members, two principal income tax questions arise:

- Is the value of the health insurance coverage — up-front coverage — paid for or provided by the tribe includible in the tribal member’s income?

¹ The statutory rules are included in the Internal Revenue Code (the “Code”), Title 26 of the United States Code.

- Is the value of any medical services — back-end benefits — paid for or provided by the tribe, directly or by tribe-purchased insurance, includible in the tribal member's income?

To answer these questions, Mr. Chairman, I think it would be helpful if I began with a brief summary of key tax provisions that apply to health care in general. I will then address in more detail three provisions of the Internal Revenue Code and an administrative exclusion that have particular relevance here.

As I do so, I'd like to emphasize that the Code provisions apply equally to all citizens and all employers, and that the administrative exclusion — the general welfare exclusion — applies equally to payments of all governments, tribal and non tribal.

Following that summary, I will discuss, in several contexts, the tax treatment of health benefits that tribes provide to tribal members who are employees, and the taxation of benefits to members who are not employees.

Summary of the Code's treatment of health care.

Section 61 of the Code is the starting point for our discussion. Under section 61, gross income includes all income, from whatever source derived, unless a specific exception applies. This seminal provision establishes the important principle that income will be taxed unless it is expressly excluded from taxation.

Of course, the Code does exclude many forms of health-care-related income.

An employer's contribution to a plan providing health coverage, and direct or indirect payments to reimburse the employee for expenses incurred for medical care for the employee and his or her spouse and dependents, are excludable from the employee's income for both income and payroll tax purposes (secs. 105, 106 and 3121).

Self-employed individuals may deduct the cost of health insurance for themselves and their spouses and dependents (sec. 162(l)).

All individuals may claim an itemized deduction for unreimbursed medical expenses, to the extent that such expenses exceed 7.5 percent of adjusted gross income (sec. 213).

Individuals who are covered by a high-deductible health plan are able to contribute tax-free to a health savings account (sec. 223).

The controlling law.

To answer the question about the inclusion or exclusion of health insurance coverage provided by a tribe and the value of medical services under that coverage or direct payment of medical services, however, we need to look more closely at three provisions of the Internal Revenue Code and at the application of what is known as the general welfare exclusion.

Let me begin with the three Code provisions: sections 106(a), 105(b), and 104(a)(3).

Sections 106(a) and 105(b) allow tribes to provide health coverage and medical benefits – up-front coverage and back-end benefits - to their employees on a tax-free basis.

Section 106(a). Section 106(a) provides, generally, that gross income of an employee does not include employer expenditures for coverage provided to an employee through an accident or health plan.

This section excludes from an employee's income the value of health coverage paid by an employer. It applies to tribal members who are tribal employees, but not to tribal members who are not employees of the tribe.

Section 105(b). Section 105(b) states that except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical expenses) for any prior taxable year, gross income does not include amounts paid, directly or indirectly, by an employer to the taxpayer to reimburse the taxpayer for expenses incurred by the taxpayer for the medical care (as defined in section 213(d)) of the taxpayer or the taxpayer's spouse or dependents (as defined in section 152).

This section provides an exclusion from income for payments for medical services provided through an employer-provided plan. Like section 106(a), it applies to tribal members who are tribal employees, but does not extend to tribal members who are not employees of the tribe.

Section 104(a)(3). The third key provision is Code section 104(a)(3). This section comes into play only when there is no employer in the picture.

It provides, generally, that gross income does not include “amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer).”

Neither the Code nor the regulations defines “insurance.” The accepted definition, for purposes of federal income taxation, dates back to Helvering v. Le Gierse, 312 U.S. 531 (1941), in which the Supreme Court stated that “[h]istorically and commonly insurance involves risk-shifting and risk-distributing.” Insurance must shift the risk of economic loss from the insured and the insured’s family to the insurance program and must distribute the risk of this economic loss among the participants in the program. Risk shifting will occur when an insurer agrees to protect the insured (or a third-party beneficiary) against a direct or indirect economic loss arising from a defined contingency involving an accident or health risk. See, Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th cir. 1978); Haynes v. U.S., 353 U.S. 81, 83 (1957) (Broadly speaking, health insurance is an undertaking by one person for reasons satisfactory to him to indemnify another for losses caused by illness.).

The parenthetical language, “(or through an arrangement having the effect of accident and health insurance)” in section 104(a)(3) was added to the Code by section 31 of the Health Insurance Portability and Accountability Act of 1996 (HIPAA), 1996-43 I.R.B. 7, effective for taxable years beginning after December 31, 1996.

The House Conference Report noted that “payments for personal injury or sickness through an arrangement having the effect of accident or health insurance (and that are not merely reimbursement arrangements) are excludable from income. In order for the exclusion to apply, the arrangement must be insurance (e.g., there must be adequate risk shifting). This provision equalizes the treatment of payments under commercial insurance and arrangements other than commercial insurance that have the effect of insurance.” H.R. Rept. No. 104-736, 104th Cong., 2d Sess. 293.

In short, this section provides an exclusion from income for payments for medical services received from an insurance plan, or a similar arrangement, that is not provided by an employer. It thus provides an exclusion for payments from an insurance plan or similar arrangement purchased or created by the tribe for those tribal members who are not employees. In some sense, this provision parallels section 105(b) for non-employees.

Let me point out that there is no Code provision that parallels section 106(a) for non-employees. Where there is no employer involved, the Code contains no provision that would allow a tribal member who is not a tribal employee to exclude the value of tribally-provided health care coverage, the up-front coverage.

The General Welfare Exclusion. The final component of the prevailing law in this area is the general welfare exclusion. This is an administrative exclusion that has developed over more than 40 years in revenue rulings and notices and has been recognized by the courts. See, e.g., Rev. Rul. 63-136, 1963-2 C.B. 19;

Graff v. Commissioner, 673 F.2d 784 (5th Cir. 1982), *affg. per curiam* 74 T.C. 743 (1980); *Bailey v. Commissioner*, 88 T.C. 1293 (1987). The exclusion applies to payments made by governmental units – tribal or non-tribal. Although Code section 61 defines broadly the items that are included in gross income, the Service has consistently concluded that payments made to individuals by governmental units, under legislatively provided social benefit programs, for the promotion of the general welfare, are not includible in a recipient's gross income ("general welfare exclusion"). See, e.g., Rev. Rul. 74-205, 1974-1 C.B. 20; Rev. Rul. 98-19, 1998-1 C.B. 840.

To qualify under the general welfare exclusion, payments must: (1) be made from a governmental fund, (2) be for the promotion of general welfare (*i.e.*, be based generally on individual or family needs), and (3) not represent compensation for services. The Service generally has not applied the general welfare exclusion to persons with significant income or assets, and any such extension would represent a departure from well-established administrative practice dating back decades and respected by courts.

Whether this exclusion would apply to a tribal government providing coverage or benefits to tribal members would depend on how the program is structured and administered.

How tribes are providing health care to members.

I would like to illustrate how these rules apply in a number of situations. This is not an exhaustive list, but reflects some of the questions we have received.

The tribe is the employer of the tribal member.

If the tribal government is the employer of the individual, it is possible to exclude both the value of the health coverage under Code section 106(a) — the up front coverage — and the amounts actually paid out to cover medical expenses under Code section 105(b) — the back end benefits.

Self-Insurance. One option might be for the tribe to self-insure. By this I mean that the tribal government promises to pay for the health care costs of their employees out of the tribe's resources. All tribal employees are covered, and all receive coverage with uniform terms and conditions. The coverage may be very extensive, and may even cover expenses that commercial health insurance typically does not cover. The tribe may provide health insurance coverage, medical benefits, or both.

Looking first at the up-front provision of coverage, Code section 106(a) provides that gross income of an employee does not include employer-provided coverage under an accident and health plan. So, assuming the tribal members are

employees, they may exclude the value of their tribally-provided health coverage from gross income.

Looking at the provision of the actual medical benefits, Code section 105(b) provides an exclusion for amounts paid, under employer-provided coverage, to reimburse the employee for medical services. Therefore, tribal government employees may exclude the value of the medical benefits paid for by the tribe.

Insurance policies. Next, what happens if the tribal government pays premiums on insurance policies, or purchases a commercial group health insurance policy to cover its employees? Again, Code sections 106(a) and 105(b) may operate to exclude both the up-front value of coverage and the later payments for medical benefits.

The tribe pays for health care costs on an *ad hoc* basis Some tribal governments have raised the situation in which the tribe pays for medical benefits on an *ad hoc* basis. In the absence of consistently applied tribal policies that address who and what is covered, an *ad hoc* arrangement would not constitute a “health plan.” Treas. Reg. § 1.105-5(a). Thus, amounts paid for medical services under such an arrangement to any tribal employee would not be excludible from income under a specific Code provision. Under an *ad hoc* approach, the issue of health care coverage does not arise since the tribe typically pays directly for medical benefits and does not provide health care coverage.

Tribal members who are not employees of the tribal government.

Now, I'd like to turn to the situations in which the tribal government would like to provide health benefits to tribal members who are not employees of the tribal government. While assistance can be provided, the options for excluding it from the tribal members' income are more limited.

The significance of the distinction between employees and non-employees is not unique to health care benefits provided by tribes to their members. The same employee – non-employee distinction applies across the country, to all citizens, all employers, all units of government.

Value of up-front coverage. There is no parallel to Code section 106(a) that would allow the tribal government to provide up front health coverage on a tax-preferred basis to all of its tribal members, without regard to whether they are employees. Code section 106(a) excludes the value of the up-front health coverage from income if it is employer-provided, regardless of whether the employer is providing premiums for third party insurance or is covering employees in a self-insured plan. With no parallel exclusion for non-employees, these tribal members would have no means under the statute to exclude that value from income.

Value of back-end benefits. There may be ways to exclude the payment of medical benefits even for tribal members who are not employees of the tribal government. Code section 104(a)(3) provides that as long as the arrangement is insurance, or has the effect of accident and health insurance, then a variety of formats may operate to exclude the payments for medical services from the tribal member's income. For example, the tribal government could self-insure and pay the benefits itself. Or, it could purchase a group policy or pay individual premiums and the medical benefits flowing from that policy would not be included in the tribal member's gross income. Again, the value of the up front health coverage or health insurance premiums would not be excluded, but the value of the medical services would be excluded as long as the arrangement meets the requirements of Code section 104(a)(3).

The General Welfare Exclusion.

Some people have suggested that the general welfare exclusion could be applied to exclude these amounts from income of tribal members. If the tribe provides such assistance only in cases of demonstrated need, pursuant to a consistently applied standard of financial need, the general welfare exclusion arguably could apply. The financial need standard and the nature of the expenses being covered would be among the factors that we would look at to determine whether the general welfare exclusion applied to a particular program.

As I mentioned earlier, this administrative exclusion generally has not been applied to persons with significant income or assets. Whether this exclusion would apply to a particular tribe and its members would depend on the factual circumstances. But any extension of the general welfare exclusion to tribal members with significant income or assets would represent a departure from well-established practice.

If the general welfare exclusion does not apply, the value of the health insurance plan coverage for non-employees must be included in gross income. We recognize that it may be difficult to determine how such coverage should be valued under a self-insured plan. Alternatively, if the general welfare exclusion does not apply and there is no health insurance plan that satisfies the requirement of section 104(a)(3), but instead benefits are paid on an *ad hoc* basis, then the provision of back-end benefits would be included in tribal members' income.

Conclusion.

Mr. Chairman, I would like to summarize my testimony and conclude.

As my prior discussion demonstrates, in the case of a tribe providing coverage and health benefits to its employees, the Code – sections 105 and 106 –

provides exclusions from gross income for both the value of the up-front coverage (e.g., coverage under a commercially purchased insurance policy or self-insurance) and the benefits provided under the coverage.

In the case of a tribe providing coverage and health benefits to tribal members who are not employees, the Code – section 104 – provides an exclusion from gross income of the value of the health benefits if provided under an insurance arrangement. However, the Code does not provide any exclusion from gross income of the value of the up-front health coverage outside the employer-provided context.

In certain cases, the administratively-based general welfare exclusion may provide an exclusion from gross income for these amounts, but only if the program meets the need standards.

I am aware of this Administration's commitment to strengthen and build on the government -to-government relationship between the United States and tribal nations and I appreciate your interest in this matter. Thank you for your patience as I worked through the technical aspects of current law. I look forward to working with Congress to examine this issue further.

This concludes my testimony this afternoon I would be happy to try to answer any questions you might have.