ANTHONY RINALDI & COMPANY, LLC

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Attorney Client Privilege
Sent via E-Mail

Mr. Allan Watson
Five Wise Men, Inc.
E-Mail: allan@fivewisemen.com

Re: Capstone Plus Program

Dear Mr. Watson:

Per your request, I have reviewed the following documents that were provided:

1. Background on Capstone Health and Wellness
2. Partnership with Amaze Health Statements
3. IRS-DOL revised mandatory Notice dated April 3, 2024
4. Group Benefits Fixed Indemnity Application
5. Capstone Plus Deck and FAQ
6. Request for Coverage Packet

The following memorandum is a summary of the transaction as it encompasses the above referenced program for the legal and taxation aspect. As we discussed during our initial conversation, it was agreed that I would conduct research and opinions and/or conclusions with respect to the following:

- ❑ Provide an explanation and analysis of the Capstone Plus Program vs. the Current Tax Law
- ❑ Distinguish the Capstone Plus Program vs. Proposed Rule on the Taxation and Substantiation Requirements for Fixed Indemnity
- ❑ Distinguish between the Capstone Plus Program vs. the tax avoidance scheme commonly marketed

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While the treatment of these issues would seemingly be straightforward, several additional outside opinions and proposed rules have served to further complicate the current legality of the program.

1. Scope of Review

My opinion expressed in this report is based on my review of the documents provided to me, including the revised and updated Capstone Plus Deck, in conjunction with the Internal Revenue Code (IRS), the proposed contract among the parties involved, and the analyzation of the transaction in its current form and/or as it is currently marketed.

2. Description of the Undertaking

I analyzed all of the referenced documents with a concentrated review, specifically of the legal assessment and calculation of any potential tax consequences as it pertains to this particular transaction.

3. Basic Explanation of the Company and Capstone Plus Program

Capstone Health & Wellness provides a preventative health and wellness program designed to help with out of pocket expenses. As stated, the primary emphasis is to serve as a preventative measure long before it becomes a health issue and assist with the financial burden associated with such.

Under the Capstone Plus Program, an Employer provides comprehensive health coverage for its employees through a group health insurance policy. The comprehensive health coverage provides a variety of preventive care benefits. Such coverage constitutes accident or health coverage for purposes of the exclusion for employer-provided accident or health coverage under IRS Code § 106(a).

In addition to the health coverage, the Employer provides all employees, regardless of enrollment in other comprehensive health coverage, with the ability to enroll in coverage under a fixed-indemnity health insurance policy that would qualify as an accident and health plan under IRS Code § 106.

Although your company offers six (6) different plan options that employees can qualify on from $1,500 plan down to the $600 plan, my focus in this opinion letter is with respect to the $1,200 plan. In this specific program, the employees pay monthly $1,200 premiums for the fixed-indemnity health insurance policy by salary reduction through a IRS Code § 125 cafeteria plan. The only payments

that the insurance company receives, with respect to the insurance provided to the employees, are the premium payments.

This is a voluntary program primarily intended to supplement its employees' other health coverage through the provision of wellness benefits. The first type of wellness benefit provided by the fixed indemnity health insurance policy is a payment of $1,010 if an employee participates in certain health or wellness activities. This benefit is limited to one payment per month. The fixed-indemnity health insurance policy provides wellness counseling, nutrition counseling, and telehealth benefits at no additional cost. The employee is responsible for any costs associated with receiving any health-related activity. In addition to the above, the fixed-indemnity health insurance policy also provides a benefit for each day that the employee is hospitalized.

Finally, under the fixed-indemnity health insurance policy, the wellness benefits are paid from the insurance company to the Employer, which then pays out the wellness benefit to employees via the Employer's payroll system.

4. Basic Explanation of Tax Code Applicable to the Employee

With respect to the tax treatment to the employee, the pertinent sections stated below apply to your plan design.

IRC Section 104(a)(3) provides 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. This exclusion does not apply, however, if the amounts are either (1) attributable to contributions by the employer that were not includable in the gross income of the employee, or (2) paid by the employer (Treas. Reg. § 1.104-1(d)). For this purpose, salary reduction under a § 125 cafeteria plan is treated as an employer contribution, and not an employee contribution.

Generally, an employee's choice between two or more benefits consisting of taxable benefits, such as cash and nontaxable benefits, such as employer-provided health coverage, results in a cafeteria plan, the taxable benefits under which are included in income unless the choice is provided in accordance with the rules under § 125 of the Code. Under § 125, an employer may establish a cafeteria plan that permits an employee to choose among two or more benefits, consisting of cash (generally, salary) and qualified benefits, including accident or health coverage. Pursuant to § 125, the amount of an employee's salary reduction through a cafeteria plan applied to purchase health coverage is not included in gross income, even though it was available to the employee and the employee could have chosen to receive cash instead. If an employee elects salary reduction pursuant to § 125 to pay for health coverage, the coverage is excludable from gross income under § 106 as employer provided accident or health coverage.

IRC Section 105(a) provides that generally amounts received by an employee through accident and

health insurance for personal injuries or sickness are included in gross income to the extent the amounts (1) are attributable to contributions by the employer which are not includable in the gross income of the employee or (2) are paid by the employer.

Section 105(b) provides that gross income does not include amounts paid by an employer to reimburse an employee for expenses incurred by the employee for medical care as defined in § 213(d). The exclusion under § 105(b) is limited to amounts paid solely to reimburse expenses incurred for medical care and does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether expenses for medical care are incurred.

Treasury Regulation § 1.105-2 provides that section 105(b) does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether the expenses are incurred for medical care. Section 1.105-2 also provides that if the amounts are paid to the taxpayer solely to reimburse expenses which were 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 taxpayer, but section 105(b) is not applicable to the extent that such amounts exceed the amount of the actual expenses for such medical care.

Revenue Ruling 69-15417 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.

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. The examples clearly state that if a taxpayer's, "reimbursements are more than their total medical expenses for the year, they have excess reimbursement". It includes instructions for calculating the taxable amount of an excess reimbursement under several different circumstances.

In PLR 9546016 (November 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).

5. Basic Explanation of Tax Code Applicable to the Employer

With respect to the employer's taxation, the fixed indemnity plan affects both FICA and FUTA, along with Federal Income Tax withholding.

Sections 3101 and 3111 impose FICA taxes (comprised of social security tax and Medicare tax) on "wages" as that term is defined in section 3121(a). Section 3121(a) defines wages as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions.

Section 3301 imposes federal unemployment (FUTA) tax on "wages" as that term is defined in § 3306(b). Section 3306(b) defines wages as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions.

Treasury Regulation § 31.3121(a)-1(b), relating to FICA tax, provides that the term "wages" means all remuneration for employment, unless specifically excepted under § 3121(a) of the Code or the regulations thereunder. Treasury Regulation § 31.3306(b)-1(b) contains a similar provision for purposes of FUTA.

Section 3121(a)(5)(G) of the Code provides an exception from FICA wages for any payment to or on behalf of an employee under a cafeteria plan (within the meaning of § 125) if such payment would not be treated as wages without regard to such plan and it is reasonable to believe that (if § 125 applied for purposes of § 3121) § 125 would not treat any wages as constructively received. Section 3306(b)(5)(G) contains a similar exception from wages for purposes of FUTA tax.

Section 3121(a)(2) provides an exception from FICA wages for:

- the amount of any payment (including any amount paid by an employer for insurance or annuities, or into a fund, to provide for any such payment) made to, or on behalf of, an employee or any of the employee's dependents under a plan or system established by an employer which makes provision for its employees generally (or for its employees generally and their dependents) or for a class or classes of its employees (or for a class or classes of its employees and their dependents) on account of:
  (A) sickness or accident disability (but, in the case of payments made to an employee or any of the employee's dependents, this subparagraph shall exclude from the term "wages" only payments which are received under a workers' compensation law);
  (B) medical or hospitalization expenses in connection with sickness or accident disability

Section 3306(b)(2) contains an exception similar to § 3121(a)(2) that applies for purposes of FUTA wages.

Temporary Treasury Regulation § 32.1(a), in effect, provides that payments to or on behalf of an employee on account of sickness or accident disability are not excluded from the term wages unless they are received under a workers' compensation law or qualify for the exception from wages provided under § 3121(a)(4) of the Code, which provides an exception for any payment on account of sickness or accident disability made after the expiration of 6 calendar months following the last calendar month in which the employee worked.

Temporary Treasury Regulation § 32.1(d) provides that for purposes of determining the payments subject to FICA taxation under Temporary Treasury Regulation § 32.1(a):

- a payment made on account of sickness or accident disability includes any payment for personal injuries or sickness includable in gross income under section 105(a) and the regulations thereunder and thus does not include—
  (1) any amount which is expended for medical care as described in section 105(b) and section 1.105-2,
  (2) any payment which is unrelated to absence from work as described in section 105© and section 1.105-3, or
  (3) any payment or portion thereof which is attributable to a contribution by the employee as determined in paragraphs (d) and (e) of section 1.105-1.

A payment made on account of sickness or accident disability does not include any payment which is excludable from gross income under section 104(a)(2), (4), or (5).

The taxable wellness indemnity benefits are provided by employers to employees as remuneration for employment under benefit plans funded by employers and, thus, fit within the basic definition of wages under § 3121(a). To the extent the taxable wellness indemnity benefits are not paid under a worker's compensation law, they do not qualify for the exception from wages provided by § 3121(a)(2)(A). Although the payments are made on account of sickness or accident disability, the parenthetical in § 3121(a)(2)(A) removes the payments from the exclusion because they are not received under a workers' compensation law. Moreover, the taxable wellness indemnity benefits cannot qualify for the § 3121(a)(2)(B) exception because the payments are not made on account of medical or hospitalization expenses in connection with sickness or accident disability.

Temporary Treasury Regulation § 32.1(d) specifically bases inclusion in the definition of "payments on account of sickness or accident disability" subject to FICA tax on the payment being "includable in gross income under § 105(a)." All the exceptions from treatment as payments on account of sickness or accident disability that are specifically mentioned in § 32.1(d) support the conclusion that the payments subject to FICA taxes under the regulations are only those payments that are includable in gross income under § 105(a) of the Code. The specifically listed numbered exceptions in

Temporary Treasury Regulation § 32.1(d) and the amounts excludable under § 104(a)(2), (4), and (5) of the Code are all amounts that are excludable from gross income. It is, therefore, clear that Temporary Treasury Regulation § 32.1(d) was not intended to provide an exception from FICA wages for payments that are includable in gross income. The taxable wellness indemnity benefits would be excludable under § 32.1(d)(1) to the extent that they are expended for medical care as described in § 105(b) of the Code and Treasury Regulation § 1.105-2. However, because the taxable wellness indemnity benefits do not qualify for the Temporary Treasury Regulation § 32.1(d)(1) exception, and no other exception applies, they are subject to FICA.

A similar analysis applies for purposes of the similar exception under § 3306(b)(2)(A) of the Code with respect to FUTA taxes. Thus, the taxable wellness indemnity benefits are also subject to FUTA taxation.

Section 3402(a) of the Code, relating to U.S. Federal Income Tax Withholding (FITW), generally requires every employer making a payment of wages to deduct and withhold upon those wages a tax determined in accordance with prescribed tables or computational procedures. The term "wages" is defined in § 3401(a) for FITW purposes as all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash with certain specific exceptions. Among the specific exceptions are several exceptions related to the provision of medical insurance and benefits (§ 3401(a)(20), 3401(a)(21), and 3401(a)(22). No statutory exception applies to the taxable wellness indemnity benefits.

The taxable wellness indemnity benefits are not sick pay (because they are not dependent upon an absence from work), and there is no exception from the definition of wages under § 3401(a) that applies to the payments. Thus, as wages under § 3401(a), the taxable wellness indemnity benefits are subject to FITW under the general FITW rules rather than the rules applicable to sick pay.

6. Analysis

Whether the Capstone Plus Program is Compliant with Current Tax Law

To address the pertinent issue at hand, we must look to the facts and circumstances involving the Capstone Plus Program in conjunction with the applicable current tax law. As previously stated, the tax law currently in existence to analyze such transaction is the excess benefit rule (Revenue Ruling 69-154). In that ruling, an employee was covered by an employer paid general health insurance policy and a supplemental employer paid policy. The benefits received under both were greater than the medical expenses the employee incurred. Nevertheless, the IRS determined the supplemental policy was "reimbursement" for the medical care expenses and was excludable up to the amount of otherwise unreimbursed portion of the medical expenses. Furthermore, the current Treasury

Regulations adopted in 1956 provide:

> Section 105(b) applies only to which are paid specifically to reimburse the taxpayer for expenses incurred by him/her for the prescribed medical care. Thus, IRC Section 105(b) does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether or not incurs an expense for medical care.

Moreover, the IRS affirmed the excess benefit rule in Publication 502 instructing taxpayers as to the amount of excess reimbursements for medical expenses to include on their tax return. Furthermore, on November 17, 1995, the IRS recognized the excess benefit rule through a Private Letter Ruling. The PLR stated 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 IRC Section 105(b).

To better illustrate the above current tax law and treatment of such, the following is an example of the tax treatment to Employee 1 and Employee 2 under the Capstone Plus Program.

> Employee 1 contributes $1,200 on a pre-tax contribution to their Section 125 account by way of salary reduction. Additionally, Employee 1 enrolls in coverage under the fixed indemnity health insurance plan. The plan will indemnify the employee with a claim payment of $1,010, so long as the employee engages in certain health and medical activities. Finally, the employee, for this specific example, incurred $300 of unreimbursed medical costs.

The issue is to determine what amounts are includable or excludable to gross income based on the above fact pattern.

- Step 1: Determine the amount of excess benefit
- Step 2: Determine if the out of pocket cost exceed or are below the excess benefit threshold

Upon the employee providing substantiation in the form of CPT codes, receipt of payments, or an Explanation of Benefits, the claim payment of $1,010 is issued to the employee on a tax free basis.

Also, as to the above, the excess benefit calculated would be $190 ($1,200-$1,010). Since the actual amount expended by the employee which was $300 of unreimbursed Section 213(d) medical expenses, the amount would be 100% excluded because the amount expended is larger than the excess benefit.

> Employee 2 enters the same plan with the same terms and amounts, except instead of incurring $300 of unreimbursed medical costs, he only expends $90 for such.

Thus, the tax analysis changes slightly.

Conversely, if the employee only expends $90 for unreimbursed medical expenses, the results would have $90 excluded, however the $100 (excess of $190-$100) would be included as taxable income. This is the analysis as to current law.

Accordingly, for the reasons cited above, the Capstone Plus Program conforms with current law. Although there have been multiple proposals put forth to change this treatment, there is no current law that supercedes this treatment.

Distinguish between the Capstone Plus Program vs. Proposed Rule on the Taxation and Substantiation Requirements for Fixed Indemnity

To address the pertinent issue stated above, I have provided a side by side comparison involving the differences of both legal and tax treatment.

Current Law:	**Proposed Changes:**
Excess benefit rule Revenue Rule 69-154- if the benefits received are greater than the amount of medical expenses expended, such amounts are excludable up to the amount of the otherwise unreimbursed portion of the medical expenses.	Invalidates Excess Benefits Rule- proposal would make full amount of fixed indemnity policy taxable, including any amounts expended for reimbursement of medical expenses.
Fixed Indemnity Policies are not subject to Employment Payroll tax.	Invalidates this and would subject Fixed Indemnity Policies to Employment Payroll tax.

With respect to the above chart, we believe both proposed changes are legally inaccurate.

1. Pursuant to Section 3401(a), wages are explained as "remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash; except that such term shall not include remuneration paid".
2. The Supreme Court has held the definition of wages is the same for income tax and employment tax purposes.
3. Therefore, in order to accommodate the proposed changes, this definition must be changed by law. Additionally, this section of the proposal is contradictory by existing law. Not only by code and Revenue Ruling, but it also has been affirmed in both Publication 502 and in PLR 9546016

that treat excess reimbursements as non-wage income.

4. Furthermore, this contradicts what fixed indemnity payments are and how they are triggered by conflating the two points. The payments are not based on performance of employment services, but are triggered by a health related medical activity. Such is substantiated by a receipt of certain CPT codes and evidenced by a receipt of payment or an Explanation of Benefits.
5. Both income tax and employment tax purposes state that withholding obligations are the legal responsibility of the employer for purposes of making payments of "wages" to an employee. Additionally, IRC Section 3401(d) states third parties can be employers, but insurance companies are not employers for such purposes. This directly contradicts the proposed change that benefits paid by the insurance company are income for employment. The benefits paid by the insurance company are not income. Thus, the claim benefits are not taxable.

Accordingly, for the reasons cited above, the Capstone Plus Program conforms with current law. Although there are multiple proposal attempts to modify such law, the basic premise of the proposals inaccurately interpret existing law. Again, these changes would require Congressional repeal of current law. Therefore, until such, the Capstone Plus program acts within current law.

Distinguish between the Capstone Plus Program vs. the tax avoidance scheme commonly marketed

To address the pertinent issue, the following should show a clear distinction between tax avoidance schemes and the Capstone Plus Program.

Prior to distinguishing such, the definition of tax avoidance is an action taken to reduce tax liability and increase after tax income. The IRS has listed the typical scheme as the employee, by way of Section 125 pre-tax contribution, reducing a large portion of their salary under the auspicious of a fixed indemnity health and wellness plan. The employee then simultaneously receives almost the entire amount deferred back tax-free. This is achieved by the employee completing some voluntary actions, such as watching a video or calling into a health coach, regardless if the employee needs or suffers a medical event.

The Capstone Plan and program offer clear distinction for the above mentioned schemes. Also, the IRS has determined this design as a sham and those marketing such unscrupulous plans could face promoter liability charges. Such charges could impose fines and criminal penalties.

While the schemes have variations the basic premise is the alleged "tax benefits" do not have triggering events that are related to any medical health and wellness to receive their benefit. This is one of the primary differences from the Capstone plan.

These schemes do not use "excepted benefits" like fixed indemnity insurance. Instead, they use

Section 125 plans alone to perpetrate the tax avoidance of the pre-tax contribution to the cafeteria plan and subsequently return a large portion of these pre-tax contributions in the form of cash.

While the Capstone Plan does have pre-tax contributions made to a Section 125 cafeteria plan, such contributions are made for the purpose of fixed indemnity insurance. Such premiums are paid to the insurance provider. This is the key distinction from the tax scheme plans.

For clarity purposes, in the tax scheme plans, the cafeteria plan Section 125 plan is setup as a fictitious transaction since it is structured solely for the purpose of tax avoidance. Thus, the IRS will disregard the structure of the transaction and impose both payroll and income tax consequences to the pre-tax contributions involved.

Meanwhile, the cafeteria plan imposed within the Capstone program is not a fictitious transaction solely for tax avoidance, but one that offers true fixed indemnity benefits as supplemental insurance. As such, it complies with the economic substance doctrine as the transaction contains valid fixed indemnity expenses.

Furthermore, Capstone differentiates itself from other companies by clearly defining specific events that must occur to trigger a claim benefit. The benefit is only activated upon the completion of certain medical activities or services. This completion must be verified through appropriate documentation, such as a CPT code, receipt, payment record, or explanation of benefits statement provided by the employee. This documentation confirms that the claim was for a covered medical event, product, or service as outlined in the insurance policy. Hence, such substantiation affirms that this plan has sufficient economic substance whereas the shams do not have any economic substance.

Accordingly, for the reasons cited above, the Capstone Plus Program distinguishes itself apart from the typical tax scheme. Therefore, the Capstone Plus Program complies with current law and contains a valid structure and is not a sham.

7. *Summary and Conclusion*

Based on the information that I have received and reviewed, along with my experience in this area, it is my opinion that the Capstone Plus Program is valid under current law.

Although there are multiple proposals being put forth and presented, including Chief Counsel Memos to change the current law, these proposals have no legal effect unless there is Congressional approval. Therefore, regardless of this fact, that these changes are a dramatic departure from existing law, yet they still have no impact or consequences on current law.

It is also important to note that a Chief Counsel Advice Memorandum (CCA) is not "the law" and simply reflects the opinion of the IRS attorney that prepared it. There is no current law that supersedes Revenue Rule 69-154. Moreover, in 2023, the Internal Revenue Service, Department of Labor, and Department of Health and Human Services (the Agencies) have issued a revised mandatory notice for fixed indemnity insurance coverage that are required by January 1, 2025.

In such, the Agencies have adopted final rules that reiterate the "excepted benefits coverage" as stated in Revenue Rule 69-154 and a notice requirement to inform enrollees and potential enrollees that this coverage is supplement to, rather than a substitute for, comprehensive coverage– neither of these rules adversely impact both the legal and tax treatment of this plan.

With that being stated, the legal and tax treatment of benefits paid under your plan is current law. Again, this opinion is rendered for the points stated above and I reserve the right to amend or revise my opinion as new information may become available.

If you should have any questions, please do not hesitate to contact me.

Best regards,

Anthony Rinaldi, Esq.
Attorney at Law