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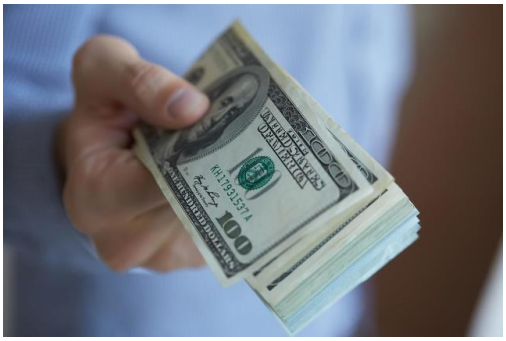
IRS Addresses Tax Treatment of Fixed-Indemnity Health Plans and Wellness Double Dip

A recently released IRS memorandum addresses the taxability of payments from an employer-provided fixed-indemnity health plan benefit. It states that payments received by employees from such plans are included in gross income if the coverage is paid for on a pretax (or otherwise tax-free) basis. Employers that provide or offer fixed-indemnity health benefits tax free should be aware of the tax consequences of this offering and seek guidance from trusted advisors for benefit designs that will work best for them and their employees.

Background

In addition to offering comprehensive health benefits to full-time employees, some employers offer an array of "voluntary benefits." Such benefits often provide coverages for specific diseases (e.g., cancer or specified illness) and/or certain medical events (e.g., hospitalization). These benefits generally qualify as health coverage under the Internal Revenue Code (Code) and are typically used to supplement comprehensive health coverage. Voluntary plans can involve group insurance coverage or individual policies issued to employees who sign up and pay for the coverage. If the employer makes any contribution toward the coverage or the coverage is paid for on a pretax basis, the plan (group or individual) could be deemed an employer-provided benefit. Fixed-indemnity health plans pay a flat (fixed) dollar amount when certain health-related events occur, such as a hospital stay, regardless of the amount of medical expenses incurred. Thus, the amounts paid by this benefit plan generally are not associated with the actual medical expenses incurred by the covered individual.

Fixed-indemnity health plans (and voluntary benefits generally), will be considered employer-provided if they are either offered employees free of charge or through a cafeteria plan (e.g., with salary reduction dollars). Under the Code, amounts paid through salary reduction are considered employer payments. Employer-provided group health plan coverage and reimbursements of qualified medical expenses are excluded from employees' gross income and employment taxes under Sections 106 and 105 of the Code, respectively. The tax law provides that proceeds from an employer-provided indemnity plan may be included in an employee's



gross income to the extent they exceed incurred medical expenses. Revenue Ruling 69-154 (issued in 1969) and regulations under Section 105 provide (among other things) that payments from an indemnity health benefit should be excludable from income up to the amount of unreimbursed medical care expenses incurred and includible as to the excess of those amounts. Under this guidance, proceeds provided through an employer-provided indemnity policy would be included in an employee's gross income to the extent they exceed unreimbursed qualified medical expenses.

An IRS Technical Advice Memorandum (TAM) 199936046 (issued in 1999) also indirectly touches on the issue of an exclusion from income. While the focus of the TAM is primarily on whether it's permissible to pay premiums for certain supplemental policies (including cancer, cancer screening, and other specific diseases coverage, hospital confinement indemnity coverage, hospital intensive care indemnity coverage, hospital intensive and sub-acute intensive care coverage, and accident-only coverage) through a cafeteria plan, it confirms, in a footnote, that proceeds from certain insurance policies – including a fixed indemnity health plan, among others – may be taxable to employees "in the event that the proceeds exceed the taxpayer's medical expenses." Conversely, one can infer that to the extent the proceeds cover otherwise unreimbursed medical expenses, they are excluded from the employee's gross income.

> **Comment.** Note that the IRS' analysis of these different types of voluntary benefits does not differ based on the specific name of the product – whether it is indemnity coverage or a similarly designed accident-only policy.

If the employee pays for the benefit plan with after-tax dollars (i.e., the premium is not paid through salary reduction or by the employer), then the plan is not employer-provided under the Code, and any payments received through the insurance for personal injuries or sickness are excluded from gross income [under Section 104(a)(3)], whether or not they cover specific medical expenses.

While the above guidance discusses different aspects of fixed-indemnity health benefits, the IRS had not issued any contemporary directives since 1999 addressing the tax consequences of this coverage when it is provided through the employment relationship, until this Chief Counsel Advice memorandum (CCA) was released late in January.

What's a Revenue Ruling?

A revenue ruling is official IRS guidance that applies the law to particular factual situations. A revenue ruling is formal guidance and can be relied upon as precedent by all taxpayers.

What's a TAM?

A TAM is often issued during an IRS audit when a technical question is raised to the Chief Counsel's Office by the particular taxpayer or auditor in the matter. A TAM applies only to a specific taxpayer, but, like the CCA, reveals the IRS position on a specific issue.

What's a CCA?

A CCA (Chief Counsel Advice) is an internal memorandum drafted by the IRS Office of the Chief Counsel (national office) to respond to a legal question posed by an area office (local/regional). A CCA may not be technically used or cited as IRS precedent, but it does demonstrate the position and reasoning on a legal issue.

Chief Counsel Advice

The Chief Counsel Advice (CCA) sets out five scenarios involving plans that pay employees a fixed-indemnity cash payment. Under the scenarios, the insurance is provided to employees, free of charge by the employer, through a cafeteria plan (i.e., salary reduction), or employee pay-all (employee-paid with after-tax dollars). The fixed-indemnity health plan pays employees $100 per office visit and $200 per day for hospital stays, without regard to medical expenses incurred. Two of the five scenarios involve a wellness program.

In one, employees who pay a premium to participate in the wellness program receive a fixed-indemnity cash benefit of $100 each for completing a health risk assessment, obtaining certain health screenings and participating in certain preventive care activities. In the other, employees receive a fixed-indemnity cash payment (either in-part or in-full) of the salary reduction premium payment that they make to participate in the wellness program (i.e., their salary reduction amounts are returned to them tax free).

Fixed-Indemnity Health Plan Payments

The CCA provides that while the employer's premium payment for the fixed-indemnity health plan coverage is excludible from gross income, any amounts received through the insurance are not because the amount paid is not related to any medical expense incurred (or coordinated with other health coverage). Additionally, to the extent that the premiums are paid directly by the employer or with pretax dollars, any amounts received through the insurance are includable in gross income. Finally, to the extent that premiums are paid with after-tax dollars, amounts received through the insurance are excluded – under Section 104(a)(3) – without regard to the amount of any medical expense incurred by the event upon which the payment is conditioned (e.g., the hospitalization).

General Principles

The IRS states that the amount paid through the indemnity plan is unrelated to any incurred medical expense, but in the scenario described in the CCA, a medical event – such as a doctor's office visit or hospitalization – triggers the payment. While the IRS cites the Section 1.105-2 regulations for the general proposition that payments unrelated to medical expenses are includible in wages, it fails to discuss other tax principles set out in the regulations. The regulations also provide that:

…If the amounts are paid to the taxpayer solely to reimburse [an employee] for expenses which he 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….

> **Comment.** It's important to consider whether the position in the CCA might be an overgeneralization of the issues and inconsistent with previous guidance (cited above). The inference here (in the Section 1.105-2 regulations, as well as the revenue ruling and TAM cited above) is that to the extent indemnity amounts cover actual medical expenses (e.g., otherwise unreimbursed medical expenses), they may be excludable from wages (and employment taxes). Perhaps, motivated by the double-dipping scenario described below, the IRS inadvertently cast a wide net. But the general notion that all payments provided through an employer-provided indemnity health plan will always be includable in wages is somewhat inconsistent with existing IRS guidance. Indeed, we understand that the IRS is aware of this concern and that it was not their intention to deviate from their existing position in this CCA. We also understand (informally) that the IRS expects to issue some clarifying guidance.

Administrative Challenges

The IRS has never discussed with much specificity the administrative and reporting expectations when an employer provides fixed-indemnity health plan benefits for employees.

Tax-Free Basis. To make the benefit more attractive and/or for administrative ease, employers sometimes offer the indemnity plan free of charge or on a pretax basis through the cafeteria plan. However, providing the benefit this way creates an employer-provided benefit under the Code and might create a taxable event when an employee receives payments under the policy. Employers should confer with counsel to determine what, if anything, is required in this instance. Some questions include:

- What are the employer's obligations – not only with regard to the tax consequences, but also with mandates like COBRA? (Note, in many instances, an indemnity health plan could be considered a HIPAA excepted benefit, so it would not be subject to the ACA mandates, but that would not preclude an obligation under COBRA.)
- As a practical matter, if the total amounts or even the excess amounts are included in wages, how does an employer determine that amount? In most cases, the employer is removed from the administration of the benefit. In some cases, the plan is an individual policy. Is the employer relieved of responsibility if it's impractical to know the amounts?
- How is any includible amount reported? Who is responsible for reporting and on what IRS tax form (e.g., are amounts reported by the employer on the Form W-2)?
- Does the employee have any responsibilities to notify the employer if he or she makes a claim under the plan?

Imputed Income. It would seem that if the benefit is provided through a cafeteria plan (or otherwise paid for by the employer), for administrative ease, the value of the coverage could be imputed in the employee's income (and taxed accordingly). An analogy could be drawn to a common approach used to offer disability benefits. If the value of the coverage is imputed in the employee's gross income, the proceeds generally will be excluded from taxation when received. Under such an arrangement, the indemnity plan, like the disability benefits, should not be considered employer-provided, and the proceeds should be excludable under Section 104(a)(3). This type of arrangement should also be permitted for a fixed-indemnity health plan benefit, but the IRS has never provided specific guidance.

After-Tax. While perhaps not as attractive, in some cases it might be less complex (from administration and tax perspectives) to provide the benefit on an after-tax basis. In this case, the benefit payout is not in the employer's hands, and the tax implications, if any, would lie with the vendor providing the benefit and the individual who receives it.

> **Comment**. Employers will need to weigh the pros and cons of the various design options, consider the risks associated with each, and decide whether the advantages of offering the benefits on a pretax basis outweigh any risks and/or administrative costs. Employers should consult with tax counsel and advisors to respond to issues like whether amounts need to be reported, on what wage reporting forms (e.g., Form W-2), and who is responsible for the reporting.

Double Dip With A Twist

In discussing the scenarios in the CCA involving wellness programs, the IRS appears to be addressing a new version of a previously discussed double-dipping scheme. (See our June 21, 2016 *For Your Information*.) In the CCA, the IRS discredits the wellness scenarios on several levels. First, it states that the payment or reimbursement of a qualified medical expense through an employer-provided medical plan is excluded from an employee's wages

(and thus, employment taxes). However, wellness incentives that are unrelated to a medical expense, like a cash payment of $100 for fulfilling certain program participation requirements, are included in the employee's income because it is not covering a qualified medical expense. Secondly, because the premiums for the wellness plan are paid by the employer and excluded from gross income, any fixed-indemnity cash payments are included in the employee's gross income and wages, regardless of the amount of medical expenses incurred upon which the payment is conditioned.

> **Comment.** The IRS reasoning in the CCA is that the payment is unrelated to medical care or expenses. The event triggering the indemnity payment under the plan is the occurrence of the wellness activity or the incurrence of the premium payment for the wellness program. The IRS prohibits this double dipping – where the same tax dollars are excluded from taxation twice.

In Closing

The CCA provides that payments received under the employer-provided fixed-indemnity health plan may not be excluded from an employee's gross income if the value of the coverage was paid for by the employer or otherwise provided on a pretax basis through a cafeteria plan. The IRS position on the taxation of employer-provided indemnity plans has always been a bit ambiguous. But the position taken in the CCA seems to stray from positions in previous guidance. Note that this CCA is not definitive IRS guidance and, as mentioned above, the IRS might clarify its position later. Employers that provide employees access to fixed-indemnity health plans should consider their options and confer with counsel and trusted advisors to ensure that their program design complies with the law. Employers will have to weigh the attractiveness and advantages of providing such benefits on a pretax basis with any possible tax implications.

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Authors
Sharon R. Cohen, JD
Mary Harrison, JD

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