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Fixed Indemnity and Wellness Programs – Double Dip Take 3

The IRS has addressed an arrangement referred to as a "fixed indemnity health plan and wellness plan" that promoters claim will provide significant tax savings for employers and employees. Concluding that the tax principles necessary for the exclusion do not apply to payments received through this type of arrangement, the IRS warns employers to steer clear. The IRS also clarifies open questions about the exclusion of medical benefits paid under a fixed indemnity health plan. Employers that have implemented or are considering these kinds of arrangements should seek advice from counsel and trusted advisors.

Background

Previously, in two separate Chief Counsel Advice (CCA) memoranda (April and December 2016), the IRS questioned a tax scheme promoted to employers under the guise of a self-funded health plan – wellness and/or fixed indemnity plan. See our June 21, 2016 *For Your Information* and April 20, 2017 *FYI In-Depth* for background on the arrangements and applicable tax principles. The self-funded plans are claimed to cost the employer and employee little or nothing, while providing employees with a benefit that ultimately reduces overall employment tax liability. Following the issuance of each CCA, promoters made incremental changes to the arrangements ostensibly to address IRS concerns. In addition to addressing the tax consequences of the most recently promoted fixed indemnity/wellness arrangement, this recent CCA seeks to clarify questions raised by the December memo about excluding qualified medical expenses covered under a fixed indemnity health plan.

Know Your Exclusions

- Payments or reimbursements of qualified medical expenses received from an employer-provided health plan are excludable from employees' gross income under Code Section 105(b) and are not subject to employment taxes.
- Payments received for personal injuries or sickness through accident or health insurance (or an arrangement having the effect of insurance) are excludable from gross income under Code Section 104(a)(3) even if they do not relate to specific medical expenses – but only if the coverage is not employer-provided.

Under the Code, coverage is considered employer-provided if the employer pays for the coverage or benefits are attributable to employer contributions (including salary reduction).

Chief Counsel Advice

The memorandum discusses self-funded health (referred by promoters as "fixed indemnity health plans") and wellness plans that provide benefits to employees at little or no cost to the employee and employer. Under the arrangement, employees make pre-tax (salary reduction) contributions to a wellness plan and a small after-tax contribution to the self-funded health plan. A large portion of the pretax contributions are returned to employees as cash payments from the health plan, as rewards through the wellness plan or as flex credits (that can be used under the cafeteria plan). Under the scheme, these payments are described as being excludable from employees' wages/income and provide an overall reduction of employment tax for the employer and employee.

Deja Vu All Over Again – Double Dip

The IRS questions whether a benefit paid under a self-funded health plan should be excluded from gross income when the amount that employees will receive as a benefit predictably exceeds the amount of their after-tax contributions (e.g., premiums paid for the benefit) for participating in wellness activities under the plan. If the employee pays for a health benefit plan with after-tax dollars (i.e., the premium is not paid through salary reduction or by the employer), then any payments received through the insurance for personal injuries or sickness, whether or not they cover specific medical expenses, are excluded from gross income – under Section 104(a)(3).

Use of Flex Credits

The CCA also describes a scenario where pre-tax contributions are returned to wellness program participants as flex credits. Such credits can be excluded from gross income (and, thus, withholding and employment taxes), if used for non-taxable benefits, like group term life, health FSA contributions, or health coverage premium reductions(s). But if the credits are used for taxable benefits offered under the cafeteria plan – like whole life insurance coverage or a gym membership (that is not a qualified medical expense) – then such amounts would be included in gross income and wages of the participating employee.

For a variety of reasons, the IRS concludes that the benefits received from the self-funded health plan should be included in employees' wages and are subject to income tax withholding and employment taxes. The IRS reasoned that:

- The certainty of receiving a benefit (for participating in a wellness program) so far exceeds the notional after-tax premium payment by the employee that it causes the arrangement to be devoid of any insurance risk (a necessity for the tax exclusion).
- The ratio of employee after-tax contributions to the benefit received is so askew that the amounts received by employees under the arrangement actually are attributable to contributions by the employer.

Fixed Indemnity Health Plan

In the previous CCA discussing fixed indemnity health plans, the IRS appeared to overstate its position on the excludability of qualified medical expenses paid for under a fixed indemnity health plan. The CCA provided that any amounts received through the insurance are includible in an employee's gross income because the amount paid is not related to any medical expense incurred (or coordinated with other health coverage). The idea that all payments made through an employer-provided indemnity health plan will always be includable in wages is somewhat inconsistent with existing IRS guidance. In a footnote in this current memorandum, the IRS says that the previous CCA should not be read to modify the result or previous IRS analysis. Thus consistent with the previous position, to

the extent indemnity amounts cover actual medical expenses (e.g., otherwise unreimbursed medical expenses), they may be excludable from wages (and employment taxes).

In Closing

Today, with the uncertainty of health care reform and reality of rising health care costs, employers of all sizes could be seduced by "products" that tout something that's too good to be true – little to no investment linked with big returns, including a tax-free return of employee contributions, employment and withholding tax savings (e.g., for the employee and employer – equal to or greater than the investment), and a business expense deduction (for the employer). The Internal Revenue Code sets parameters within which all welfare benefit tax exclusions must operate. Those parameters, established decades ago, often provide limitations for plan designs that claim to be completely "ground-breaking." The taxes and penalties associated with improper income tax withholding and/or payment of employment taxes can far outweigh the benefits of these programs. It's vital that innovative arrangements be thoroughly vetted to ensure legal compliance.

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