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Clearing the air – again – on taxation of fixed indemnity health benefits

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There is still some confusion related to the taxability and reporting requirements for health indemnity benefits when the premium is paid by the employer or by the employee on a pretax basis. Much of the confusion comes from articles and information based on outdated and unintentionally confusing IRS guidance issued in December 2016. The IRS clarified and superseded this guidance in a memorandum dated April 24, 2017 (irs.gov/pub/irs-wd/201719025.pdf). This advisory provides a detailed look at IRS guidance to help clear up confusion. **The bottom line is that the IRS has confirmed the tax exclusion for benefits received under pretax-paid health indemnity policies up to the amount of the unreimbursed medical expenses incurred.** This information may be of interest to agents, brokers and employers.

Long-standing IRS rules and Revenue Ruling 69-154

The taxation of benefits under fixed indemnity health policies is governed by IRS Code section 105(b). In 1969, the IRS issued an important ruling under this code section, Revenue Ruling 69-154. This ruling concluded that when a fixed indemnity health policy is paid for on a pretax basis, benefits are taxable only to the extent that they exceed the individual's unreimbursed medical expenses (i.e., only "excess benefits" are taxable).

Under Revenue Ruling 69-154, determining the amount, if any, of taxable benefits under a fixed indemnity health policy paid for with pretax dollars involves a variety of factors that are known only to the employee (and not the employer or insurer). These factors include any other fixed indemnity health policies the individual has, the total amount of medical expenses and the amount of reimbursed medical expenses. If the employee has more than one fixed indemnity health policy, such as a policy paid with after-tax dollars, the calculation may be more involved, as the employee may need to allocate expenses between their various policies. The employee will make this determination with their tax advisor when filing their personal income taxes for the year in question.

The IRS unintentionally confuses the issue

In December 2016, the IRS released a memo focused on shutting down abusive tax shelters involved with so-called "wellness programs." In that memorandum, the IRS used overly broad language, which caused confusion about whether the tax exclusion rules under Code section 105(b) and Revenue Ruling 69-154 continued to apply to fixed indemnity health policies. Many incorrectly thought the December 2016 memorandum meant that pretax health indemnity benefits were always taxable. This led to the incorrect conclusion that employer withholding and reporting obligations applied to such coverage when funded on an employer-paid or pretax salary reduction basis. Following soon after the December 2016 memo was issued, the IRS received a number of comments asking for clarification on these issues.

The IRS clears the air

In April 2017, as a result of the many comments received, the IRS issued revised guidance. This new guidance specifically confirmed the continued application of Revenue Ruling 69-154 and its conclusion with respect to the taxation of fixed indemnity health benefits

What does this all mean?

The April 2017 IRS memorandum reconfirms that ***if an indemnity health policy is paid for by the employer or by the employee with pretax salary reduction funds,*** benefits are excludable up to the amount of unreimbursed medical expenses. Stated differently, only the excess amount paid above unreimbursed medical expenses is taxable. Further, since some portion of the benefits may be received tax-free, and neither the employer nor the insurer can know what that portion is, only the employee/policyholder will know what amounts to include in income (excess benefits) and should report such amounts on their personal Form 1040. **It's up to the employee/policyholder to identify and report any amount of excess benefits, including income on their personal Form 1040.**

If an indemnity health policy is paid for by the employee on an after-tax basis, then the entire amount of the benefits is tax-free.

Conclusion

If you see materials about the taxation of benefits from an indemnity health policy paid for on a pretax basis, it's important to make sure that the materials are referencing the IRS memorandum dated April 2017, which confirmed the long-settled rules. Materials that indicate such benefits are always taxable are most likely looking only at the prior December 2016 memorandum, not the most recent IRS guidance. Aflac's advisory titled The IRS clears the air on taxation of fixed indemnity benefits provides further guidance on this issue.

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subject: Tax Treatment of Benefits Paid by Self-Funded Health Plans

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Is a benefit paid under an employer-provided self-funded health plan included in income and wages if the average amounts received by the employees for participating in a health-related activity predictably exceed the after-tax contributions by the employees?

CONCLUSION

Yes, the amounts are included in income and wages for reasons including, but not limited to, one or both of the reasons listed below. As a result, the exclusion from gross income under section 104(a)(3) does not apply to the amounts received by the employees.

(1) The employer-provided self-funded health plan does not involve insurance risk, and accordingly, is not insurance (nor does it have the effect of insurance) for federal income tax purposes (including section 104(a)(3)).

(2) The ratio of the average amounts received by the employees for participating in health-related activities to the after-tax contributions by the employees

demonstrates that the amounts received by the employees are attributable to contributions by the employer (and not employee after-tax contributions) so that the exclusion under section 104(a)(3) does not apply.

FACTS

In General

We understand that promoters (typically product developers or insurance brokers, but sometimes other persons) are selling self-funded health plans (often referred to by promoters as fixed indemnity health plans) and wellness plans to employers. The plans are promoted as a way to provide certain benefits to employees at no or little cost to the employer and no or little cost to the employees on a net of withholding take-home pay basis. The promoters claim the benefits do not constitute income or wages and thereby reduce the employer and employee share of employment taxes with respect to employee remuneration. Under such plans:

- Employees who voluntarily participate in the plans make pre-tax contributions to the wellness plans and relatively small after-tax contributions to the self-funded health plans. A large portion of the pre-tax contributions are returned to the employees as cash payments from the self-funded health plans or rewards through the wellness plans that are purportedly not includible in income or wages.

- The pre-tax contributions to the wellness plans lower the amount of Federal Insurance Contributions Act (FICA) taxes that are owed by the employees and the employers under sections 3101 and 3111. The cash payments that are made to the employees from the plans are treated as not includible in income or wages with the result that the participating employees' net take-home pay (on either a per-pay-period or an annual basis) generally remains unchanged.

- The employer pays a fee to the promoter for administering the plans, the amount of which is less than (or at most insignificantly more than) the FICA taxes that would have been paid by the employer had the plans not been adopted. As a purported result, the employer is able to provide a health plan and a wellness plan to its employees at "no or little cost" to the employer.

Examples

Situation 1. An employer provides all employees, regardless of enrollment in other comprehensive health coverage, with the ability to enroll in coverage under a self-funded health plan. Employees electing to participate in the self-funded health plan pay a small after-tax employee contribution (the amounts deducted to pay the premium for the self-funded health plan are included in the gross income of employees and are subject to FICA, Federal Unemployment Tax Act (FUTA) taxes, and federal income tax withholding). The self-funded health plan pays employees a fixed cash payment benefit for participating in certain activities that are related to health (for example, calling a toll-

free telephone number that provides general health-related information, attending a seminar that provides general health-related information, participating in a biometric screening, or attending a counseling session). The employees are not charged for participating in any of the activities. The fixed-dollar amount employees receive under the self-funded health plan for each covered activity (for example, $1,425 per activity) is much greater than the amount of the after-tax premium the employees pay to participate in the self-funded health plan (for example, $60 per month). Each employee may receive benefits under the self-funded health plan based on participation in no more than one covered activity each month (a maximum of 12 covered events per year). Under an actuarial analysis, all employees are expected to receive benefit payments under the self-funded health plan that markedly exceed their after-tax premium payments and, in practice, all employees (or nearly all employees) do receive payments from the self-funded health plan that are in excess of their after-tax contributions.

Situation 2. The facts are the same as *Situation 1*, except the employer also provides employees with the ability to enroll in coverage under a wellness plan, which would independently qualify as an accident and health plan under section 106, together with the self-funded health plan described in *Situation 1*. Employees electing to participate in the wellness plan pay a pre-tax employee contribution (for example, $1,500 per month) through a section 125 cafeteria plan (and, therefore, the amount of the salary reduction is not included in compensation income or wages at the time the salary would otherwise have been paid). These pre-tax contributions for participation in the wellness plan are in addition to the small after-tax contributions for participation in the employer-provided self-funded health plan. The wellness plan provides the employees with health-related wellness activities at no charge to the employees. Typically, if the employee's net take-home pay (on either a per-pay-period or an annual basis) after receiving the fixed cash payment from the self-funded health plan exceeds the amount of the employee's net take-home pay (on either a per-pay-period or an annual basis) prior to implementing the plans, the wellness plan provides that the excess is paid in the form of flex credits that can be used for benefits under the section 125 cafeteria plan. Consequently, the net take-home pay (on either a per-pay-period or an annual basis) of each employee who participates in the plans generally remains unchanged.

The following chart reflects how promoters may present the net benefits provided by plans described in *Situation 2* to employers (assuming a 15 percent income tax rate). In addition, the promoter's description of the plans may emphasize that the amount of FICA taxes paid by the employer and employees is reduced.

Prior to Adopting the Plans	Each Employee	After Adopting the Plans
$4,000	Monthly Wage	$4,000
$0	Wellness Plan Contribution	<$1,500>
$4,000	Taxable Income	$2,500
<$600>	Income Taxes	<$375>
$3,400	Post-tax Income	$2,125
$0	Self-funded Health Plan Contribution	<$60>

$0	Fixed Cash Payment	$1,425
$3,400	Net Pay	$3,490
$0	Flex Credits	<$90>
$3,400	Net Take-home Pay	$3,400

LAW AND ANALYSIS

Income and Statutory Exclusions from Income

Section 61(a)(1) and § 1.61-21(a) provide that, except as otherwise provided in subtitle A, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.

In general, section 106(a) provides that gross income of an employee does not include employer-provided coverage under an accident or health plan. Under section 105(b), an employee generally may exclude from income amounts received through employer-provided accident or health insurance if those amounts are paid to reimburse expenses incurred by the employee for medical care (of the employee, the employee's spouse, or the employee's dependents, as well as children of the employee who are not dependents but have not attained age 27 by the end of the taxable year) for personal injuries and sickness.

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. Id.

The legislative history to section 104(a)(3) provides that "payments for personal injury or sickness through an arrangements [sic] having the effect of accident or health insurance (and that are not merely reimbursement arrangements) are excludable from income. In order for this exclusion to apply, the arrangement must be insurance (e.g., there must be adequate risk shifting.)" H.R. Rep. No. 104-736, at 294 (1996) (Conf. Rep.).

Section 1.104-1(d) provides, in relevant part, that if an individual purchases a policy of accident or health insurance out of the individual's own funds, amounts received thereunder for personal injuries or sickness are excludable from gross income under section 104(a)(3). Section 104(a)(3) also applies to amounts received by an employee for personal injuries or sickness from a fund which is maintained exclusively by employee contributions. § 1.104-1(d). However, if an employer is either the sole contributor to such a fund, or is the sole purchaser of a policy of accident or health insurance for its employees (on either a group or individual basis), the exclusion provided under section 104(a)(3) does not apply to any amounts received by the employees through such fund or insurance. Id.

Rev. Rul. 69-154, 1969-1 C.B. 46, clarifies that excess indemnification received under a medical insurance policy or plan that is attributable to an employer's contribution is includable in the employee's gross income. Under the ruling, if the employer paid the entire premium on a policy, section 104(a)(3) does not apply and thus to the extent an employee received indemnification in excess of the medical expenses incurred by the employee, the excess is included in the employee's gross income because the exclusion under section 105(b) only applies to the reimbursement of the amount of the medical expense.[1]

Generally, an employee 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 section 125. Under section 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 section 125, the amount of an employee's salary reduction applied to purchase such 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 section 125, the coverage is excludable from gross income under section 106 as employer-provided accident or health coverage.

APPLICATION OF EMPLOYMENT TAXES

Sections 3101 and 3111 impose FICA taxes on "wages" as that term is defined in section 3121(a), with respect to "employment," as that term is defined in section 3121(b). Section 3121(a) defines the term "wages" for FICA purposes as all remuneration for employment, with certain specific exceptions.

Section 3301 imposes FUTA tax on wages paid with respect to employment. The general definitions of the terms "wages" and "employment" for FUTA purposes are similar to the definitions for FICA purposes. See sections 3306(b) and (c).

Section 3402(a), relating to federal income tax withholding, 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 section 3401(a) for federal income tax withholding purposes as all remuneration for services performed by an employee for an employer, with certain specific exceptions.

To the extent amounts are excluded from gross income under sections 105(b) or 106(a), they are also excluded from wages subject to income tax withholding under section 3401. In addition, amounts paid to reimburse expenses incurred by the

[1] *Situations 2* and *3* in 2016 IRS CCA Lexis 131 were intended to address situations in which no medical expenses were incurred or reimbursed, and should not be read to modify the analysis or result in Rev. Rul. 69-154.

employee for medical care (of the employee, the employee's spouse, or the employee's dependents, as well as children of the employee who are not dependents but have not attained age 27 by the end of the taxable year) for personal injuries or sickness are excepted from wages for FICA and FUTA tax purposes under sections 3121(a)(2) and 3306(b)(2), respectively.

Section 3121(a)(5)(G) provides an exception from FICA wages for any payment to or on behalf of an employee under a cafeteria plan (within the meaning of section 125) if such payment would not be treated as wages without regard to such plan and it is reasonable to believe that (if section 125 applied for purposes of section 3121) section 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 his 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 32.1 of the Temporary Employment Tax Regulations under the Act of December 29, 1981 (Pub. L. 97-123)[2] provides rules related to the FICA taxation of payments on account of sickness or accident disability under section 3121(a)(2)(A). Section 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 section 3121(a)(4), which provides an exception for any payment

[2] Although section 7805(e)(2) provides that any temporary regulation shall expire within 3 years after the date of issuance of such regulation, that paragraph is effective only for temporary regulations issued after November 20, 1988, and thus does not apply to this temporary regulation issued in 1982. Section 32.1 was amended in 2005 by T.D. 9233, 70 F.R. 74198, 2006-1 C.B. 303, confirming its continuing authority. The temporary regulations also provide the guidance needed to satisfy the last sentence of section 3121(a) which references regulations to provide an exception to the treatment of a third party as the employer with respect to making a payment on account of sickness or accident disability that is included in FICA wages solely by reason of the parenthetical matter contained in section 3121(a)(2)(A).

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.

Section 32.1(d) provides that for purposes of § 32.1(a), a payment made on account of sickness or accident disability includes any payment for personal injuries or sickness includible 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 § 1.105-2,

(2) any payment which is unrelated to absence from work as described in section 105(c) and § 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 § 1.105-1.

Section 32.1(d) also provides that 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 last sentence of section 3121(a) and § 32.1(e) generally provide that any third party which makes a payment included in wages solely by reason of the parenthetical matter contained in section 3121(a)(2)(A) is treated as the employer with respect to such payment. The temporary regulations distinguish between employers and agents for purposes of this provision. If the third party is acting as an agent of the employer, the employer for whom services are normally rendered is the employer for purposes of the FICA liability with respect to the payments on account of sickness or accident disability. If the third party is not an agent of the employer, the third party is responsible for the payment of FICA taxes although, under certain conditions, it can transfer liability for the employer share of FICA taxes to the employer for whom services are normally rendered.

Section 31.3401(a)-1(b)(8)(i)(a) provides that income tax withholding is required on all payments by an employer of amounts includible in gross income under section 105(a) and § 1.105-1 to an employee under an accident or health plan for a period of absence from work on account of personal injuries or sickness. Payments on which withholding is required are wages under section 3401(a) for purposes of the income tax withholding requirements.

Payments are considered made by the employer and subject to income tax withholding under this provision if a third party makes the payment as an agent of the employer. The determining factor as to whether a third party is an agent of the employer is whether the third party bears any insurance risk. If the third party bears no insurance risk and is reimbursed on a cost plus fee basis, the third party is an agent of the employer even if the third party is responsible for making determinations of the eligibility of individual employees of the employer for sick pay payments. If the third party is paid an insurance

premium and not reimbursed on a cost plus fee basis, the third party is not an agent of the employer, but the third party is a payor of third party sick pay for purposes of voluntary withholding from sick pay under section 3402(o) and the regulations thereunder. Third party payments of sick pay, as defined in section 3402(o), are not wages under section 3401 or § 31.3401(a)-1.

Application to Fixed Indemnity Health Plans

A fixed indemnity health plan generally refers to a plan that pays covered individuals a specified amount of cash for the occurrence of certain health-related events, such as medical office visits or days in the hospital. Similarly, a critical disease or specific disease policy pays a specified amount for the diagnosis of a disease. The amount paid is not related to the amount of any medical expense incurred or coordinated with other health coverage.

The exclusion from gross income under section 104(a)(3) applies to amounts received through accident or health insurance, or through an arrangement having the effect of accident or health insurance, for personal injuries or sickness. [3] Amounts received from a self-funded fixed indemnity health plan may qualify for this exclusion in certain circumstances.

As a general rule, employees who elect to participate in a self-funded fixed indemnity health plan, which constitutes insurance or has the effect of insurance, offered by their employer and who pay 100 percent of the premiums on an after-tax basis may exclude from their gross income and wages for income tax withholding purposes reasonable amounts received through the self-funded fixed indemnity health plan as a result of the employees experiencing certain health-related events (for example, a medical office visit or a hospital stay). See sections 104(a)(3), 105(b), and 106(a), and the accompanying regulations. For the income tax withholding authority, see section 3401(a) and § 31.3401(a)-1(b)(8).

For example, assume a traditional fixed indemnity health plan that pays fixed amounts on unpredictable health events such as a medical office visit or a hospital stay and receives premium payments on an after-tax basis, and that, unlike the arrangements presented in the situations described above, the fixed indemnity health plan provides insurance or has the effect of insurance. If that plan pays an individual $200 for a medical office visit and the covered individual's unreimbursed medical costs as the result of the visit were $30, the $200 would be excluded from income. The exclusion under section 104(a)(3), however, does not apply to the extent that amounts paid are attributable to contributions by the employer which were not includable in the gross income of the employee, or paid by the employer. Thus, if a fixed indemnity health plan with premiums paid on a pre-tax basis through a section 125 cafeteria plan paid $200 for a medical office visit and the covered individual's unreimbursed medical costs as the

[3] For analysis of other situations regarding the taxation of payments to employees in relation to employer-provided health plans, see Revenue Ruling 2002-3, 2002-3 I.R.B. 316; 2016 IRS CCA Lexis 50; and 2016 IRS CCA Lexis 131.

result of the visit were $30, $30 would be excluded from gross income under section 105(b) and the excess amount of $170 would be included in gross income.

DISCUSSION

Situation 1

The exclusion under Section 104(a)(3) applies to amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance). Neither the Code nor the regulations define the term “insurance.” The Supreme Court has explained, however, that in order for an arrangement to constitute insurance for federal income tax purposes both risk shifting and risk distribution must be involved. Helvering v. Le Gierse, 312 U.S. 531, 61 S. Ct. 646, 85 L. Ed. 996 (1941). The risk transferred must be the risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir. 1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950), and must not be merely an investment or business risk. Le Gierse, 312 U.S. at 542; Rev. Rul. 2007-47, 2007-2 C. B. 127.

In *Situation 1*, the participants receive a payment for engaging in certain activities related to health, but the arrangement does not involve a risk of economic loss or fortuitous event. Accordingly, there is no insurance for federal income tax purposes. Similarly, because there is no insurance risk, there can be no “risk shifting,” which is required for an arrangement to “have the effect of insurance.” See H.R. Rep. No. 104-736, at 294 (1996) (Conf. Rep.).

Thus, because the self-funded health plan is neither insurance nor does it “have the effect of insurance”, amounts received through the plan are not excluded from income under section 104(a)(3) or from wages under section 3401(a).

Moreover, because the average benefits paid or predicted to be paid through the self-funded health plan markedly exceed the after-tax contributions paid by a participating employee (for example, $17,100 ($1,425 x 12) in annual benefit payments versus $720 ($60 x 12) in annual premiums), the benefits in excess of the premiums (for example, $16,380 ($17,100 - $720)) 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. As a result, the exclusion under section 104(a)(3) would not apply to such excess and the excess ($16,380) would be includible in the gross income of the participating employee. In addition, the excess would be included as wages of the participating employee under section 3401(a). Because the plan is not insurance, a third party making the payments of benefits under the plan would have no insurance risk and would be treated as an agent of the employer under the income tax withholding regulations relating to payments on account of sickness or accident disability. Thus, the excess payments would be subject to income tax withholding on the same basis as if the employer were making the payments. § 31.3401(a)-1(b)(8)(i)(a). The excess would also be subject to FICA and FUTA taxes because no exception from wages applies to the excess, the excess payments are not made on account of sickness or accident

disability, and are not paid for medical or hospitalization expenses in connection with sickness or accident disability. Even if the excess payments could be considered to be paid on account of sickness or accident disability, section 3121(a)(2)(A) and § 32.1 would in effect provide that such excess payments would be subject to FICA and FUTA taxation.

Situation 2

The outcome regarding benefits received under the self-funded health plan would be the same in *Situation 2* as it is in *Situation 1*. However, the flex credits awarded under the wellness plan would be excluded from the income and wages of a participating employee unless the flex credits were used to purchase taxable benefits under the section 125 cafeteria plan, such as whole life insurance coverage (in contrast to group term life insurance) or a gym membership. In that instance, the flex credits used to purchase the taxable benefits under the section 125 cafeteria plan would be included in the gross income and wages of the participating employee.

Please call (202) 317-6000 if you have any further questions.