



TaxNewsFlash

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Tax treatment of employer-funded, fixed-indemnity insurance policy (Chief Counsel legal advice memo)

The IRS publicly released a legal advice memorandum¹ (from the Office of Chief Counsel) concerning the tax treatment of an employer-funded, fixed-indemnity insurance policy.

Read [202323006](#) [PDF 135 KB] (dated May 9, 2023)

KPMG observation: This is the third in a series of Chief Counsel Advice (CCAs) released addressing wellness arrangements. These wellness arrangements had originally been promoted as providing tax-free reimbursement payments with the arrangement funded through FICA savings. However, the IRS has consistently provided that the wellness payments in excess of unreimbursed medical expenses are wages subject to payroll taxes.

The issues presented in the memo are:

- Whether wellness indemnity payments under an employer-funded, fixed-indemnity insurance policy (including when the premium for the coverage is paid by employee salary reduction through a cafeteria plan under section 125) are includible in the gross income of the employee if the employee has no unreimbursed medical expenses related to the payment
- Whether the wellness indemnity benefits that are includible in gross income (taxable wellness indemnity benefits) are wages for purposes of Federal Insurance Contributions Act (FICA) taxes,

¹ Legal advice memoranda are signed by executives in the National Office of the Office of Chief Counsel and issued to Internal Revenue Service personnel who are national program executives and managers. The memos are issued to assist IRS personnel in administering their programs by providing authoritative legal opinions on certain matters, such as industry-wide issues. The memos cannot be used or cited as precedent.

Federal Unemployment Tax Act (FUTA) taxes, and federal income tax withholding (FITW) (collectively, “employment taxes”) with respect to the payments of benefits

Facts

- An employer provides comprehensive health coverage for its employees through a group health insurance policy.
- 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 section 106.
- Employees pay monthly \$1,200 premiums for the fixed-indemnity health insurance policy by salary reduction through a section 125 cafeteria plan.
- The only payments that the insurance company receives with respect to the insurance provided to the employees are the premium payments.
- The employer’s fixed-indemnity health insurance policy 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 \$1,000 if an employee participates in certain health or wellness activities (limited to one payment per month).
- Use of preventive care, such as vaccinations, under a comprehensive health plan in which an employee is enrolled, qualifies the employee for the payment for the 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, although in many cases all or part of the cost of the health-related activity will be provided at no cost or is covered by other insurance.
- The fixed-indemnity health insurance policy also provides a benefit for each day that the employee is hospitalized. 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.

Conclusion

In the legal advice memorandum, the IRS concluded that:

- Wellness indemnity payments under an employer-funded, fixed-indemnity insurance policy (including when the premium for the coverage is paid by employee salary reduction through a cafeteria plan under section 125) are includible in the gross income of the employee if the employee has no unreimbursed medical expenses related to the payment.
- The exclusion under section 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.
- The exclusion from income in section 105(b) does not apply to payments when the employee has no unreimbursed medical expense either because the activity that triggers the payment does not cost the employee anything or because the cost of the activity is reimbursed by other coverage. The fixed indemnity health insurance policy pays \$1,000 per month without regard to whether the

employee has any unreimbursed health insurance expenses. Thus, the payment is included in the employee's gross income.

- Because the payment is provided in connection with the employee's employment, it is included in remuneration and treated as "wages" for employment tax purposes. The exclusions from "wages" for medical expenses would not apply because the payments are not for medical expenses.
- When the insured plan pays \$1,000 because the employee used a wellness benefit, the \$1,000 is included in the employee's income and wages. Accordingly, taxable wellness indemnity benefits are wages for purposes of FICA, FUTA, and FITW with respect to the payments of benefits in the situation described above.

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