taxnotes federal

Volume 181, Number 9 ■ November 27, 2023

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Reprinted from *Tax Notes Federal*, November 27, 2023, p. 1601

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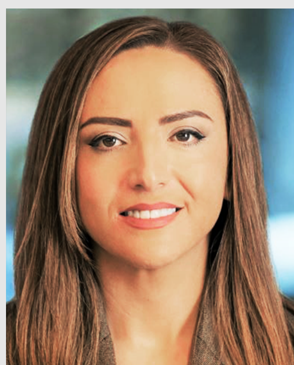
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In this article, Tackney and Grimsley examine recently proposed regulations that would classify employer-provided fixed indemnity health coverage not as health insurance but as income replacement that should be taxed when paid to the insured employee and subject to wage reporting and withholding. They caution employers that provide or have considered providing this coverage to determine how the program is administered.

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Recently proposed Treasury regulations (REG-120730-21)[1] would eliminate an employer's ability to provide (or an employee's ability to pay for) fixed indemnity health coverage on a pretax basis while also providing (or receiving) nontaxable benefits. For the purposes of the regs, fixed indemnity health coverage refers to an arrangement that pays an amount to the insured because of a medical event regardless of whether the individual incurred any medical expenses (for example, a $350-per-day benefit for any day spent in a hospital). Many fixed indemnity health insurance providers have taken the position that when provided as part of an employee benefit plan, the benefit may be provided on a pretax basis and result in benefit payments, some or all of which may be excluded from gross income, and none of which are subject to employment tax withholding or related reporting (that is, they are not reportable on a Form W-2). The proposed regulations state that since these benefits do not require any actual medical expense to be paid, they serve as income replacement rather than health insurance and so should be taxed when paid to the insured employee and subject to wage reporting and withholding. In essence, the proposed regulations would put employer-provided fixed indemnity health coverage under a regime that is similar to employer-provided disability insurance.

In this same way, the proposed regulations address a series of promoted arrangements purporting to provide "costless" wellness or health benefits through a salary reduction and reimbursement arrangement, eliminating any basis for the claimed tax benefits. Employers who are providing or have considered providing fixed indemnity health coverage or costless wellness or health benefit programs to their employees should take these developments into account and

[1]These proposed regulations are found in a tri-agency (Treasury and the IRS, the Department of Health and Human Services, and the Labor Department) set of regulations addressing other issues related to fixed indemnity health insurance, but this article focuses solely on the Treasury/IRS regulations concerning the tax treatment of employer-provided fixed indemnity health insurance.

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determine how the program is administered from a wage reporting and withholding perspective.

I. Increase in Popularity

Employers of all sizes typically have both business and personal goals in seeking to improve their employees' health and well-being. These goals have come under pressure from the continued rise of healthcare costs. In recent years, a common practice has been to raise deductibles and co-pays to keep premiums lower. In response, fixed indemnity health insurance providers have entered the employee benefits market and offered a means for employers to assist with the rising out-of-pocket outlays their employees face.

For tax purposes, this calls into question the nature of the benefits as health benefits (generally excludable from gross income and wages) versus income replacement benefits (generally includable in gross income and wages). Treasury and the IRS recently proposed regulations that would answer the question by providing that fixed indemnity health coverage is not excludable health coverage under section 105. The preamble to the proposed regulations suggests strongly that these amounts would be wages subject to employment taxes and the related reporting and withholding obligations. Notably, none of the IRS guidance, including the preamble, identifies which party is responsible for the reporting and withholding — the insurance company paying the benefit or the employer providing the benefit program.

Unsurprisingly, fixed indemnity health insurance stakeholders have reacted strongly to the proposed regulations, and how this issue is resolved in the final regulations remains to be seen. To fully appreciate the landscape, however, one must consider that the IRS has long been concerned with pretax health arrangements as a means of providing costless employee benefits by reducing FICA taxes. Through a series of legal opinions, the agency expressed skepticism, signaling that these arrangements were too good to be true and did not provide the purported benefits. But the arrangements continue to be sold by promoters. If finalized, the proposed regulations would eliminate the basis for the claim of tax savings under these arrangements.

This article examines the history of tax issues involving employer-provided fixed indemnity health arrangements, starting with a summary of relevant code provisions and a revenue ruling central to the regulatory issues, moving to a series of arguably too-good-to-be-true costless health and wellness arrangements and the IRS's reaction to them, and finally summarizing the recent proposed regulations that would comprehensively address employer-provided fixed indemnity health arrangements.

II. Technical Background

Sections 104, 105, and 106 generally govern the taxation of employer-provided health benefits. Section 106 provides that gross income of an employee generally does not include employer-provided coverage under an accident or health plan. Section 105 provides that employees may exclude from income amounts received under an employer-provided accident or health insurance arrangement if those amounts are paid to reimburse medical expenses (as defined under section 213(d)) incurred by the employees and their spouses and dependents. 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. The section 104(a)(3) exclusion does not apply, however, if the amounts are either attributable to (1) contributions by the employer that were not includable in the gross income of the employee, or (2) payments by the employer.[2]

Rev. Rul. 69-154, 1969-1 C.B. 46, provides an analysis of the consequences of duplicate health insurance coverage that has been argued to be relevant to the analysis of fixed indemnity health arrangements. It addresses various scenarios, including situations in which the duplicate coverage is a combination of an individual health insurance policy purchased after tax by the employee and employer-sponsored health insurance coverage. While various allocations of excludable and includable income may be needed because of the duplicate coverage, in essence the

[2] *See* reg. section 1.104-1(d).

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revenue ruling provides that any amount of health indemnity payments exceeding the otherwise unreimbursed medical expenses the individual incurred is taxable income. Notably, the revenue ruling addresses duplicative coverage but does not address fixed health indemnity coverage.

Section 125 allows an employer to establish a cafeteria plan under which an employee may make an election to pay for certain eligible employee benefits pretax, typically through salary reduction. One eligible employee benefit is coverage under an employer-sponsored health plan.[3] The ability to use pretax funds that are not subject to FICA tax under section 3121(a)(5)(G) is central to the promoters' claimed tax benefits in certain arrangements discussed later.

III. The Double Dip

In what has been referred to as the "double dip," the first iteration of costless health benefit arrangements allowed employees to pay pretax for some health benefit arrangements — for example, health insurance, wellness programs, fixed indemnity health — and receive a cash payment that the promoter represents would either be tax free to the employee or, at minimum, would not be subject to reporting and withholding (that is, would not be subject to FICA tax or federal or state income tax withholding). These arrangements have morphed as the IRS has indicated with each successive iteration that it does not agree with the represented tax benefits. But at the heart of each program are two intended goals:

- the employee will not experience any negative change in take-home pay, and may even see an increase; and
- the employer will be able to pay for the program with FICA tax savings, making it cost-free.

Unfortunately, what is not highlighted is that even under the promoter's analysis, the cash payments may be taxable to the employee through the Form 1040 even if they're not reported on a Form W-2 (perhaps cynically relying on the difficulty the IRS has in discovering unreported income), putting the typically unaware employee at audit risk. Nor do promoters highlight that the employee's earnings record for purposes of Social Security benefits will be reduced significantly. And finally, they don't mention that if the product truly resulted in the purported tax treatment, then the entire U.S. workforce could avoid the FICA tax regime for all compensation, thereby bankrupting the Social Security system.

A. Rev. Rul. 2002-3

The original double dip arrangement arose in the 1990s and involved the employee paying a premium for health insurance with pretax funds through a cafeteria plan and then being reimbursed for some (or all) of that premium payment as a cash award under the health insurance arrangement. Because a payment for a health insurance premium is a medical expense under section 213(d), promoters asserted that the cash award was a tax-free reimbursement of a medical expense. In this manner, employee pretax contributions could be reimbursed purportedly tax free.

Rev. Rul. 2002-3, 2002-3 IRB 316, addressed this arrangement. Consistent with its long-standing view, the IRS characterized the pretax salary reduction contributions as made by the employer rather than paid by the employee. For that reason, the arrangement did not provide for the employer to reimburse the employee for health insurance premiums that the employee paid, which would have been excluded from the employee's income.[4] Further, the payment did not reimburse the employee for an actual medical expense incurred by the employee, so the payments were not excluded from income under section 105. Finally, the revenue ruling concluded that the payments did not qualify for any exclusions from employment taxes, so they were wages for both federal income tax withholding and FICA tax purposes.

[3] *See* section 125(f)(1) and prop. reg. section 1.125-1(a)(3)(B).

[4] Rev. Rul. 61-146, 1961-2 C.B. 25.

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B. Double Dip Wellness Plans

1. CCA 201622031.

Employers appeared to have understood the IRS's position because the double dip arrangement faded in popularity. Surprisingly, the advent of the wellness plan and the Affordable Care Act encouraged a new iteration. Indeed, some materials concerning these new arrangements cited the ACA provisions encouraging wellness plans as support for their tax analysis, even though those provisions changed nothing about the tax treatment of employer-provided health plans.

In response, the IRS issued chief counsel advice legal memoranda. CCA 201622031 (CCA 1) addresses wellness plans that in substance operated like the classic double dip but instead of paying a premium for traditional health plan benefits, the cost was wrapped into a wellness plan. In the first situation, the employee enrolls at no cost in an arrangement that provides some preventive benefits, such as health screenings, that cause the arrangement to be a group health plan but also provides a cash award or taxable benefit such as gym membership fees if the employee participates. The assertion that the cash rewards or other nonmedical benefits would be tax free appeared to flow from some misconception that all benefits provided under a group health plan are excluded from income and wages. The analysis points out that the benefits must consist of medical benefits under section 213(d) or the reimbursement of employee expenses incurred to obtain medical benefits under section 213(d). In the second and third situations addressed in CCA 1, the employee pays pretax for enrollment through a cafeteria plan. In the second situation, the employee again receives a cash award or taxable benefit related to participation, while in the third situation, the employee receives a cash payment labeled as a return of some (or all) of the amount paid to enroll. The analysis of the second situation is the same as that of the first — cash or other taxable benefits paid to an employee remain taxable as wages even if provided under a health plan. The third situation raises the classic double-dip argument that the health expense being reimbursed is the pretax premium paid by the employee. For the reasons cited in Rev. Rul. 2002-3, the IRS determined that the cash payments were taxable as compensation income and FICA wages.

2. CCA 201703013.

Critics responded to the CCA 1 analysis by arguing that the arrangements were not traditional health plans and thus not subject to the double-dip analysis. Rather, the arrangements constituted fixed indemnity health plans providing payments based on medical events, and it was section 104 that excluded the payments from income. The IRS quickly responded with CCA 201703013 (CCA 2), setting out a series of situations demonstrating its views on the application of section 104.

In the first situation addressed in CCA 2, the employee pays for enrollment with after-tax dollars for the coverage. The IRS concludes that the payments to the employee are excludable from income under section 104. This is not a surprise because this is the same tax treatment applied to a fixed indemnity health policy purchased by an individual with after-tax dollars.

In Situation 2 of CCA 2, the employee pays nothing, and in Situation 3 the employee pays the premium with pretax dollars under a cafeteria plan. The IRS concludes in both cases that because the employee did not pay for the premium with after-tax dollars, section 104 does not exclude these payments from income and the amounts paid are taxable wages subject to employment taxes.

In Situation 4 of CCA 2, the employee pays with pretax dollars under a cafeteria plan and receives payments under a wellness plan characterized as fixed indemnity health payments based on the employee's participation in medical events such as health screenings, health assessments, and preventive care activities. Because the amounts reimbursed were unrelated to any employee expenses, the IRS finds that the exclusion under section 105(b) does not apply, and because the premiums were paid with pretax dollars, the income exclusion under section 104 does not apply. Without these exclusions, the IRS finds the payments to be taxable wage payments subject to employment taxes.

In Situation 5, the employee pays with pretax dollars under a cafeteria plan and receives payments under a wellness plan characterized as

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fixed indemnity health payments on account of the employee's participation in the wellness plan arrangement. Presumably, this situation addresses the programs that purported to return enough pretax dollars so that the employee's take-home pay was not lowered because the payments were not reduced by employment tax withholdings (and the source of the claim that the employer could pay for the wellness plan through its savings on the employer portion of FICA tax). Under the same analysis applied to Situation 4, the IRS finds the payments under this arrangement are taxable wage payments subject to employment taxes.

CCA 2 initially created a stir because the analysis did not consider whether the employee had unreimbursed medical expenses related to the medical event that resulted in the fixed indemnity health payments. In response, a footnote to a later CCA (CCA 201719025 (CCA 3)) indicated that the CCA 2 analysis assumed no unreimbursed medical expenses paid by the employee, and that nothing in CCA 2 was intended to modify the conclusions reached in Rev. Rul. 69-154. But note that in a later footnote to the preamble to the regulations proposed under section 105, Treasury and the IRS distinguished Rev. Rul. 69-154 as addressing duplicative coverage rather than fixed indemnity health arrangements.

3. CCA 201719025.

A third variation then arose in CCA 3, seeking to distinguish itself from Rev. Rul. 2002-3 and the wellness plans addressed in CCA 1 and CCA 2. This variation purported to provide tax-free cash to employees through self-insured employer-provided arrangements. To address the issues raised in the previous IRS analyses, the employee would make a small after-tax contribution to participate in a health plan, though again, the take-home pay would remain the same (or increase) through FICA tax savings.

The first arrangement in CCA 3 is relatively simple — the employee makes a small after-tax contribution (for example, $50) and receives a significantly larger payment for participating in a no-cost wellness or health-related activity (for example, $1,425 per activity, with a limit of one activity per month). The argument is that the after-tax employee payment means the arrangement is a form of traditional after-tax fixed indemnity health insurance, and therefore the payments are excluded from income under section 104. The IRS disagreed. First, it pointed to legislative history indicating that the section 104 exclusion applied only to arrangements that operated as insurance. Given the virtual certainty that an employee would participate in the no-cost, minimal-effort activities to qualify for significant cash payments, the IRS found that the arrangement involves no real risk and therefore is not insurance and does not have the effect of insurance. Second, the IRS found that because there is no real risk and the payments are far more than the after-tax premium, and substantially certain to be paid to every participant, the after-tax employee contribution does not pay for the arrangement, but rather the employer does. For either or both reasons, the IRS found, the payment to the employee is not excluded from income under section 104 and is wages for purposes of employment taxes.

Situation 2 adds a second feature to the after-tax self-insured arrangement to provide the source of the additional cash payments and to address the potential increase in take-home pay to the employee. Under Situation 2, the employee can elect to participate on a pretax basis in a wellness plan that qualifies as a health plan through a salary reduction contribution generally equal to the cash payment received through the after-tax health plan. If the two amounts did not match perfectly so that the take-home pay increased for the employee, that excess would be an employer contribution to the cafeteria plan for that employee (a flex credit). In essence, the salary reduction contribution to the wellness plan would be reimbursed through the health plan. The IRS again disagreed, finding that the health plan payment does not qualify for exclusion under section 104 and is wages for purposes of employment taxes.

4. CCA 202323006.

The latest effort to provide a costless benefit arrangement wraps the concept of no-cost benefits through pretax employee contributions and tax-free (or simply non-reportable) payments into an insured fixed indemnity health product. The arrangement provides for a bona fide insured fixed indemnity health feature typically covering

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four or five health events. The employee pays a pretax premium well over the value of that fixed indemnity health coverage but can obtain a refund of the premium payment as a separate indemnification payment for a minimal-effort wellness activity (for example, viewing a five-minute wellness video available on a smartphone). The intent is for the cash payments to the employee not to be subject to reporting and employment tax withholding so that the employee's take-home pay stays the same and the employer has FICA tax savings to fund the program's cost.

CCA 202323006 (CCA 4) illustrates and examines a product under which an employee makes a $1,200 pretax contribution every pay period through a cafeteria plan. The employee receives a limited amount of bona fide fixed indemnity health benefits for which the employee in substance pays $200. For the remaining $1,000, the employee can obtain reimbursement by participating in the wellness program. The available wellness program typically includes some substantive and valuable benefits (for example, limited telehealth or biometric screenings or physical exams), but it also includes certain benefits requiring minimal effort by the employee (for example, the smartphone video). The employer and insurance company treat the $1,000 payment as not subject to employment taxes.

In CCA 4, the IRS disagrees with this treatment. Because the $1,000 payment is made regardless of any expense incurred by the employee, the IRS reasons that the payment is not excludable from income under section 105. Further, because the employee does not pay after-tax for the program, the exclusion from income under section 104 does not apply. Without these exclusions, the payment is wages for purposes of FICA taxes and FUTA tax. Similarly, without these exclusions and because it fails to qualify as sick pay, the payments are wages subject to federal income tax withholding.

IV. Proposed Regulations

As the latest and most comprehensive government response, Treasury and the IRS recently issued proposed regulations addressing the taxation of employer-provided fixed indemnity health arrangements. The proposed regulations say that the exclusion from gross income for payments of employer-provided health benefits under section 105 does not apply to payments from fixed indemnity health arrangements and other similar plans to the extent those payments are made without regard to the actual amount of incurred medical expenses and premiums paid. The preamble further says that Rev. Rul. 69-154 may be distinguished as addressing duplicative coverage of multiple health insurance policies, rather than fixed indemnity health coverage, and so does not provide a basis for exclusion.

This view of Rev. Rul. 69-154 demonstrates that taxpayers may not necessarily rely on a chief counsel advice legal memorandum for guidance as the preamble analysis arguably runs counter to the conclusion reached in CCA 3 (although as a CCA addressing particular arrangements with facts beyond traditional fixed indemnity health coverage, the advice would never have opined differently other than that it did not change the results of any outstanding revenue ruling, so it is difficult to argue that the CCA provided any particular view of the issue raised in the proposed regulations). The preamble further concludes that as a taxable payment to an employee under an employee benefit plan, the payment is wages subject to employment taxes. Notably, however, the preamble does not address whether the employment tax reporting and withholding obligations fall on the employer sponsoring the program or the insurance company making the payment. Finally, the proposed regulations would clarify that medical expenses must be substantiated for reimbursements to be excludable under section 105(b), eliminating some confusion that arose from the existing regulatory language.

V. Potential Consequences

In all the CCAs and the proposed regulations, payments resulting from these arrangements may not only be taxable to the employee but also considered wage payments for purposes of employment taxes. This means that the IRS's view is that the payments should be reported on a Form W2 and that there will be a liability for any failure to withhold and pay employment taxes.

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Moreover, a failure to withhold and report will leave the employee with unreported income against which no federal or state income tax withholding has been applied.

In many of these instances, the identity of the responsible employer is not clear, and the IRS has not addressed this issue in any of the CCAs or the proposed regulations. When the payments are made by a third party, such as an insurance company providing health or fixed indemnity health insurance or a third-party plan administrator making the payment, will the employer be subject to the employment tax liabilities? Or instead, will the payer of those amounts be treated as the employer under section 3401(d)(1) (third party having control of the payment of the wages is the employer for purposes of federal income tax withholding)? While this may lead to finger-pointing among the various parties, the IRS does not agree that reporting and employment taxes do not apply, given their consistent attention to declaring the payments not only compensation income but also wages for employment tax purposes. Also, from the IRS and Social Security Administration's perspective, a failure to report the wages means that the employees have had their Social Security earnings records wrongfully lowered.

The unwinding of unreported wages can be a complex matter, particularly if the wages were paid in prior years and through third parties. Employers in this situation should consult their tax advisers for the best process for addressing the exposure and for moving forward with any health or wellness arrangements. More importantly, if an employer is approached with an arrangement that may be an employer-sponsored fixed indemnity health arrangement, particularly one purporting to offer a tax result that appears too good to be true, the employer should approach the arrangement skeptically and ensure that it is reviewed by a trusted tax adviser before not only putting itself at risk but also its employees.[5] ■

[5]The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only and does not necessarily represent the views or professional advice of KPMG LLP.

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