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VOLUNTARY BENEFIT TAXATION





Are you considering allowing employees to pay pre-tax for supplemental insurance benefits (often called “voluntary benefits”) such as Accident, Critical Illness or Hospitalization insurance? You may want to consider only allowing employees to pay post-tax for the following reasons:

Reason 1: Most insurers will NOT take the necessary steps to ensure that either you or the insurer withhold any federal taxes due on the benefits paid under these policies.

Reason 2: Recent IRS guidance reiterates that such payments should be included as “wages” and that an employer who is obligated to withhold taxes and fails to do so may be liable for the taxes that should have been withheld. (Code § 3403)

IRS Chief Counsel Memorandum 201703013 (<https://www.irs.gov/pub/irs-wd/201703013.pdf>) addresses fixed-indemnity insurance and hospital benefits and wellness programs that qualify as accident and health plans under Tax Code § 106 and for which employees pay on a pre-tax basis.

Key Items to Consider

The bottom line under Tax Memo 201703013 is that:

- If the employer pays, or employees pay by salary reduction through a Code § 125 cafeteria plan, the premiums for a fixed-indemnity health insurance policy or a “wellness program” that pays a fixed-indemnity cash payment benefit (such as \$100 for completing a health risk assessment or participating in certain health screenings),
- Then any benefits paid under such policy or wellness program must be included in the employee’s gross income.
- Also, employers are obligated to withhold federal income and employment taxes on amounts that should be included in employees’ gross incomes; and employers who fail to do so may be liable for the taxes they should have withheld. (Code § 3402 and § 3403)

Two exceptions or differences not noted in the Tax Memo:

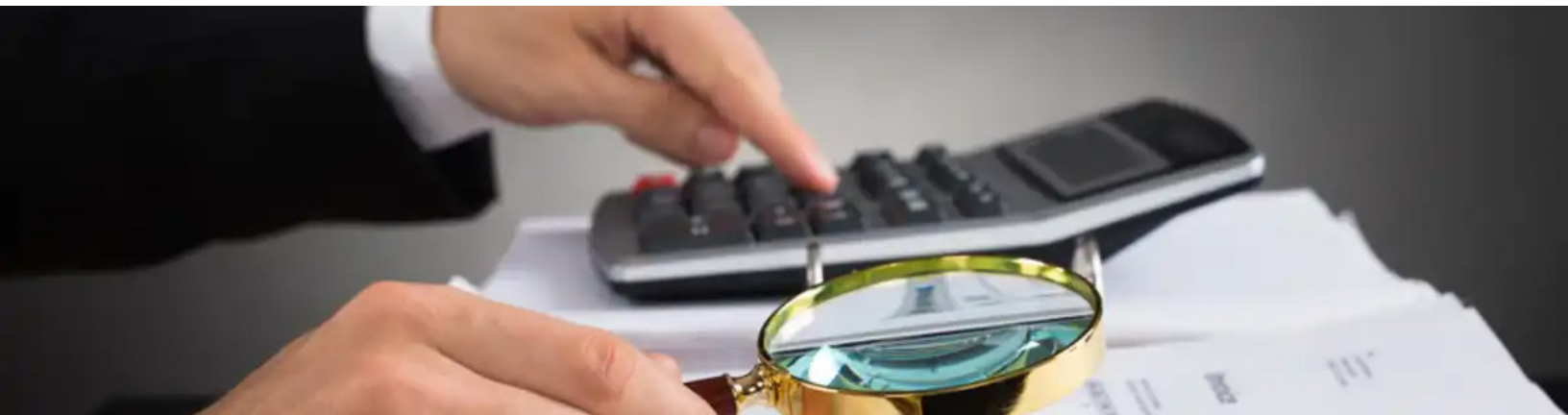
- In the application of these Code sections, benefits paid under pre-tax insurance have only been taxable to the extent the benefits exceed the amount of unreimbursed medical expenses.
- Wellness payments would not be taxable if they are only paid as contributions to the employees’ H.S.A. accounts.

How Does the IRS Determine Taxable Amounts?

arrangements described above? The primary way the IRS would become aware of such pre-tax arrangement is by asking on audit if the employer offers voluntary benefits and allows employees to pay pre-tax. In order to determine if taxes were due, the IRS also would have to know which employees received benefit payments, the amount of those payments, and the amount of unreimbursed medical expenses each employee had.



While all this might be unlikely, if the IRS determines on audit that an employer offered pre-tax voluntary benefits and these benefits were not included in taxable income, the employer could be liable for unpaid income and employment taxes on those benefits amounts.



Tax Memo 20170313 Examples

Example 1: Accident and Hospital Indemnity

A fixed indemnity health plan that pays employees \$100 for each medical office visit, and \$200 for each day in the hospital, without regard to the amount of medical expenses actually incurred by the employee or the amount that is paid or reimbursed by other insurance.

Example 2: Wellness Program that Pays a Fixed Indemnity Cash Payment

A wellness plan pays employees a fixed indemnity cash payment benefit of \$100 for completing a health risk assessment, \$100 for participating in certain prescribed health screenings, and \$100 for participating in other prescribed preventive care activities, without regard to the amount of medical expenses otherwise incurred by the employee.

Employer Consequences of Noncompliance

An employer who is obligated to withhold taxes and fails to do so will be liable for the taxes that should have been withheld. This is why employers who offer the types of plans described above and allow employees to pay pre-tax for them should reconsider this or confirm with the insurer or wellness provider that any taxes due on benefits will be paid. Specifically:



The Tax Code Reasons these Benefits are Taxable

The general rule (Code § 61) is that an employee's gross income includes all compensation received for services provided, including wages, fees, commissions and fringe benefits. Other sections of the Code provide specific exceptions, however, so certain amounts are not included in gross income. Relevant Code sections and excluded amounts are:

- **§ 106(a):** If the employer pays the premiums or cost for coverage under an employer-provided accident or health plan, these amounts are not included in gross income.
- **§ 105(b):** Amounts received through employer-provided accident or health insurance are not included in gross income if those amounts are paid to reimburse expenses incurred by the employee for medical care (of the employee, spouse, dependents, or children under age 27 who are not tax dependents). However, if an accident or health plan pays amounts without regard to the amount of expenses the employee incurred for medical care, these amounts are not excluded from gross income.
- **§ 104(a)(3):** Amounts received through accident or health insurance for personal injuries or sickness generally are not included in gross income. However, this exception does not apply (and these amounts are included in gross income) if the amounts are either: 1) attributable to contributions by the employer that were not included in gross income of the employee, or 2) paid by the employer. For this purpose, employee salary reduction amounts under a § 125 cafeteria plan are treated as employer contributions, not employee contributions.

How these Tax Rules Apply to the Situations in Tax Memo 20170313

Employers should review the fact situations below and ensure that applicable taxes (if any) are being withheld and paid to the IRS.

Example 1: A fixed-indemnity health plan that pays employees \$100 for each medical office visit, and \$200 for each day in the hospital, without regard to the amount of medical expenses actually incurred by the employee or the amount that is paid or reimbursed by other insurance.

- If an employee pays on an after-tax basis for premiums for this coverage, amounts paid by the plan are excluded from gross income under §104(a)(3).
- If the employer pays the premiums for this coverage, or the employee pays on a pre-tax basis through a §125 cafeteria plan, any amount paid by the plan is included in the employee's gross income, regardless of the amount of medical expenses incurred by the employee. The exclusions noted above under §105(b) and §104(a)(3) do not apply.

Example 2: Employer wellness program that pays employees a fixed indemnity cash payment for participating in the wellness program or for completing specific wellness activities. The amount paid may be a specific dollar amount or a percentage of compensation, but the fixed amount is paid without regard to the amount of medical expenses incurred by the employee.

- If the employee pays for this coverage on a pre-tax basis through a §125 cafeteria plan, any amount paid by the plan is included in the employee's gross income, regardless of the amount of medical expenses incurred by the employee. The exclusions noted above under §105(b) and §104(a)(3) do not apply.



CRITICAL ILLNESS CONSEQUENCES

Let's suppose an employee receives a \$15,000 Critical Illness Benefit for a diagnosis of cancer and is in the 20% tax bracket. Pre-taxing the premium saves them \$70 per year in income taxes. However, the benefit becomes taxable to the extent that the benefit exceeds their out of pocket medical costs.

So if the employee's out of pocket costs were \$3,000, the remaining \$12,000 would be considered taxable income by the IRS.

Carriers usually do not withhold taxes on these benefits, so it is incumbent upon the employee to know of and plan for the tax burden. The more likely outcome is an employee getting a January surprise in the form of a 1099 following a critical illness. This spike in taxable income could bump an employee into a higher tax bracket creating an even bigger tax problem for the employee. On the human front, the employee would be experiencing all this extra financial stress while recovering from a serious health crisis. In this scenario, that \$27 of FICA savings may have cost an employee their financial and emotional well-being.



VOLUNTARY BENEFITS ASSOCIATION*

Voluntary Benefits Association, Inc. a 501(c)(3) non-profit trade association

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