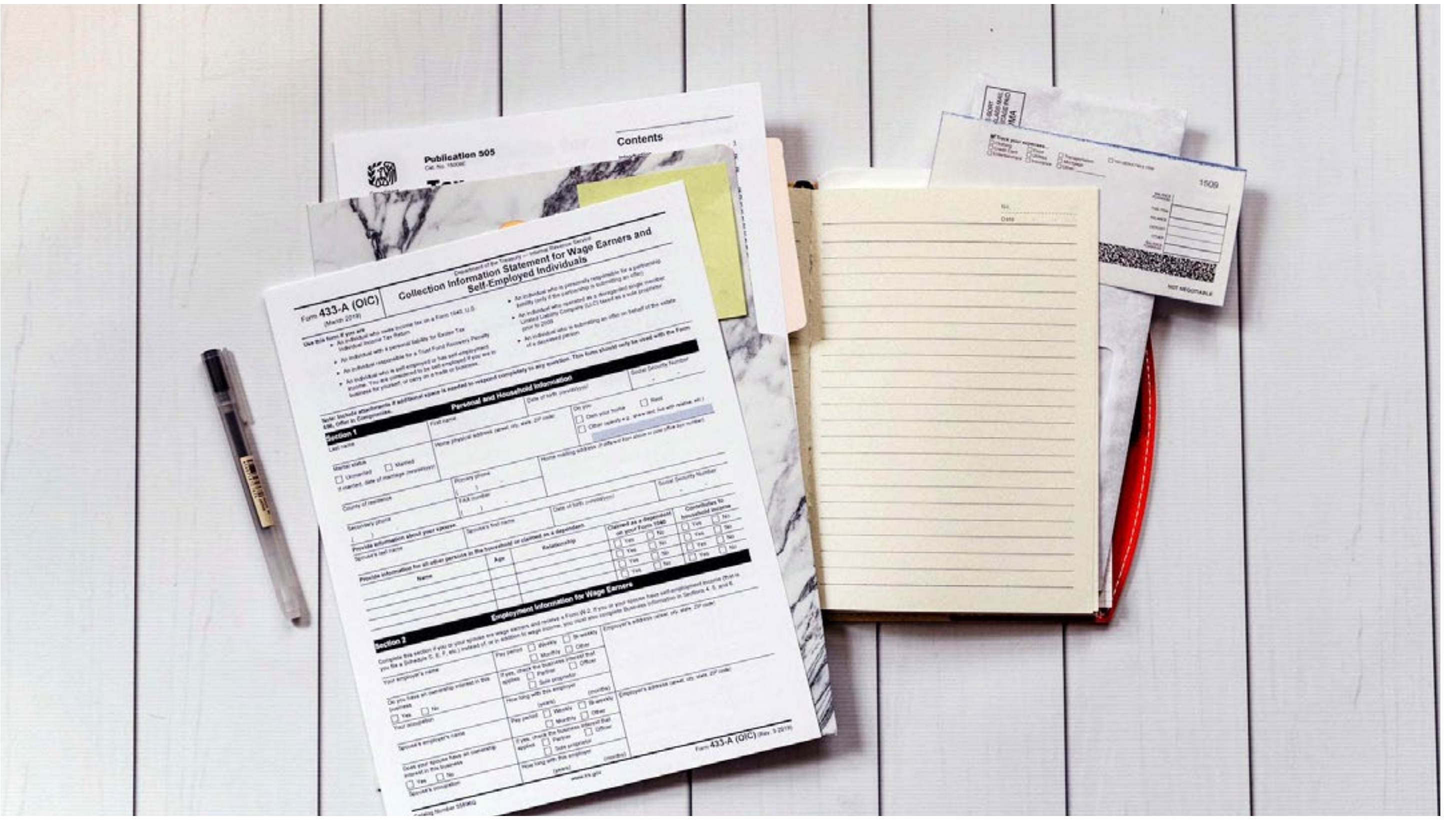

ACA, HIPAA AND FEDERAL HEALTH BENEFIT MANDATES:

PRACTICAL Q&A

The Affordable Care Act (ACA), the Health Insurance Portability and Accountability Act of 1996 (HIPAA) and other federal health benefit mandates (e.g., the Mental Health Parity Act, the Newborns and Mothers Health Protection Act, and the Women's Health and Cancer Rights Act) dramatically impact the administration of self-insured health plans. This monthly column provides practical answers to administration questions and current guidance on ACA, HIPAA and other federal benefit mandates.

Attorneys John R. Hickman, Ashley Gillihan, Steven Mindy, Carolyn Smith, Ken Johnson, Amy Heppner, and Laurie Kirkwood provide the answers in this column. John is partner in charge of the Health Benefits Practice with Alston & Bird, LLP, an Atlanta, New York, Los Angeles, Charlotte, Dallas and Washington, D.C. law firm. Ashley and Steven are partners in the practice, and Carolyn, Ken, Amy, and Laurie are senior members in the Health Benefits Practice. Answers are provided as general guidance on the subjects covered in the question and are not provided as legal advice to the questioner's situation. Any legal issues should be reviewed by your legal counsel to apply the law to the particular facts of your situation. Readers are encouraged to send questions by E-MAIL to John at john.hickman@alston.com.

IRS CRACKS DOWN AGAIN ON ANOTHER DOUBLE DIP ARRANGEMENT CLOAKED AS A WELLNESS PROGRAM

Notwithstanding numerous IRS rulings in this area (and some criminal enforcement activity) reported in our previous articles, double dip tax arrangements have continued to proliferate.

A June 2023 Chief Counsel Memorandum (CCA) addresses the most current flavor of the double dip (again couched in terms of a "wellness plan"), and the result is not surprising. Although the details of such schemes may vary, they all have one fatal flaw: the promised, purported tax benefits are illusory.

IRS GUIDANCE ON HEALTH PLAN TAX SCHEMES

The classic "double dip"

What is commonly referred to as the classic "double dip" first appeared in the early 2000s. This arrangement consists of two basic steps.

First, employees pay for their portion of the cost of employer health plan through pre-tax salary reduction. This cost is normally otherwise excluded.

Second, employees receive back a portion of their salary reduction contribution to bring their take-home pay back up to the pre-salary reduction level. This reimbursement is purportedly untaxed and would not be considered additional income.

This is the "double dip" – both the initial payment and the subsequent monies returned avoid the appropriate taxes and the employee purportedly has no cost.

In the original scheme, the payments were characterized by the promoter as "reimbursements" for the cost of the health plan. The promoter pocketed a fee from employers and employees from the purported tax savings. The problem was, and continues to be, that the purported tax-free payments are in fact taxable wages subject to income and employment taxes and withholding, which the IRS made clear in Revenue Ruling 2002-3.

Variations on a theme – so called "wellness" plans

Following the 2002 revenue ruling, promoters modified their approaches, but with the same core problem – the promised tax-free payments are illusory.

In a memorandum released December 12, 2016, the IRS addressed an abusive tax arrangement marketed primarily to small employers that utilized a so-called "wellness program" coupled with a self-funded indemnity plan that purported to provide significant tax benefits for both employers and employees.

Under the program, disproportionally large benefits – which often corresponded to the amount of wages sought to be sheltered from tax – could be triggered by nontraditional medical events.

While most health indemnity policies are fully insured and triggered solely by an accident or sickness, as required by tax law, benefits under the self-funded health indemnity plan lacked economic substance. Payments could be made for merely completing a health risk assessment or calling a health coach.

While there are legitimate wellness programs, the IRS had little trouble revealing the fatal tax defects of these arrangements under review.

The most recent IRS memo

The latest IRS memo addressing double dip tax schemes was released in June 2023. The focus of the memo is the involvement of an insured fixed indemnity wellness policy. In this scenario, employees pay monthly premiums of $1,200 for the policy through pre-tax salary reductions.

The policy provides for certain "wellness benefits". In addition, employees could separately purchase a traditional fixed indemnity benefit for each day the employee was hospitalized. It is significant to note that the memo addresses the wellness benefit only.

The memo describes the scenario as:

- An employer provides comprehensive health coverage for employees through a group health insurance policy. In addition, the employer offers all employees, regardless of their enrollment in the comprehensive health coverage, the opportunity to enroll in a fixed indemnity health insurance policy.
- Employees pay a monthly premium of $1,200 for the fixed indemnity policy through a pre-tax salary reduction.
- The policy pays a monthly benefit of $1,000 triggered by certain health or wellness activities, including preventive care that is paid for by the comprehensive health coverage. The wellness benefit also offers full coverage of several triggering events, including wellness counseling, nutrition counseling, and telehealth benefits, at no additional cost.
- The wellness benefits are paid from the insurance company to the employer, which then pays the benefits to the employee through the employer's payroll system.

Using similar analysis to the prior memos, the IRS found that the $1,000 wellness payments are taxable income subject to employment taxes (e.g., FICA, FUTA), because the payments are made without regard to whether the employee incurred any unreimbursed medical expenses; more specifically, either there are no medical expenses, or they are completely reimbursed by the policy and/or the employer's comprehensive health plan.

WHAT TO WATCH OUT FOR: IF IT LOOKS TOO GOOD TO BE TRUE, IT PROBABLY IS

Some promoters are increasingly aggressive in marketing variations on the double dip abusive tax shelters, promising the same "win-win"

– tax benefits for both the employer and employees, with no reduction in employee take-home pay.

Regardless of how they are cloaked, e.g., as part of a self-funded or fully-insured "wellness plan," they all have the same fatal flaw – the promised tax benefits are not real. What do the faulty schemes look like? Let's take a look.

Typical promoter claims

Promotional materials vary, but the promises of tax benefits are similar. Statements that promoters may use to describe the benefits of the arrangement include:

- Employees increase their insurance benefits without changing their paychecks.
- Employees can purchase supplemental insurance without reducing their take-home pay.
- FICA tax savings for the employer and employees; employees get the same take-home pay.
- Tax savings pay for additional benefits.

Promoters may also claim that the plan or materials are proprietary and may ask the employer to sign a nondisclosure agreement.

Core features of the arrangements

Regardless of the terms used to describe these arrangements, they appear to have the same essential core features. To avoid being exactly like the classic double dip, the current "wellness plan" schemes add an additional trigger, often referred to as wellness plan compliance, as the basis for bringing the employee's pay back to the pre-salary reduction level.

Step 1: The employee makes a salary reduction election.

- *If the promised tax benefits are realized*, the salary reduction election reduces employee and employer FICA and FUTA payroll taxes and employee income taxes.
- The pre-tax salary reduction election reduces the employee's paycheck.

Step 2: Bring the employee's paycheck back up to the pre-salary reduction level.

- The employee receives purportedly tax-free payments ("wellness payments") equal to most of the employee's salary reduction amount. The amount of salary reduction returned to the employee is generally reduced by a promoter's fee. Part of the

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monies returned, which aren't paid directly to the employee, may be used to pay for a traditional fixed indemnity plan.

- To receive the benefit payment, the employee is required to take certain actions, also referred to as "benefit triggers." Examples of typical triggers include:

    - Using preventive care services that are paid for by another health plan.

    - Participating in certain activities that are generally related to health but do not involve a medical expense that is not already fully covered by the policy.

    - Calling a toll-free telephone number or checking a website that provides general health information.

    - Attending a seminar or webinar that involves general health information.

    - Talking to or checking in with a health coach.

What's the problem?

The payments in Step 2 are taxable, which reduces the employee's take-home pay. For the payments in Step 2 to be tax-free, the payments must be reimbursements for an incurred medical expense. The benefit triggers, while perhaps health related, do not involve unreimbursed medical expenses as defined under federal tax rules. Thus, the purported tax savings evaporate.

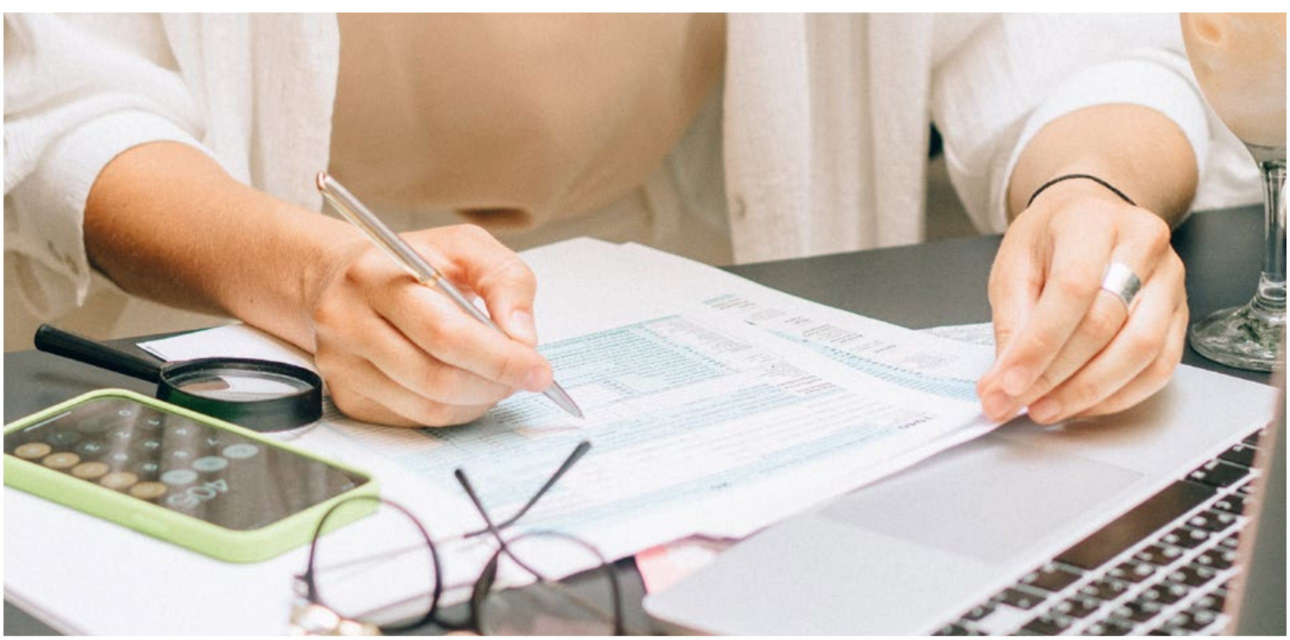
WHAT DOES WORK?

Using a cafeteria plan to pay for health benefits on a pretax basis.

It's straightforward to take advantage of a cafeteria plan so that employees can pay for qualified benefits on a tax-free basis through employee salary reduction.

Employee salary reduction amounts may be used to pay for their share of the employer's major medical plan, dental, or vision coverage, as well as pay premiums for supplemental insurance policies, such as specified disease, hospital or other fixed indemnity health policies on a pretax basis.

Tax benefits of such pretax arrangements are straightforward and distinguishable from the tax gimmick marketed under the "wellness plans."



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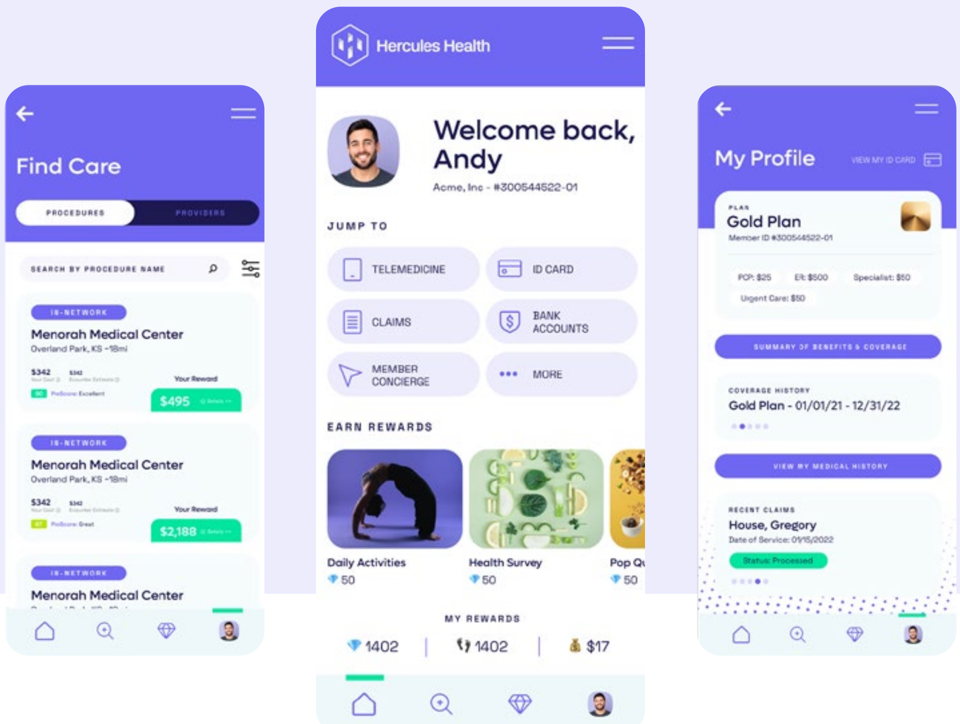

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The tax treatment of benefits paid under fixed indemnity health polices is well established and depends on whether the premium was paid on a pretax or after-tax basis.

- If the premiums are paid on a pretax basis through employer contributions or employee pretax salary reduction through a cafeteria plan, determining if those benefits are taxable depends on the individual's unreimbursed medical expenses. If the amount paid under the policy does not exceed the individual's related unreimbursed medical expenses for the triggering event, then the amount received is not includible in the employee's income. In other words, if a benefit is paid that is equal to or less than a medical expense for the triggering event, it doesn't count as income and would not be taxable. However, if the amount received under the fixed indemnity policy is more than the individual's related unreimbursed medical expenses, then the excess benefit or amount that exceeds the unreimbursed amount, is taxable.

- If the premiums for the policy are paid by the individual on an after-tax basis, then the benefits received are not subject to tax.

IRS Revenue Ruling 69-154 sets forth the excess benefit rule and includes some detailed examples. 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 which are known only to the employee, not the employer nor the insurer.

These factors include what other coverage the individual has, the total amount of medical expenses they incur, and the amount of reimbursed medical expenses they receive. If the employee has more than one fixed indemnity policy, such as a policy paid with post-tax dollars, the calculation may be more involved, as the employee may need to allocate expenses between the various policies. The employee will make this determination with their tax advisor when filing their personal income taxes for the year in question.

It should be noted that the December 2016 memo inadvertently used overly broad language that caused confusion around the long-standing "excess benefit rule". The April 24, 2017 IRS memo clarified and reconfirmed the continued validity of the "excess benefit" rule set forth in Rev. Rul. 69-154 – i.e., that only "excess benefits" under fixed indemnity health policies are taxable.

The April 2017 memo also has a helpful example of a traditional fixed indemnity health plan that pays fixed amounts on the occurrence of health events, such as a medical office visit or a hospital stay where the premiums for the policy are paid on a pretax basis through a cafeteria plan. The plan pays $200 for a medical office visit. If the covered individual's unreimbursed medical cost as a result of the visit is $30, then $30 is excluded from the employee's income and the excess amount of $170 is taxable.

CONCLUSION

Unfortunately, tax avoidance benefit schemes continue to exist. While federal agencies work to stop them, it is equally important for employers to know what to look for and how to avoid these schemes. To take advantage of the legitimate tax benefits for employer health plans, employers should employ the straightforward salary reduction arrangement under IRS Tax Code Section 125. While it does result in a reduction in take-home pay, it also offers real tax savings on the premiums compared to paying on a post-tax basis and benefits the employee in the form of desired insurance coverage.

The information in this article is provided for general informational purposes and is not provided as tax or legal advice for any person or for any specific situation. Employers and employees and other individuals should consult their own tax or legal advisers about their situation. ■