THE ECFC FLEX TECHNICAL ADVISORY COUNCIL

John R. Hickman, Esq., CFCI, *Alston & Bird, LLP*
ECFC Technical Advisory Chair and Editor-In-Chief

Kathryn Bakich, Esq.
The Segal Company

Katie Bjornstad Amin, Esq.
Groom Law Group

Dan S. Brandenburg, Esq., CFCI
The Wagner Law Group

Sharon Cohen, Esq.
Xerox HR Services

Donna Crisalli, Esq.
ECFC

Jody L. Dietel, ACFCI, CAS
WageWorks, Inc.

Ashley Gillihan, Esq.
Alston & Bird, LLP

Andrew Haynes, Esq.
Haynes Benefits PC

Darcy Hitesman, Esq.
Hitesman & Wold, P.A.

Christine Keller, Esq., LL.M.
Groom Law Group

Janet LeTourneau, CFCI
WageWorks, Inc.

Susan Monkmeyer, Esq.
Thomson Reuters/EBIA

J.D. Piro, Esq.
Aon Hewitt

Martha Sewell, Esq.
Kilpatrick Townsend & Stockton LLP

Chantel Sheaks, Esq.
PricewaterhouseCoopers LLP

Mark L. Stember, Esq.
Kilpatrick Townsend & Stockton LLP

William F. Sweetnam, Jr., Esq.
ECFC

Important Note: The information contained herein is not intended to be legal, accounting or other professional advice. We assume no liability whatsoever in connection with your use or reliance upon this information. This information does not address specific situations. If you have questions about your specific situation, we recommend that you obtain independent professional advice.

Whack-a-Mole – IRS Takes Aim at Latest Wellness Program Scheme,
But Overly Broad Language Can Be Taken Too Far As Applied to Traditional Coverage

© 2017 John Hickman, Esq. and Carolyn Smith, Esq. *Alston & Bird LLP*, and Christine Keller, J.D. and Katie Bjornstad Admin, Esq., *Groom Law* Group,

---

Background

As we addressed in a prior column, there are a number of abusive tax arrangements marketed (primarily to small employers) that utilize a wellness program to provide tax advantages similar to the classic double dip arrangements first prohibited by the IRS in the early 2000s. One recent manifestation sought to convert otherwise taxable wages to tax-free "reimbursements" under a hybrid health indemnity plan/wellness program combination. Under the program, employees paid pre-tax "premiums" and received disproportionally large "benefits" (which often corresponded to the amount of wages sought to be sheltered) and received payment for non-traditional triggering events. Whereas most health indemnity policies are fully insured[1], with benefits triggered solely by an accident or sickness (as required under the Internal Revenue Code), benefits under the self-funded health indemnity plan lacked economic substance in that payments could be made for merely completing a health risk assessment or calling a health coach. The IRS issued a Chief Counsel Memorandum (CCM) on this arrangement in early 2016, and in a recent follow-up CCM,[2] the IRS exposed the fatal defects under the self-insured program. As discussed herein, however, some overly broad statements in the most recent CCM appear to be contrary to established law with regard to more traditional fully insured health indemnity plans. Our primary focus in this article is on that topic.[3]

The Classic "Double Dip"

The classic double dip arrangement involved two steps. First, employees would make a salary reduction election to pay for their portion of the cost of an excludable employer health plan on a pre-tax basis. Next, employees were reimbursed for a portion of their salary reduction contribution purportedly on a tax-free basis. These arrangements were touted as a win-win: employers and employees get to pocket tax savings generated by the pre-tax salary reduction, while employees have no reduction in take-home pay due to the purported tax-free reimbursement. If it seems too good to be true, it probably is. While the pre-tax salary reduction for the employee health coverage was permissible, the so-called tax-free "reimbursement" to employees for the premiums used to pay for the health coverage was not!! There simply is no basis in the tax code for tax-free reimbursements of premiums paid by the employee with pre-tax salary reductions, and the IRS made that clear in 2002 in Revenue Ruling 2002-3.

Recent "Wellness Plan" Arrangements and IRS Response

---

[1] We seldom see self-funded health indemnity plans, as an indemnity policy that is not fully insured would not qualify as a HIPAA excepted benefit. In the present case the promoters apparently argued that the health indemnity program was integrated with ACA compliant coverage.

[2] https://www.irs.gov/pub/irs-wd/201703013.pdf . The CCM from last year addressing abusive wellness programs can be found at https://www.irs.gov/pub/irs-wd/201622031.pdf

[3] Note: The vast majority of employer wellness arrangements provide meaningful incentives to employees to incent healthy behavior. We do not take issue with such programs. Rather, the "fatal defect" arises with respect to the incorrect tax treatment of certain programs as described in more detail herein.

Fast forward to some fifteen years later where there has been a resurgence of similar health benefit schemes, this time characterized as "wellness plans." In the arrangement addressed in our prior column, purportedly tax-free "wellness benefits" were funded with pre-tax salary reduction wages. Under a recent iteration of the arrangement, tax-free "premium" contributions are funneled through a self-funded health indemnity plan that purportedly pays a substantial tax-free indemnity benefit when the participant engages in certain wellness activities provided by the arrangement (e.g., participating in a health fair, contacting a wellness coach, etc.). Unlike more traditional fixed indemnity health insurance, the plan is self-funded, and the purportedly tax-free benefit payments are not triggered by events that result in medical expenses for the participant. As described by the IRS:

> *Situation 4*. An employer provides all employees, regardless of enrollment in other comprehensive health coverage, with the ability to enroll in coverage under a "wellness plan" that qualifies as an accident and health plan under § 106. Employees electing to participate in the wellness plan pay an employee contribution by salary reduction through a § 125 cafeteria plan (and therefore the amount of the salary reduction is not included in compensation income at the time the salary would otherwise have been paid). The 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.
>
> *Situation 5*. An employer provides all employees, regardless of enrollment in other comprehensive health coverage, with the ability to enroll in coverage under a wellness plan that qualifies as an accident and health plan under § 106. Employees electing to participate in the wellness plan make an employee contribution by salary reduction through a § 125 cafeteria plan (and therefore the amount of the salary reduction is not included in compensation income at the time the salary would otherwise have been paid). The wellness plan pays employees a fixed indemnity cash payment benefit each pay period (for example, equal to a percentage of the salary payable for the pay period) for participating in the wellness plan, without regard to the amount of medical expenses otherwise incurred.

The IRS had little difficulty concluding that benefits paid under the purported wellness programs were taxable. However, as background to the wellness rulings they were trying to address, the IRS went even further, seemingly concluding that benefits under ***any*** fixed indemnity health policy would be taxable ***because the amount of payment does not correlate to the amount of medical expense incurred.*** The CCM states:

> The value of coverage by an employer-provided wellness program that provides medical care (as defined under § 213(d)) generally is excluded from an employee's gross income under § 106(a), and any reimbursements or payments for medical care (as defined under § 213(d)) provided by the program is excluded from the employee's gross income under § 105(b). However, any reward, incentive or other benefit provided by the medical program that is not a payment for or reimbursement of medical care (as defined under § 213(d)) is included in an employee's compensation income, unless excludible as an employee fringe benefit under § 132. That is because under § 1.105-2, the exclusion under § 105(b) does not apply to amounts, which a taxpayer would be entitled to receive irrespective of whether or not the taxpayer incurs expenses for medical care, ***including amounts paid irrespective of the amount of expense incurred by a taxpayer.***
>
> A fixed indemnity health plan is a plan that pays covered individuals a specified amount of cash for the occurrence of certain health-related events, such as office visits or days in the hospital. The amount paid is not related ***to the amount of any medical expense incurred or coordinated with other health coverage***. Consequently, while the payment by the employer for coverage by a fixed

indemnity health plan is excludible from gross income under § 106, any payments by the plan are not excluded under § 105(b).

The CCM, which by its terms is not controlling law and cannot be cited as precedent, is inconsistent with current controlling law under Code Section 105, which would allow amounts paid under a pre-tax funded health indemnity policy to be received tax-free, but only up to the amount of otherwise unreimbursed medical expenses. Indeed, at the time Section 105 was enacted, many employer-funded health plans paid benefits on a fixed indemnity basis, without necessarily coordinating coverage from other sources. The IRS specifically addressed such situations in a 1969 Revenue Ruling,[4] which clarified that any "excess" fixed indemnity benefits would be included in gross income. If fixed indemnity payments are never (as seems to be suggested by the CCM) considered to be a reimbursement for medical expenses—even when the payment is triggered by a health care related event that likely triggers medical expenses, such as hospitalization or an office visit—the Revenue Ruling would be unnecessary, and not make sense.

The Applicable Law

The federal tax laws start from the premise (in Code Section 61) that all income is taxable unless a specific exception applies. *If* the wellness and fixed indemnity payments are excludable from gross income, they would be excludable under either Code Section 105 or 106; however, Code Sections 105 and 106 do not support the conclusion that **all** wellness and fixed indemnity payments are excluded. Rather, as discussed below, any exclusion is limited to the amount of unreimbursed medical expense. Section 105 and 106 work together to provide an exclusion from income for both the value of employer provided *health coverage* (regardless of amounts received) and the *benefits* received by the employee through such coverage but only to the extent such benefits reimburse otherwise unreimbursed medical expenses.

For example, with regard to the value of *coverage*, if an insurance carrier charges the employer $300 per month to provide self-only coverage, the value of that coverage is $300. If the employer chooses to pay $200 for that coverage, then the $200 is excluded from income under Code Section 106. Amounts that the employee elects to reduce from his or her compensation on a pre-tax basis through a Code Section 125 cafeteria plan to pay for health coverage are also considered "employer" contributions. See Prop. Treas. Reg. § 1.125-1(r)(2). Thus, the value of the coverage paid for with pre-tax salary reductions is also considered provided by the employer and excluded from income by virtue of Code Section 106. In the example above, if the employee pays for the remainder of the $300 premium not paid by the employer through salary reduction, that $100 would also be excluded from income under Code Section 106.[5]

Section 105 determines the extent to which *benefits* received through employer-provided accident or health coverage are excluded from income. If the coverage was paid for on a pre-tax basis, then the general rule in Code Section 105(a) is that benefit payments received under the coverage are taxable. However, Code Section 105(b) provides an important exception to this general rule. Under Section 105(b), benefit payment amounts received under such coverage are excludable from income if such amounts represent direct or indirect reimbursements for expenses actually incurred for medical care (as defined in Code Section 213(d)) that if paid directly by the employee would give rise to a deduction under Section 213.

The applicable IRS regulation (Treas. Reg. 1.105-2) provides as follows:

---

[4] Rev. Rul. 69-154 https://www.irs.gov/pub/irs-drop/rr-69-154.pdf

[5] What if the value of the coverage was $300 but the salary reduction for that benefit was $1,000? Would the cost of the coverage still be excluded from income? The IRS did not specifically address this issue in the CCM but we note that such excessive cost of coverage may not even qualify for exclusion under 106 in that instance. If not, the benefit would not constitute a qualified benefit that can be offered under the cafeteria plan—thereby jeopardizing the tax status of the cafeteria plan.

> Section 105(b) provides an exclusion from gross income with respect to the amounts referred to in section 105(a) (see section 1.105-1) which are paid, directly or indirectly, to the taxpayer to reimburse him for expenses incurred for the medical care (as defined in section 213(e)) of the taxpayer, his spouse, and his dependents (as defined in section 152). . . . Section 105(b) applies only to amounts which are paid specifically to reimburse the taxpayer for expenses incurred by him for the prescribed medical care. ***Thus, section 105(b) does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether or not he incurs expenses for medical care***. For example, if under a wage continuation plan the taxpayer is entitled to regular wages during a period of absence from work due to sickness or injury, amounts received under such plan are not excludable from his gross income under section 105(b) even though the taxpayer may have incurred medical expenses during the period of illness. . . . . ***If the amounts are paid to the taxpayer solely to reimburse him for expenses which he incurred for the prescribed medical care, section 105(b) is applicable even though such amounts are paid without proof of the amount of the actual expenses incurred by the taxpayer, but section 105(b) is not applicable to the extent that such amounts exceed the amount of the actual expenses for such medical care.***

Thus, as long as an amount is ***triggered by a medical event giving rise to an expense,*** some portion may be excludable, even if it is paid ***without proof of the amount of the actual expense incurred by the taxpayer.*** Because most traditional insured health indemnity policy benefits are only paid when a medical event has resulted in a medical expense being incurred, it cannot be said that such benefits are paid "***irrespective of whether an expense is incurred for medical care***."

Further support for this position can be found in IRS Revenue Ruling 69-154. In that ruling, the IRS looked at several situations in which health indemnity benefits exceeded the amount of medical expenses incurred. As with traditional insured health indemnity benefits today, the health indemnity policies in the ruling did not coordinate with other coverage or otherwise reduce benefits because the medical expense had been fully reimbursed. Yet the IRS concluded that the health indemnity coverage in the ruling would provide tax-free benefits to the extent of any unreimbursed medical expenses.

Conclusion

As noted above, we understand that the CCM was intended to address certain abusive practices associated with the hybrid wellness/self-funded health indemnity coverage arrangement that was under review. We stress that traditional health indemnity policies are fully insured and only pay benefits in the event of a medical event that triggers medical expenses. In light of the foregoing, we believe that to the extent traditional health indemnity benefits are examined, IRS Rev. Rul. 69-154 and the regulations under Code Section 105 control. See also, Tech. Adv. Mem. 199936046 (May 19, 1999), FN 1 ("...Although it is possible that a portion of the proceeds of the insurance policies under discussion may be taxable to the employees under section 105(a) (e.g., in the event that the proceeds exceed the taxpayer's medical expenses, see Rev. Rul. 69-154, 1969-1 CB 46), such inclusion would have no bearing on the application of section 106").

Thus, amounts payable under such health indemnity policies should be excludable from an employee's income to the extent of any otherwise unreimbursed medical care expenses.[6] Any claim payments (combining the total from all health and medical policies/plans) that exceed the amount of unreimbursed Section 213 medical expenses would be taxable.

In informal conversations, the IRS confirmed our interpretation, and indicated that additional guidance clarifying these issues may be coming.

---

[6] Note that if the employee paid the entire premium on an after-tax basis, then all of the amounts payable under the policy would be excluded from income under Code Section 104(a)(3).