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Too Good to Be True? Risks of Indemnity/Wellness Program Schemes

Promoters are selling programs to employers that purport to save on payroll taxes by combining an insurance policy with a "wellness" payment that promoters claim is not taxable wages. The Internal Revenue Service (IRS) has repeatedly rejected these schemes as impermissibly "double dipping" on tax benefits, but these products continue to proliferate. This column explores IRS guidance on these arrangements and potential risks to employers under federal law.

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The costs of healthcare continue to rise, and employers seeking to help contain those costs are understandably enticed by promises of savings. Promoters are selling programs that combine some kind of insurance—usually a fixed indemnity insurance policy—with a monthly claim payment for completing certain specified activities. These programs promise tax savings to the employer and an increase of net take home pay for employees.

Usually, employees pay a large monthly premium but receive most of the premium amount back as a tax-free claim payment purported to be a reimbursement for completing some kind of wellness or health activity. The remaining premium amount is used to cover the cost of a small insurance policy (usually a hospital/fixed indemnity policy) and access to minimal services such as telehealth care and wellness coaches. Sometimes the promoter's fee is built into the premium, and sometimes it is a separate per employee fee. The "wellness" claim payment part of the program usually involves activities that would not be considered nontaxable medical expenses, such as receiving a generic newsletter or clicking on a website, and/or are low-cost, free, or already reimbursed by another source (like the employer's medical plan) and thus do not justify the amount of the claim payment. The promoters of these programs take the position that the claim payments are not taxable wages, but the Internal Revenue Service (IRS) has repeatedly disagreed with that position.

To date, IRS guidance is in the form of non-precedential rulings or memoranda individualized to the requesting taxpayer, and promoters continue to slightly modify their programs so that they don't exactly match the facts in available IRS guidance. However, the spirit of the programs is still the same, and employers who are approached by promoters of such programs should exercise extreme caution. As discussed in this column, if it sounds too good to be true, it probably is.

Legal Basis for Providing Nontaxable Health Benefits to Employees

There are viable ways for employers to offer health benefits to employees on a tax-favored basis under current law. The value of employer-provided coverage under an accident or health plan is excludable from employees' gross income. [Internal Revenue Code (Code) § 106(a)] Similarly, payments or reimbursements of medical expenses (as defined in Code Section 213(d)) of the employee or the employees' spouse or dependents are excludable from employees' gross income. [Code § 105(b)] Employees can pay their share of accident and health plan premiums on a pre-tax basis if the employer uses a cafeteria plan to give employees the choice between taxable and nontaxable benefits. [Code § 125(a)]

For purposes of federal payroll taxes—including Social Security and Medicare (FICA), and federal unemployment tax (FUTA)—taxable wages do not include the amount of any payment (including any amount paid by an employer for insurance) made to, or on behalf of, an employee or the employee's dependents under an accident or health plan or system established by an employer. [Code § 3121(a)(2); Code § 3306(b)(2)] Likewise, taxable wages do not include payments made to or on behalf of an employee under a cafeteria plan, but only "if such payment would not be treated as wages without regard to such plan." [Code § 3121(a)(5)(G); Code § 3306(b)(5)(G)]

However, the exclusion from taxation for reimbursements of medical expenses does not apply to the extent that amounts reimbursed exceed the amount of the actual expenses for such medical care, and "does not apply to amounts that the taxpayer would be entitled to receive irrespective of whether or not he incurs expenses for medical care." [Treas. Reg. § 1.105-2] The double dipping programs maintain that certain activities, like receiving a newsletter, are medical expenses, but that argument is tenuous considering IRS guidance. Alternatively, the programs maintain that running the premium and claim payment through a cafeteria plan exempts the claim payment from taxable wages, but if the cafeteria plan did not exist, the claim payment would likely be treated as wages because it either (1) does not reimburse a legitimate medical expense, or (2) reimburses in excess of the actual cost of any medical care. Therefore, the exemption for cafeteria plan payments would not apply.

IRS Guidance on Double Dipping Programs

The term "double dipping" originated in response to a 2002 Revenue Ruling regarding an arrangement by which an employer reimbursed employees tax free for health insurance premiums paid by employees on a pre-tax basis through salary reductions. [Rev. Rul. 2002-3] The employer requested a ruling that Code Sections 105(b) and 125 allowed both the salary reduction and the reimbursement payment to be excluded from taxable wages. The IRS ruled that the exclusions from gross income under Code Sections 106(a) and 105(b) did not apply to the employer's reimbursement for pre-tax premiums, so the reimbursement was taxable wages subject to income and payroll taxes. The employer was "double dipping" by providing tax-free reimbursement of already pre-tax amounts.

The IRS then ruled against an arrangement in which employers purported to provide tax-free advance reimbursements of future unreimbursed medical expenses. [Rev. Rul. 2002-80] The advance reimbursement caused employees' net pay to be the same as it would have been without a salary reduction for health coverage. If the employees' claims at the end of the year were not sufficient to justify the entire advance reimbursement, the employer would include the remainder in the employees' taxable income. The IRS ruled that because the reimbursement amount was provided without regard to whether the employee incurred a medical expense, the Code Section 105 exclusion from taxable income did not apply. Even if the reimbursements were applied to some medical expenses throughout the year, employees were not required to incur expenses to receive it.

The next iteration of the double dipping programs, considered by the IRS in 2016 Chief Counsel Advice (CCA), involved wellness programs providing rewards run through a cafeteria plan. [CCA 201622301] The IRS noted that the wellness program arrangements are very similar to the double-dip arrangements addressed in prior Revenue Rulings. Promoters then began changing the structure of their wellness programs to differentiate them from the arrangements that the IRS had found to be impermissible in existing guidance. Promoters began adding an insurance component with hybrid indemnity/wellness programs, but the indemnity portion was self-insured. The IRS rejected this new arrangement in a 2017 CCA, again concluding that the wellness reimbursement portion of the arrangement was taxable wages. [CCA 201703013]

In another CCA, the IRS found that a self-insured fixed indemnity plan and wellness program combination was not accident or health insurance because there was no risk shifting, and found that the substantial claim payments were taxable wages. [CCA 201719025] Promoters then moved to a fully insured fixed indemnity combined with a wellness program reimbursement, which the IRS considered in another CCA in 2023. [CCA 202323006] The IRS concluded that the wellness payments were taxable wages because the payments were made without regard to whether the employee had incurred any unreimbursed medical expenses. All of these CCAs, while not precedential guidance for employers other than those to which the CCAs are addressed, give valuable insight into how the IRS views these double dipping arrangements.

The IRS issued proposed regulations regarding short-term limited duration insurance in 2023 that would have taxed all benefits under certain health indemnity programs when funded on a pre-tax basis. [88 FR 44596] That portion of the regulations was not finalized, however, due to being overly broad. The IRS did indicate in the preamble to the final regulations that it intends to address taxation of fixed indemnity payments in future guidance, and specifically states, "No inference should be drawn regarding whether or the extent to which the Treasury Department or the IRS agree with any comments on the [proposed regulations] based on this decision [not to finalize the proposed regulations at this time]." [89 FR 23346] The preamble also specifically calls out programs like the proposal and reiterates the IRS views such payments as taxable wages: "The Treasury Department's and the IRS's concerns have recently escalated after identifying an increasing number of arrangements, some involving fixed indemnity plans and policies, that distribute cash benefit payments, purportedly for medical expenses, even if any expenses incurred may already have been reimbursed through other coverage, or participants do not incur any medical expenses within the meaning of section 213(d) of the Code. In some cases, no medical expenses are incurred and participants simply complete certain health-related activities. Benefit payments from such accident and health plans that are not made on account of medical expenses incurred generally would not qualify for exclusion from gross income, FICA, FUTA, or Federal income tax withholding." [89 FR 23345]

Promoters continue to sell double dipping programs to employers that have slightly different features than those addressed in the CCAs. They argue that because the IRS did not finalize the regulations, and the CCAs are not binding on all employers, their programs are permitted. However, the IRS position on this has not changed over the years and it is not likely to change in the future. Recent informal statements by a senior IRS official indicate that the IRS may be planning to amend the applicable payroll tax regulations to address these programs.

Risks for Employers

Employers have an affirmative obligation to properly withhold income tax as well as the employees' portion of payroll taxes on taxable wages at the time the wages are paid. [Code § 3102(a); § 3402(a)] Employers also have an affirmative obligation to pay the employer's portion of applicable payroll taxes. [Code § 3111(a)] Employers must properly report federal payroll tax withholdings on Forms 941 (or Form 944, if applicable).

If employers are not treating the claim payments under a double dipping arrangement as taxable wages at the time they are paid, and are thus not withholding and reporting appropriate taxes, they face substantial federal penalties (not to mention potential state penalties). The IRS may assess penalties for the filing of incorrect information returns. [Code § 6011, §

6721, and § 6722] The IRS may also assess penalties for incorrect filings on Form 940 and 941, and interest and penalties could also apply to late payments of payroll taxes. [Code § 6651; § 6656] These penalties increase for willful disregard of withholding and filing requirements. Employers may also be responsible for paying any employee FICA taxes the IRS cannot collect. Practitioners have experienced IRS examinations of employment tax returns that involve these double dipping schemes, and the IRS has assessed penalties, required filing of amended returns, and assessed sanctions.

It is possible that when future guidance is issued, the IRS might treat existing double dipping programs as abusive tax avoidance schemes. In 2005, the IRS included double dipping arrangements disapproved by the IRS in Rev. Ruls. 2002-3 and 2002-80 in a limited settlement program allowing eligible taxpayers to voluntarily resolve various transactions the IRS considers abusive. [IRS Announcement 2005-80] Given the IRS' position on those arrangements, it is possible the IRS would take a similar position on current iterations of double dipping programs. Penalties for not reporting abusive tax avoidance transactions and listed transactions can be up to 75 percent of the tax savings from the transaction [Code § 6707].

Additionally, these arrangements could implicate other federal laws, such as the Employee Retirement Income Security Act of 1974 (ERISA), the Affordable Care Act (ACA), and the Health Insurance Portability and Accountability Act (HIPAA), because they generally are not voluntary arrangements due to employees being auto-enrolled, and generally do not meet the requirements to be considered an excepted benefit.

Given the substantial risks associated with double dipping programs, employers should exercise caution when evaluating these programs.