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IRS Issues Memorandum on Taxation of Indemnity Plans

The IRS Office of Chief Counsel has issued a memorandum clarifying the tax treatment of certain types of fixed indemnity plans offered by employers. The memorandum states that the benefits provided by a fixed indemnity health plan must be treated as taxable income to an employee if the plan is employer-paid or if the employee can purchase the coverage on a pre-tax basis through a cafeteria plan.

Background

Fixed indemnity health plans typically pay a fixed dollar amount for certain health-related events such as an office visit or the number of days spent in the hospital. They may also include fixed payments when an individual has certain medical conditions. Importantly, the amounts paid are not related to the actual medical expenses incurred by the individual. Employers often offer these types of benefits as supplements to core health insurance benefits. In some cases, employer pay the plan premiums or allow the employee to purchase these benefits on a pre-tax basis through a cafeteria plan.

When will the Benefit be Taxable?

In memorandum, the IRS states that benefit payments under fixed-indemnity health plans are taxable unless the premiums for coverage are paid on an after-tax basis. This configuration creates an administrative problem for the employer since most insurance companies are not in a position to assist the employer with the taxation of benefits paid to a participant. Employers offering a plan in this manner will need to add imputed income to the employee's

compensation to reflect the amount in benefits received by the employee. The obvious alternative would be to allow the employee to pay for these types of benefits only on an after-tax basis.

Impact on Wellness Plans

The memorandum includes two scenarios described as wellness programs. In one example, the "wellness plan" pays cash to participants for specified activities such as completing a health risk assessment. In the other example, employees receive an incentive for simply participating in the program in general. This guidance is not surprising. The IRS has long held that virtually all cash incentives related to wellness programs need to be treated as taxable income to employees. The memorandum clarifies that an incentive or other benefit under a wellness program is excludable from an employee's income only if it pays for, or reimburses, qualifying medical care. It appears that this guidance targets programs that are being marketed as "wellness programs" by some vendors when they are actually just a structure to use tax savings to pay for certain voluntary benefits. Under this guidance, the benefits provided by these programs will now need to be treated as taxable income, making them much less attractive as an option.

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Summary

This type of memorandum does not carry the same weight as a final regulation, but it provides important insight into the IRS's interpretation of current laws and regulations. The IRS clearly takes the position that fixed indemnity insurance plan benefits are taxable if the employer pays for the premiums or if the employee pays for the plan on a pre-tax basis. To be tax free, a health plan-related payment must be based on the actual amount of expenses incurred by the individual, as it is with traditional health insurance plans. The guidance has no impact on traditional group health insurance plans. It also does not change the tax treatment of legitimate wellness programs offered by most employers.

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