
COMPLIANCE ALERT



EMPLOYEE BENEFITS | June 30, 2023

FICA Reduction Redux – IRS Issues Guidance on Wellness Indemnity Payments

On June 9, 2023, the IRS released [OCC Memo 202323006](#), which advises that wellness indemnity payments under a fixed indemnity insurance policy are wages for purposes of Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) taxes, and federal income tax withholding (FITW) (collectively, “employment taxes”) if the employee has no unreimbursed medical expenses related to the payment.

The memo, drafted by the IRS Office of Chief Counsel (OCC), provides guidance on programs marketed to employers that purport to significantly reduce the employer’s FICA obligation. While OCC memos are not law or regulations, they provide authoritative legal advice to IRS personnel to assist them on industry-wide issues. They are a good indication of how the IRS will pursue the matter upon audit.

Under the latest iteration of these so-called FICA-reduction programs, employees make a pre-tax salary reduction to pay for a fixed indemnity insurance policy. Each month, most of the employee’s contribution is reimbursed as a non-taxable claim payment under the indemnity policy after the employee participates in certain health or wellness activities, which typically do not result in any out-of-pocket cost to the employee. The vendor’s promotional materials show employees receiving the same (or more) take home pay than before joining the program. This is due to the fact that premiums are paid pre-tax, and the wellness indemnity payments are non-taxable (or so the vendor claims). The programs are also marketed as no-cost to the employer, with the vendor being compensated by part of the FICA savings.

If these programs sound too good to be true, it’s because they are. In its memo, the IRS describes a FICA-reduction program that includes the following elements:

- The employer offers employees the ability to enroll in a fixed-indemnity health insurance policy.
- The premiums are \$1,200 per month, paid by employee salary reduction through a § 125 cafeteria plan.
- The policy makes a benefit payment of \$1,000 per month if an employee participates in certain health or wellness activities.
 - › For example, the use of no-cost preventive care under the employee’s traditional health plan qualifies the employee for the payment that month.
- The policy also provides wellness counseling, nutrition counseling, and telehealth benefits at no additional cost.
- Benefits under the policy are paid from the insurance company to the employer, which then pays the wellness benefit to employees via its payroll system.

The IRS concludes that wellness indemnity payments under the program are includible in the gross income of the employee when the employee has no unreimbursed medical expenses related to the payment. This is because the tax exclusion for medical reimbursements does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether

expenses for medical care are incurred. In other words, the employee cannot receive a tax-free reimbursement for a medical expense when the employee has no out-of-pocket expense, either because the activity that triggers the payment does not cost the employee anything or because the cost of the activity is reimbursed by other coverage.

The fixed indemnity health insurance policy pays \$1,000 per month without regard to whether the employee has any out-of-pocket expenses. Thus, the payment is included in the employee's gross income. Because the payment is provided in connection with the employee's employment, it is also treated as "wages" for employment tax purposes. The exclusions from "wages" for medical expenses would not apply because the payments are not for medical expenses.

Thus, under the facts described above, when the insured plan pays \$1,000 because the employee used a wellness benefit, the \$1,000 is included in the employee's income and wages. Accordingly, they are wages for purposes of FICA, FUTA, and FITW when made as described above.

Have you been pitched a FICA-reduction program recently? If so, it's a run-don't-walk situation. An employer sponsoring a FICA-reduction arrangement is exposed to under-reporting, under-withholding, and interest penalties, as well as incorrect W-2 penalties. Employers may also be responsible for any employee FICA taxes they cannot collect.

Note that some FICA reduction programs purport not to involve indemnity payments. For example, under one program, an employee's pre-tax premiums for a wellness plan are reimbursed when the employee engages in certain participatory activities. As with wellness indemnity payments, cash reimbursements under this program would also be considered wages if the employee has no unreimbursed medical expenses related to the payment.

Employers that have a FICA reduction program in place or who are considering one should consult with qualified benefits counsel. They aren't employee benefit programs in the traditional sense, and they do not work as advertised.

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