

New IRS Memo Concludes Benefits Paid by Fixed-Indemnity Health Plans May Be Taxable Income

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On January 20, 2017, the Office of Chief Counsel of the Internal Revenue Service (IRS) issued a Memorandum on the tax treatment of benefits paid by fixed-indemnity health plans. In the Memorandum, the OCC concludes that payments from fixed-indemnity health plans that are not included in the employee's compensation, such as those that were paid for either by the employer or through salary reduction as part of a section 125 cafeteria plan, may be taxable benefits. While this guidance is non-binding and cannot be used as precedent, it is important for employers to be aware of the OCC's guidance as they select their benefit plans for 2018.

Fixed-indemnity health plans are plans that give beneficiaries a fixed cash payout when they experience certain health-related events, such as a doctor's visit or a stay in the hospital. Some plans will pay benefits for specific illnesses, such as \$200 a day while the beneficiary is receiving cancer treatment. Wellness plans can also provide fixed-indemnity benefits, such as providing \$100 for certain screenings (regardless of actual cost).

The tax treatment of these benefits when the plan is offered through a taxpayer's employer has been an open question. Generally, premiums for employer-provided health insurance, as well as amounts that employer-provided accident or health plans pay out for incidents or care, are excluded from a taxpayer's income. Yet, the Internal Revenue Code (IRC) does not provide a clear answer on whether benefits from fixed-indemnity plans receive the same tax exemption.

Guidance: Five Scenarios

To provide guidance on this issue, the OCC considered five different scenarios in which an employee receives cash payout benefits from a fixed-indemnity plan. The Memorandum makes clear that its conclusion in each of the five scenarios derives from the fact that a fixed-indemnity plan, unlike traditional insurance, pays a benefit that bears no relationship to the amount of health care expenditures incurred by the employee. Whether the benefits are taxable ultimately depends on whether or not the premiums were paid from an amount included in the employee's compensation. If not, then the benefits are taxable.

Scenario One

Under the first scenario proposed by the OCC, an employer gives all employees the opportunity to participate in a fixed-indemnity plan. Employees pay premiums for the plan with after-tax dollars: the employer withholds the premiums from the employee's salary, but the amount of the premiums are included in the employee's compensation. The plan pays employees \$100 per medical office visit and \$200 for each day in the hospital. The OCC concludes that these payments from the plan are excludible from income because the premiums had been included in the employee's compensation.

Scenario Two

Scenario two is the same as scenario one, except that the employee's premiums are paid by the employer at no cost to the employee. This factor changes the analysis. Under this scenario, the OCC concludes that any payments from the plan are included in the employee's gross income.

Scenario Three

Scenario three is also identical to scenario one, except that the premiums are paid through a salary reduction arrangement under a section 125 cafeteria plan (and, as a result, the premiums are excludible from the employee's income). The OCC concludes that, as is the case with scenario two, any payments from the plan are includible in the employee's income.

Scenarios Four and Five

Scenarios four and five address employee wellness plans. In both scenarios, as is the case with scenario three, employees who elect to participate in the plans do so by paying premiums through a salary reduction arrangement under a section 125 cafeteria plan. Under scenario four, the employee receives a cash payment of \$100 for completing a health risk assessment; \$100 for participating in prescribed health screenings; and \$100 for participating in prescribed preventative activities. Under scenario five, the employee simply receives a cash payment each pay period for participating in the wellness plan. In both scenarios, the OCC concludes that the payment from the plans is taxable income.

The Memorandum also addresses the treatment of the payments from the indemnity plans for purposes of employment taxes: Social Security (FICA), unemployment and withholding taxes. The IRS concludes that, in scenarios two, three, four, and five, the benefits paid are subject to FICA and unemployment taxes, and are also subject to withholding.

Conclusion

While this guidance coheres with previous analysis on the status of fixed-benefit health plans and does not disturb the larger question of the exclusions from income under sections 104, 105 and 106 of the Internal Revenue Code regarding employer contributions, it is notable because for the first time, the IRS has addressed the tax treatment of payments under an indemnity plan. Employers should review the Memorandum closely as they design their benefit plans for 2018.

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