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COMPLIANCE ALERT

Tax Treatment of Certain Wellness Arrangements

The IRS recently released Memorandum Number 202323006 ("the Memo"[1]) which addresses the tax treatment of arrangements that claim to offer significant tax savings and "free benefits" to employers and employees through a wellness plan associated with an indemnity insurance plan. In the Memo, the IRS determines that benefits provided through the arrangement in question should be treated as taxable income to the employee and subject to payroll taxes and income tax withholding.
The memo may be found here: 202323006.pdf (irs.gov).

Background

Similar types of arrangements promising significant tax savings, and "free benefits" funded by those savings, have been around for years. A new version of these arrangements seems to re-emerge every so often and the IRS has released memorandums and other guidance several times to address each new iteration. In virtually every case the IRS has determined that the tax saving "plan" does not work, and that some of the benefits provided through the arrangement should be treated as taxable income to employees. This latest example is no different.

Specifics of the Arrangement Addressed in the Memo

- An Employer provided employees with the ability to enroll in coverage under a fixed-indemnity health insurance policy.
    - Employees paid a monthly $1,200 premium for the fixed-indemnity health insurance policy by a pre-tax salary reduction through a § 125 cafeteria plan.
- The fixed indemnity health policy provided a "wellness benefit" payment of $1,000 per month if an employee participates in certain health or wellness activities.
    - Use of preventive care under a health plan in which an employee is enrolled, qualified the employee for the payment for the month.
    - The fixed-indemnity health insurance policy also provides wellness counseling, nutrition counseling, and telehealth benefits at no additional cost.
- The fixed-indemnity health insurance policy also provides a benefit for each day that the employee is hospitalized.

IRS Findings

In short, the IRS determined that benefits provided through the arrangement (that were described by the promoters of the plan as "tax-free") should be treated as taxable compensation to the employee. As such, the employer should pay applicable payroll taxes and withhold the appropriate amount of income tax from the payments made to employees.

The IRS memo makes important points about the tax status of certain benefits including:

- Indemnity payments (including those described as "wellness payments") under a fixed-indemnity insurance policy, where the premium for the coverage is paid by employee salary reduction through a cafeteria plan under Section 125, should be treated as taxable income to the employee if the employee has no unreimbursed medical expenses related to the payment.

- Tax free benefits provided to employees under § 105(b) do not apply to:
    - Amounts the taxpayer would be entitled to receive irrespective of whether expenses for medical care are incurred; or
    - Payments when the employee has no unreimbursed medical 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 memo goes on to state that since the fixed-indemnity policy in this case paid employees $1,000 per month without regard to whether the employee has any unreimbursed health insurance expenses, the payment should be included in the employee's gross income and treated as "wages" for employment tax purposes.

Employer Risks

Employers offering these types of plans could be subject to back taxes, penalties, and interest on unpaid payroll taxes and could also face penalties based on the employer's incorrect filing of its Forms W-2. The employer could also be required to restate these payments as taxable compensation to employees, subjecting them to additional tax liability.

The Bigger Picture

While this IRS memo addresses a specific type of arrangement, it is not the only time the IRS has issued similar guidance for other "tax-saving" plans promoted over the years. Different issues have been addressed by the IRS in previous Chief Counsel Memoranda 201622031 (05/27/2016), 20170313 (01/20/2017), and 201719025 (05/12/2017). In all these memos the IRS found that arrangements described as providing "tax-free" benefits, or payroll tax savings that exceeded the cost of the "plan" were, in fact, not legitimate.

Undoubtably, promoters of similar arrangements will argue that this latest IRS memo does not apply to their approach, and that their "plan" is different. However, employers should be very wary of offering any benefit that claims to create enough tax savings to be able to offer "free" benefits to employees. In virtually all cases these "plans" will not hold up to scrutiny and can expose the employer and employee to the risk of tax related payments, interest, and penalties.

[1] Office of Chief Counsel memoranda are issued to provide legal opinions on certain matters to internal IRS staff. While they cannot be used or cited as precedent, they represent the Service's interpretation regarding the specific legal issues addressed in the memo.

Oswald Companies Compliance Team | gbcompliance@oswaldcompanies.com
Danielle Jarvis, Compliance Team Leader | djarvis@oswaldcompanies.com; 216.649.7384