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Insights

Employers Beware - So Says the IRS

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The Internal Revenue Service ("IRS") issued a May 12, 2017 memorandum from the Office of Chief Counsel (CCA 201719025) that reminds us all of the old saying "If it seems too good to be true then it probably is." The cost of benefits for employers and employees is not getting any cheaper as many of us know all too well. This fact leads some to get rather "creative" with cost saving measures in an attempt to offer less expensive alternatives to purchase benefits for employees. Although some such designs may provide good options, the IRS identified a method that was not.

Example

Employer A provides employees with the ability to purchase fixed price health plan benefits for minimal cost (assume $700 a year) with after tax dollars. Under the health plan, the employees receive benefits for completion of certain activities. Activities include health care screenings, educational sessions, weight loss programs, etc. The benefit paid for *each* activity completed is $1500. The question is whether the amount received by the employee for activity completion is taxable income.

In the IRS memo, the employer treated the benefits as not taxable. The insurance company and/or third party administrator encouraging the employer to implement this plan stated that the employer could, by saving on tax payments, provide low-cost benefits to its employees. The result was financially positive for the employees and employer. The employees received income from benefits that did not require withholding and the employer saved the employer portion of the Federal Insurance Contributions Act ("FICA") taxes that would otherwise be payable on employees' income.

IRS Conclusion

The IRS ruled that even though the income received was for health benefits, the income was taxable because the health benefits did not qualify for exclusion under Section 104 of the Internal Revenue Code ("Code"). One requirement for benefits to be excluded from taxation under the Code is an insurance component. The IRS explained that because the employees' premium payment was so low and the rewards for participating in the activities under the plan so high that they were not truly risking anything by enrolling in the plan. The lack of risk to the employees resulted in the insurance requirement under the Code not being satisfied. An additional requirement under the Code for income exclusion of benefits is that the benefits be paid for by employee contributions. In the current example, because the enrollment cost was so minimal the IRS stated that the employer essentially paid for the benefits and thus this requirement was not met either.

Note that the IRS also reviewed another example that included the same facts as presented above but that incorporated the use of a wellness plan (that did satisfy the Code requirements for income exclusion) but generally came to the same conclusion, that unless the insurance risk was present and the benefits were paid predominately by employees, the result remained the same.

What does all of this mean to you? Here are a few takeaways.

- Examine any benefit structures that pay benefits in fixed amounts several times in excess of amounts paid by the employees for enrollment in the program.
- Review any agreement(s) with insurance companies or other third party administrators that administer benefit plans with fixed payments for completing certain activities.
- Seek legal counsel to review any benefit plans or arrangements to ensure their eligibility for income exclusion under the Code.

Not only is it important for employers to be concerned about any taxes that they may not be paying, but they also must ensure it is properly characterizing such benefit payments to their employees. Without reporting income properly, employees and employers could realize expensive consequences that include back taxes, tax penalties and interest.