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The IRS clears the air on taxation of fixed-indemnity benefits

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The IRS has released a helpful memorandum that lays to rest some recent confusion relating to the taxation of benefits received from fully insured health indemnity products when the premium is paid on a pretax basis. The recent IRS memo confirms the long-standing position (based on regulations and rulings dating back to the 1960s) that such benefits are includible in the employee's income only to the extent that the amounts received exceed the individual's unreimbursed medical expenses. This article discusses the tax issues and the IRS memos and is relevant to employers of all sizes.

Fixed-indemnity insurance

Fixed-indemnity insurance as discussed in this article pays a fixed-dollar amount as set forth in the policy based on a medical event trigger, such as a visit to the doctor, a hospital stay, or the diagnosis of a particular condition or disease (such as cancer). Although the trigger for payment is based on a medical event, the amount of the payment is not related to the amount of any medical expense incurred as a result of the payment trigger, and benefits are not coordinated with other health coverage that the individual may have.

The applicable law

For decades, the issue of how these types of fixed-indemnity benefits are taxed has been settled based on the statutory provisions, regulations and IRS rulings.

- If the premiums for the policy are paid by the individual on an after-tax basis, then the benefits received are not subject to tax.
- If the premiums are paid on a pretax basis through employer contributions or employee pretax salary reduction through a cafeteria plan, then whether the benefits are taxable depends on the individual's unreimbursed medical expenses. If the amount paid under the policy does not exceed the individual's unreimbursed medical expenses, then the amount received is not includible in the employee's income. However, if the amount received under the fixed-indemnity policy is more than the individual's unreimbursed medical expenses, then the excess is taxable.

The IRS looked at several situations in which health indemnity benefits exceeded the amount of medical expenses incurred in a 1969 ruling (Rev. Rul. 69-154). As with insured health indemnity benefits today, the health indemnity policies included in the ruling did not coordinate with other coverage or otherwise reduce benefits because the medical expense had been fully reimbursed. The IRS concluded that the health indemnity coverage in the ruling would provide tax-free benefits to the extent of any unreimbursed medical expenses.

The IRS unintentionally creates some confusion

In a memorandum released in December 2016, the IRS addressed an abusive tax arrangement marketed primarily to small employers that utilized a so-called "wellness program" coupled with a self-funded indemnity plan that purported to provide significant tax benefits for both employers and employees. Under the program, disproportionally large benefits – which often corresponded to the amount of wages sought to be sheltered from tax – could be triggered by nontraditional medical events. Whereas most health indemnity policies are fully insured and triggered solely by an accident or sickness as required under the tax laws, benefits under the self-funded health indemnity plan lacked economic substance in that payments could be made for merely completing a health risk assessment or calling a health coach.

While there are many legitimate wellness programs, the IRS had little trouble in revealing the fatal tax defects of the arrangement under review. Unfortunately, in discrediting the abusive arrangement, the IRS used overly broad language which could be read to indicate that benefits under any fixed-indemnity health plan would always be fully taxable. This reading is inconsistent with the regulations and the earlier controlling Revenue Ruling. Thus, our belief was that this statement was limited to the abusive tax arrangements and could not as a matter of law impact taxation of traditional, fully insured fixed-indemnity benefits. Nevertheless, the IRS memo generated some confusion.

The IRS clears the air

In a recent memorandum dated April 24, 2017,[1] the IRS made it clear that nothing had changed with respect to traditional fully insured fixed-indemnity arrangements. In particular, the April 2017 memo states that the prior memo was "intended to address situations in which no medical expenses were incurred or reimbursed, and should not be read to modify the analysis or result in Rev. Rul. 69-154."

The recent memo also includes a helpful example of a traditional fixed-indemnity health plan that pays fixed amounts on the occurrence of health events such as a medical office visit or a hospital stay where the premiums for the policy are paid on a pretax basis through a cafeteria plan. The plan pays $200 for a medical office visit. If the covered individual's unreimbursed medical costs as a result of the visit were $30, then $30 would be excluded from the employee's income and the excess amount of $170 would be taxable.

Conclusion

The IRS has now reconfirmed the income tax treatment of benefits paid under fully insured fixed-indemnity plans. If the premium is paid by the employer or by the employee through a cafeteria plan, the benefits are subject to income tax only to the extent that the employee's unreimbursed medical expenses are less than the benefit payment.

Source

[1] https://irs.gov/pub/irs-wd/201719025.pdf

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