

Clearing the air – again – on taxation of fixed indemnity health benefits

By Carolyn Smith and John Hickman, Alston & Bird, LLP

There is still some confusion related to the taxability and reporting requirements for health indemnity benefits when the premium is paid by the employer or by the employee on a pretax basis. Much of the confusion comes from articles and information based on outdated and unintentionally confusing IRS guidance issued in December 2016. The IRS clarified and superseded this guidance in a memorandum dated April 24, 2017 ([irs.gov/pub/irs-wd/201719025.pdf](https://www.irs.gov/pub/irs-wd/201719025.pdf)). This advisory provides a detailed look at IRS guidance to help clear up confusion. **The bottom line is that the IRS has confirmed the tax exclusion for benefits received under pretax-paid health indemnity policies up to the amount of the unreimbursed medical expenses incurred.** This information may be of interest to agents, brokers and employers.

Long-standing IRS rules and Revenue Ruling 69-154

The taxation of benefits under fixed indemnity health policies is governed by IRS Code section 105(b). In 1969, the IRS issued an important ruling under this code section, Revenue Ruling 69-154. This ruling concluded that when a fixed indemnity health policy is paid for on a pretax basis, benefits are taxable only to the extent that they exceed the individual's unreimbursed medical expenses (i.e., only "excess benefits" are taxable).

Under Revenue Ruling 69-154, determining the amount, if any, of taxable benefits under a fixed indemnity health policy paid for with pretax dollars involves a variety of factors that are known only to the employee (and not the employer or insurer). These factors include any other fixed indemnity health policies the individual has, the total amount of medical expenses and the amount of reimbursed medical expenses. If the employee has more than one fixed indemnity health policy, such as a policy paid with after-tax dollars, the calculation may be more involved, as the employee may need to allocate expenses between their various policies. The employee will make this determination with their tax advisor when filing their personal income taxes for the year in question.

The IRS unintentionally confuses the issue

In December 2016, the IRS released a memo focused on shutting down abusive tax shelters involved with so-called “wellness programs.” In that memorandum, the IRS used overly broad language, which caused confusion about whether the tax exclusion rules under Code section 105(b) and Revenue Ruling 69-154 continued to apply to fixed indemnity health policies. Many incorrectly thought the December 2016 memorandum meant that pretax health indemnity benefits were always taxable. This led to the incorrect conclusion that employer withholding and reporting obligations applied to such coverage when funded on an employer-paid or pretax salary reduction basis. Following soon after the December 2016 memo was issued, the IRS received a number of comments asking for clarification on these issues.

The IRS clears the air

In April 2017, as a result of the many comments received, the IRS issued revised guidance. This new guidance specifically confirmed the continued application of Revenue Ruling 69-154 and its conclusion with respect to the taxation of fixed indemnity health benefits

What does this all mean?

The April 2017 IRS memorandum reconfirms that ***if an indemnity health policy is paid for by the employer or by the employee with pretax salary reduction funds***, benefits are excludable up to the amount of unreimbursed medical expenses. Stated differently, only the excess amount paid above unreimbursed medical expenses is taxable. Further, since some portion of the benefits may be received tax-free, and neither the employer nor the insurer can know what that portion is, only the employee/policyholder will know what amounts to include in income (excess benefits) and should report such amounts on their personal Form 1040. **It’s up to the employee/policyholder to identify and report any amount of excess benefits, including income on their personal Form 1040.**

If an indemnity health policy is paid for by the employee on an after-tax basis, then the entire amount of the benefits is tax-free.

Conclusion

If you see materials about the taxation of benefits from an indemnity health policy paid for on a pretax basis, it's important to make sure that the materials are referencing the IRS memorandum dated April 2017, which confirmed the long-settled rules. Materials that indicate such benefits are always taxable are most likely looking only at the prior December 2016 memorandum, not the most recent IRS guidance. Aflac's advisory titled [The IRS clears the air on taxation of fixed indemnity benefits](#) provides further guidance on this issue.

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