ACA, HIPAA AND FEDERAL HEALTH BENEFIT MANDATES: PRACTICAL Q&A

The Affordable Care Act (ACA), the Health Insurance Portability and Accountability Act of 1996 (HIPAA) and other federal health benefit mandates (e.g., the Mental Health Parity Act, the Newborns and Mothers Health Protection Act, and the Women's Health and Cancer Rights Act) dramatically impact the administration of self-insured health plans. This monthly column provides practical answers to administration questions and current guidance on ACA, HIPAA and other federal benefit mandates.

Attorneys John R. Hickman, Ashley Gillihan, Carolyn Smith, and Dan Taylor provide the answers in this column. Mr. Hickman is partner in charge of the Health Benefits Practice with Alston & Bird, LLP, an Atlanta, New York, Los Angeles, Charlotte, Dallas and Washington, D.C. law firm. Ashley Gillihan, Carolyn Smith and Dan Taylor are members of the Health Benefits Practice. Answers are provided as ***general guidance*** on the subjects covered in the question and are ***not provided as legal advice*** to the questioner's situation. Any legal issues should be reviewed by your legal counsel to apply the law to the particular facts of your situation. Readers are encouraged to send questions by E-MAIL to Mr. Hickman at john.hickman@alston.com.

DOL CRACKS DOWN ON HEALTH PLAN TAX AVOIDANCE SCHEMES WITH CRIMINAL SANCTIONS; EMPLOYERS AND EMPLOYEES MAY BE LEFT HOLDING THE BAG

A recent federal-state criminal enforcement action demonstrates the continued commitment of the Department of Labor (DOL) and other federal agencies in combating fraudulent tax avoidance schemes involving health benefit arrangements. Promoters face the worst consequences; however, employers and employees who innocently participate in these schemes may be held liable for income and employment taxes that should have been paid.

This article discusses the recent criminal case and provides guidance to help identify faulty schemes. The article also addresses legitimate plans, including the tax treatment of benefits under traditional fixed indemnity health coverage, such as excepted benefit hospital and other fixed indemnity policies.

DOL AND STATE AUTHORITIES JOIN FORCES IN PROSECUTING FRAUDULENT TAX SCHEME

The recent case publicized by the DOL involves a version of what is commonly referred to as the classic "double dip"[1]. The original double dip first appeared in the early 2000s, and consists of two basic steps: (1) employees pay for their portion of the cost of an otherwise excludable employer health plan through pre-tax salary reduction; and (2) employees are paid a portion of their salary reduction contribution purportedly on a tax free basis, to bring their take-home pay back up to the pre-salary reduction level.

In the original scheme, the payments were characterized by the promoter as "reimbursements" for the cost of the health plan. The promoter pockets a fee from employers and employees from the purported tax savings. The problem is that the purported tax-free payments are in fact taxable wages subject to income and employment taxes and withholding, and the IRS made that clear in Revenue Ruling 2002-3. Subsequent IRS memos have addresses more recent variations on this theme.

In the recent case, the promoters collapsed the two steps of the classic double dip into a series of paper transactions that in effect did nothing more than reduce participants' taxable wages and related employment taxes. The scheme caused millions of federal FICA and personal income taxes to be underpaid. The only actual money that changed hands was the required promoter's fees paid by employers and employees.

Several regional offices of the DOL, the DOL's office of inspector general, a number of state authorities, the IRS criminal investigation division, and the FBI participated in the joint investigation. In prosecuting the case, the DOL relied on ERISA § 519, which prohibits false statements and representations in relation to a multiple employer welfare arrangement (MEWA).

A conviction in the case was secured through a guilty plea. According to the DOL, among the sanctions, millions of dollars of assets of the defendants had been seized and, consistent with ERISA §§ 411 and 504, the defendants are barred from employment, consultation activities and any type of service or position related to employee benefit plans or labor unions for 13 years.

For employers and employees who may be duped into these schemes, the chilling aspect is that, as noted by the DOL, "the employer-clients and employee-participants are now individually responsible" for underpaid employment and income taxes.

Penalties on underpayments may be waived by the IRS for employers and employees who were not aware the arrangement was fraudulent, but the amount of unpaid taxes, plus interest, can still be collected. As regulators continue to pursue these unlawful arrangements, employers need to be sure they are dealing with a legitimate plan in order to avoid unexpected tax liabilities for themselves and their employees.

RECENT "WELLNESS PLAN" TAX AVOIDANCE SCHEMES: IF IT LOOKS TOO GOOD TO BE TRUE, IT PROBABLY IS

Variations on the class double dip have continued to appear over the years. Many recent schemes are frequently cloaked as part of an otherwise innocuous "wellness plan". These newer arrangements, marketed primarily to small employers, promise the same "win-win" -- tax benefits for both the employer and the employees, with no reduction in employee take-home pay. They also have the same fatal law -- the promised tax benefits are not real.

The IRS has addressed various arrangements in a series of memos starting in 2016. The activity around the "wellness plan" tax avoidance schemes appears to have slowed somewhat with the issuance of the IRS guidance, but there are reports that some promoters are still at work. What do the fraudulent schemes look like? Let's take a look.

Typical promoter claims

Promotional materials may vary, but the promises of tax benefits are similar. Statements that may be used by promoters to describe the benefits of the arrangement may include claims such as:

- Employees increase their insurance benefits without changing their paychecks.
- Employees will be able to purchase supplemental insurance products without reducing their take-home pay.
- FICA tax savings for you as the employer and your employees; employees get the same take-home pay.
- Tax savings pay for additional benefits.

Promoters may claim that the plan/materials are proprietary and may ask the employer to sign a non-disclosure agreement. Some arrangements require the purchase of credit life insurance and borrowing.

Core features of the arrangements

Regardless of the particular terms used to describe these arrangements, they have the same essential core features. To avoid being exactly like the classic double dip, the current "wellness plan" schemes add an additional trigger ("wellness plan" compliance) as the basis for bringing the employee's pay back up to the pre-salary reduction level.

Step 1: The employee makes a salary reduction election.

- If the promised tax benefits are realized, the salary reduction election reduces employee and employer payroll taxes (FICA, FUTA) and employee income taxes.
- The salary reduction election reduces employee's paycheck.

Step 2: Bring the employee's paycheck back up to the pre-salary reduction level.

- The employee receives purportedly tax-free payments ("wellness payments") equal to most of the employee's salary reduction amount. The amount of salary reduction returned to the employee is generally reduced by a promoter's fee.
- In order to receive the payment, the employee is required to take certain actions. Examples of typical payment triggers include:
  - Participating in certain activities that are generally related to health but do not involve a medical expense
  - Calling a toll-free telephone number or checking a web-site that provides general health information
  - Attending a seminar or webinar that involves general health information
  - Talking to or checking in with a health coach

STOP!

What's the problem? The payments in Step 2 are taxable, which reduces the employee's tax-home pay. In order for the payments in Step 2 to be tax free, the employee must be reimbursements for an incurred medical expense. The activities involved, although perhaps health related, do not involve medical expenses as defined under the federal tax rules – at least not expenses that exceed the amount of payments made. Thus, the purported tax savings evaporate.

WHAT DOES WORK?

Using a cafeteria plan to pay for health benefits on a pre-tax basis, including supplemental fixed indemnity health insurance

It's actually pretty straightforward to take advantage of a cafeteria plan so that employees can pay for qualified benefits on a tax-free basis through employee salary reduction. Employee salary reduction amounts may be used to pay for their share of the employer's major medical plan, as well as to purchase supplemental health insurance policies, such as specified disease, hospital or other fixed indemnity health policies on a pre-tax basis.

These fully-insured supplemental policies pay 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). Tax benefits of such pre-tax arrangements are straightforward and distinguishable from the "tax gimmick" marketed under the "wellness plans".

The tax treatment of benefits paid under fixed indemnity health polices is well established and depends on whether the premium was paid on an after-tax or pre-tax basis.

- **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 pre-tax basis (through employer contributions or employee pre-tax 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 benefit", meaning the amount in excess of such unreimbursed medical expenses, is taxable.

IRS Revenue Ruling 69-154 sets forth the "excess benefit" rule, and includes some detailed examples. Under Revenue Ruling 69-154, determining the amount, if any, of taxable benefits under a fixed indemnity health policy paid for with pre-tax dollars involves a variety of factors which are known only to the employee (and not the employer or insurer).

These factors include what other fixed indemnity 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 policy, such as a policy paid with post-tax dollars, the calculation may be more involved, as the employee may need to allocate expenses between the various policies. The employee will make this determination with their tax advisor when filing their personal income taxes for the year in question.

Note that, in one of the memos shutting down abusive "wellness plan" tax schemes (dated Dec. 12, 2016), the IRS inadvertently used some overly broad language which caused confusion about whether the long-standing rule that only "excess benefits" under fixed indemnity health policies are taxable. In a subsequent memo (dated April 24, 2017), the IRS made it clear that nothing had changed with respect to traditional fully-insured fixed indemnity arrangements. In particular, the April 2017 re-confirms the continued validity of Rev. Rul. 69-154.

The April 2017 memo also has 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 pre-tax 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, $30 would be excluded from the employee's income and the excess amount of $170 would be taxable.

LEGITIMATE WELLNESS PROGRAMS

There are many legitimate wellness programs that comply with applicable legal requirements, including the federal tax rules in the Internal Revenue Code, as well as rules from the Department of Labor and the Equal Employment Opportunity Commission that relate to the amount and type of rewards that can be offered under the wellness plan. The following chart provides a high level guide as to how legitimate wellness programs are structured compared to "wellness plan" tax schemes.

	The program is funded by…	The benefits (rewards) vary by…	Any increase in take home pay (after any salary reduction)..	Benefits are..
The wellness program is more likely to be a legitimate plan if …	The employer	Wellness activities engaged in and health results	Is generally nominal	Taxable unless deposited in a health reimbursement arrangement (HRA) or health savings accounts (HSAs)
The wellness program is more likely to be suspicious and a tax avoidance scheme if…	Through employee salary reduction	Amount of salary reduction contributed	Could be significant and may vary by salary reduction amount	Purportedly tax free

CONCLUSION

No "wellness" plan or complicated arrangement or signing of a confidentiality agreement is needed to reap the legitimate tax benefits for employer health plans; just a straightforward salary reduction arrangement under Code Section 125. Will there be a reduction in tax-home pay? Yes, but there are also real tax savings on the premiums compared to paying on a post-tax basis and the employee will also receive value in the form of the insurance purchased through the plan. ■

References:
1) See, DOL press release https://www.dol.gov/newsroom/releases/ebsa/ebsa20190619. The facts and background of the case are drawn from this press release.