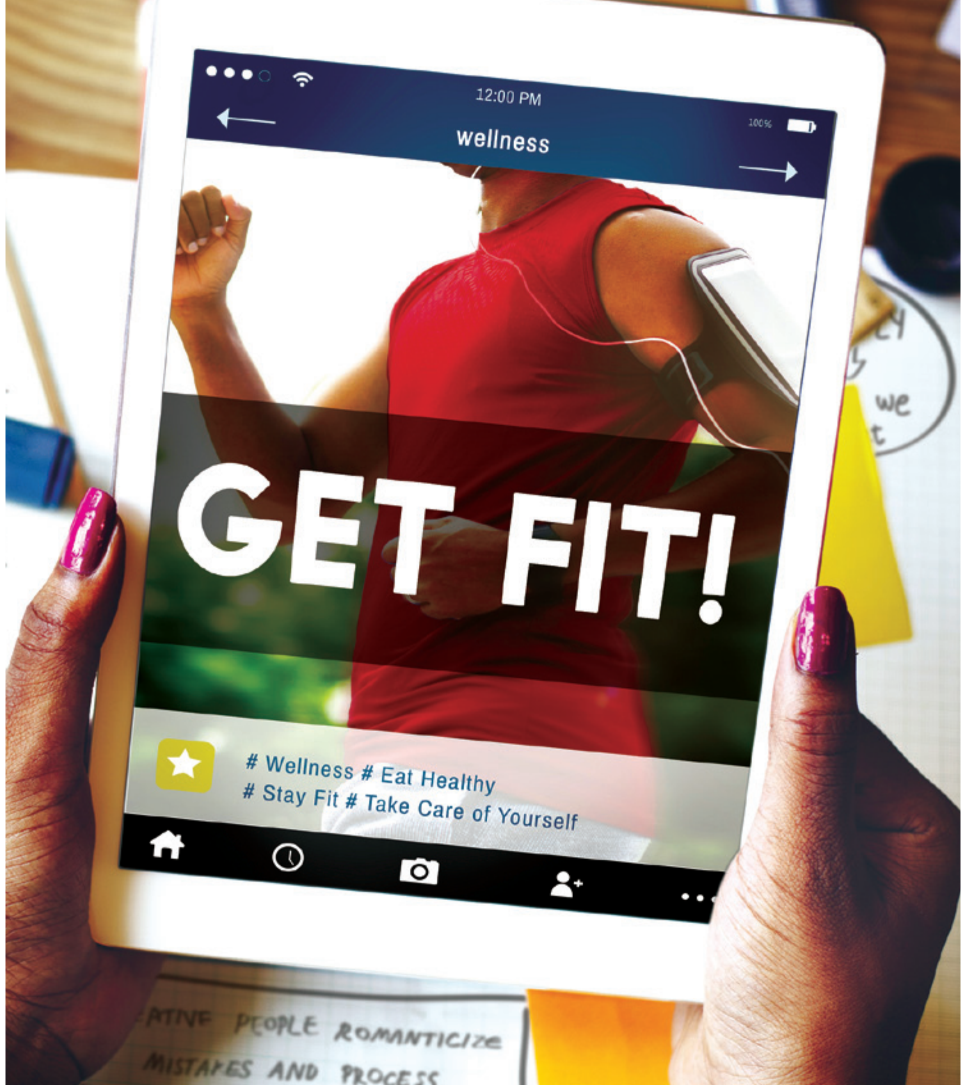

PPACA, HIPAA and Federal Health Benefit Mandates: Practical Q&A

So-Called Tax-Free "Wellness Plan" Reimbursements – Not So Good for Employers' or Employees' Financial Health

If you're at an ice cream store, a double dip is tasty and refreshing. In the employer health benefits arena, the "double dip" may sound good, but it isn't. "Double dip" is the name for a health benefits tax scheme that initially made the rounds some years back. Now, some 15 years later, we are seeing double dip arrangements with a new "wellness plan" twist. [Note: The vast majority of employer wellness arrangements provide meaningful incentives to employees to incent healthy behavior. We do not take issue with such programs. Rather, the "fatal defect" arises with respect to the incorrect tax treatment of certain programs as described in more detail herein].

The classic double dip involved two steps. First, employees would make a salary reduction election to pay for their portion of the cost of an excludable employer health plan. Next, employees were reimbursed for a portion of their salary reduction contribution purportedly on a tax free basis. These arrangements were touted as a win-win: employers and employees get to pocket tax savings generated by the salary reduction, while employees have no reduction in take-home pay due to the purported tax free reimbursement. If it seems too good to be true, it probably is. While the salary reduction for the employee health coverage was permissible, the so-called tax-free "reimbursement" to employees for the premiums used to pay for the health coverage was not!! There simply is no basis in the tax code for tax free reimbursements of premiums paid by the employee with pre-tax salary reductions and the IRS made that clear in Revenue Ruling 2002-3.

Fast forward to some fifteen years later where there has been a resurgence of similar health benefit schemes, this time characterized as "wellness plans." The core elements of the current arrangements are remarkably similar to the classic double dip (although some details may differ). First, employees make a salary reduction election to pay for cost of a wellness plan (and an additional amount for administration). Next, employees who participate in certain wellness program activities (e.g. they open an email that contains health educational information) receive a tax free payment. This payment to employees is characterized as a "wellness payment" or "wellness reward" for participation in the wellness plan and it does not correspond to any expenses incurred by the employee. Regardless of how it is characterized, it is effectively a repayment of the employee's pre-tax salary reduction for the wellness program. Finally, under some arrangements, employees may elect additional benefits, paid for by the purported tax savings. Again it's sold as win-win: employers pocket payroll tax savings and they are able to provide the wellness payment without having to expend any additional funds from its general assets. Moreover, employees can use their tax savings to purchase additional benefits with no reduction in take-home pay. Promoters receive a fee for administering the arrangement, again paid for with tax savings so that neither the employer nor the employee is out of pocket for the fee. What's the problem? Once again, there simply is no basis in the tax laws for excluding the wellness payment from employees' income. The IRS issued guidance on May 27, 2016, to address the issues raised with these programs (the "May 27 IRS Guidance").[1] According to the IRS, these wellness plan arrangements really are no different than the classic double dip that the IRS said more than 10 years ago just doesn't work.

Employers and employees who find themselves in these "Wellness Plan" arrangements can face significant adverse tax consequences. Further, in a post-Affordable Care Act (ACA) world, a number of other compliance issues also arise. This article provides a high-level overview of the issues associated with "Double Dip II".

What Makes These So-Called Wellness Plans Appear So Attractive?

A simple example illustrates the draw of these Wellness Plans. We'll look at Sue, who has current weekly pay of $900. For simplicity we will assume tax withholding for Sue, including income and the employee share of payroll taxes, of 20%. Here's what Sue's current take-home pay looks like:

Current Weekly Gross Pay	$900
Taxes	($180)
Current Take-Home Pay	$720

Now let's see what's supposed to happen when Sue's employer adopts a "Wellness Plan" compared to her current situation. We'll assume a $200 per week pre-tax salary reduction contribution for the "cost" of the Wellness Plan, a reimbursement of 95% of the salary reduction (reflecting a 5% administrative fee), and the same 20% tax withholding on the rest of her pay.

Current Pay	Sue's Paycheck	with Wellness Plan
$900	Weekly Gross Pay	$900
$0	Salary Reduction for Wellness Plan Contribution	($200)
$900	Taxable Income	$700
($180)	Taxes	($140)
$720	Post-Tax Income	$560
N/A	Wellness Plan Reimbursement (95% of salary reduction)	$190
N/A	Tax on Reimbursement	$0
	Subtotal	**$750**
$0	Amount Available for Add'l Benefits	($30)
$720	Take-Home Pay	$720

Employer payroll tax savings on salary reduction amount:
7.65% X $200 =
$15.3/wk ($795.5/yr)

This arrangement, if the tax benefits are realized, looks attractive to employers because they have FICA tax savings. Employees also have tax savings, which they can use for additional benefits. On the other hand, if the tax benefits are not realized, then the arrangement fails economically. [Note: some of the arrangements we have seen (and evaluated by the IRS) purported to provide tax savings on employee contributions of up to 5 times as much as is outlined here.]

Are the Wellness Payments Tax-Free?

No, Wellness Payments of this type are not tax free. Like the classic double dip, there is simply no basis on which to exclude such payments from income. The May 27 IRS Guidance makes it clear that such payments are not only taxable, but are wages subject to income and employment tax withholding.

The Applicable Law

The federal tax laws start from the premise (in Code Section 61) that all income is taxable unless a specific exception applies. *If* the Wellness Payments are excludable from gross income, they would be excludable under either Code Section 105 or 106; however, Code Sections 105 and 106 do not support the conclusion that the Wellness Payment is excluded. Section 105 and 106 work together to provide an exclusion from income for both the value of employer provided *health coverage* (regardless of amounts received) and the *benefits* received by the employee through such coverage but only to the extent such benefits reimburse otherwise unreimbursed medical expenses.

For example, with regard to the value of *coverage*, if an insurance carrier charges the employer $300 per month to provide self-only coverage, the value of that coverage is $300. If the employer chooses to pay $200 for that coverage, then the $200 is excluded from income under Code Section 106. Amounts that the employee elects to reduce from his or her compensation on a pre-tax basis through a Code Section 125 cafeteria plan to pay for health coverage are also considered "employer" contributions. See Prop. Treas. Reg. 1.125-1(r)(2). Thus, the value of the coverage paid for with pre-tax salary reductions is also considered provided by the employer and excluded from income by virtue of Code Section

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106. In the example above, if the employee pays for the remainder of the $300 premium not paid by the employer through salary reduction, that $100 would also be excluded from income under Code Section 106.[2]

Section 105 determines the extent to which *benefits* received through employer-provided accident or health coverage are excluded from income. If the coverage was paid for on a pre-tax basis, then the general rule in Code Section 105(a) is that benefit payments received under the coverage are taxable. However, Code Section 105(b) provides an important exception to this general rule. Under Section 105(b), benefit payment amounts received under such coverage are excludable from income if such amounts represent direct or indirect reimbursements for expenses actually incurred for medical care (as defined in Code Section 213(d)) that if paid directly by the employee would give rise to a deduction under Section 213.

Amounts that are excludable from gross income under Sections 105 and 106 are also excludable from wages for purposes of income tax withholding under Section 3401 and FICA and FUTA payroll taxes (Section 3121(a)(5)(G) and 3306(b)(5)(G)). Similarly, salary reduction contributions made by employees through a Section 125 cafeteria plan are excludable from wages for withholding and payroll tax purposes.

Discussion

It is possible that there is a cost to the employee to participate in the Wellness Plan (similar to a health plan premium).[3] If that is true, then the employee could make a pre-tax salary reduction under the cafeteria plan equal to the cost to participate in the Wellness Plan; however, there is no circumstance in which those pre-tax salary reductions could be returned to the employee as a tax free benefit absent corresponding medical expenses. In the wellness program described above, the receipt of the wellness payment is not conditioned on the employee actually incurring an expense. Consequently, the Wellness Plan payments of the type discussed here are not reimbursement for medical expenses and, thus, do not fall within the exclusion from income provided under Section 105. We have seen some programs that operate under the assumption that Wellness Payments are made because the employee will or is likely to incur medical expenses. The IRS has made it clear that such advance payment in anticipation of medical expenses are taxable income in Revenue Ruling 2002-80. The cafeteria plan rules also clearly prohibit such an approach.

The IRS has recently confirmed this analysis in the May 27 Guidance. The IRS concluded that:

- Cash rewards or other benefits that do not qualify as reimbursement for medical expenses are not excludable from employees' income or for payroll tax purposes.[4]
- Reimbursements of all or a portion of premiums for participating in a wellness program are not excludable from income or payroll taxes if the premiums were originally made on a pre-tax salary reduction basis.

So, now let's look at Sue's situation when the Wellness Payment is properly treated as taxable.

Current Pay	**Sue's Paycheck**	**with Wellness Plan** (Reimbursement Treated as Non-Taxable)	**with Wellness Reimbursement Properly Treated as Taxable**
$900	Weekly Gross Pay	$900	$900
$0	Salary Reduction for Wellness Plan Contribution	($200)	($200)
$900	Taxable Income	$700	$700
($180)	Taxes	($140)	($140)
$720	Post-Tax Income	$560	$560
N/A	Wellness Plan Reimbursement (95% of salary reduction)	$190	$190
N/A	Tax on Reimbursement	$0	($38)
$720	**Subtotal**	**$750**	**$712**
$0	Amount Used for Additional Benefits	($30)	($30)
$720	Take-Home Pay	$720	$682

- When the Wellness Payment is properly treated as taxable, the purported tax savings disappear, so that there is no "free money" from which to purchase benefits or pay fees associated with the Wellness Program. While the employee may choose to purchase additional benefits, there will be a net reduction in take-home pay. Moreover, the employer is subject to FICA taxes on that amount.

What are the Potential Adverse Consequences to Employers and Employees that Participate in a Defective Wellness Plan?

Employers who participate in Wellness Plans of the type discussed in this memo will have under paid employment taxes. Thus, they will likely have liability for additional employment taxes, including interest on late payments and potentially significant penalties. The IRS may impose a "trust fund" penalty equal to 100% of the amount of employment taxes that should have been withheld and paid over to the federal government. This penalty is in addition to the amount of tax liability and may be imposed even if the employee pays the tax.

Employees who participate in these defective Wellness Plans will have under paid their income and payroll taxes. Thus, they will likely have liability for additional income and payroll taxes, including interest on late payments and potentially significant penalties.

Arrangements similar to the defective Wellness Plans have been found to be prohibited tax shelters. Promotors of tax shelters can be liable for significant penalties, including potentially criminal sanctions.

We also note that arrangements that charge the employee more than the fair market value of the wellness plan and/or allow employees to use salary reductions to purchase benefits such as whole or universal life could result in disqualification of the cafeteria plan.

Do the Defective Wellness Plans Raise Other Legal Issues?

Yes, a variety of other laws are implicated, including the following:

- **Nondiscrimination Rules** Final EEOC regulations under the Americans with Disabilities Act (ADA) published on May 17, 2016 extend the 30% limitation on the amount of wellness plan incentives awarded under participatory plans that utilize health information. Prior regulations issued by Treasury/IRS, DOL and HHS only applied the limit to health contingent plans.
  - » In general, the 30% limit is based on the total cost of self-only coverage offered by the employer.
  - » If the employer does not have another group health plan, then cost is based on the second lowest-cost Silver plan offered in the ACA Exchange in which the employer has its principal place of business for a 40-year old non-smoker. While this cost varies by geography, premiums in the $200-$350 per month range are common. This would leave room for only $60-105 in wellness benefits – far less than the amounts purportedly available under some arrangements.
- **ACA Requirements** Wellness Plan arrangements of the sort described here do not by themselves satisfy the ACA minimum requirements (e.g., required preventive services, no annual dollar limit on benefits). Thus, unless the employer has another group health plan that is ACA compliant, the Wellness Plan arrangement may subject the employer to penalties of $100 per day for violation (for employers with more than 50 employees). Further, regardless of employer size, participants and the DOL may bring actions to force compliance with ACA requirements.

- **Employer Penalties** For employers with 50 or more full-time equivalent employees, Wellness Plan arrangements are not designed to shield employers from ACA penalty exposure under Code Section 4980H.

- **Cafeteria Plan Rules** Code Section 125 limits the benefits that may be offered through a cafeteria plan to listed qualified benefits. Some Wellness Plan arrangements purport to allow benefits to be paid on a salary reduction basis through a cafeteria plan even though they are not qualified benefits. For example, whole life insurance is not a qualified benefit and may not be offered through a cafeteria plan. Offering benefits that are not qualified may disqualify the entire cafeteria plan.

- Other issues may also arise, including other nondiscrimination issues, issues under GINA and possible Cadillac plan tax issues (effective in 2020).

Conclusion

The defective Wellness Plans described here attempt to use a cafeteria plan and a wellness program to provide greater tax savings to employees and employers than is otherwise permitted by the Code. While the details and descriptions of these programs may vary and change, the underlying core element is an attempt to convert what is clearly taxable income into purportedly non-taxable income without an underlying medical expense reimbursement. It is these purported tax savings that make the programs appear attractive, despite the fees charged for participation. In reality, there is no basis in the Code for excluding Wellness Payments or similar payments from income or applicable employment taxes. When the arrangements are taxed properly, the attraction of the arrangements disappears. Employers and employees who participate in these arrangements are likely liable for additional taxes, interest and penalties, which can be significant. Similar arrangements to those described here have been found to be prohibited tax shelters; promotors of tax shelters can be subject to significant penalties, including criminal sanctions.

Employers who have adopted these arrangements may wish to consult legal counsel to determine the best way to unwind the arrangements.

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 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 email to Mr. Hickman at john.hickman@alston.com.

References

[1]*The May 27 IRS Guidance may be found at www.irs.gov/pub/irs-wd/201622031.pdf (last visited on May 31, 2016).*

[2]*What if the value of the coverage was $300 but the salary reduction for that benefit was $1000? Would the cost of the coverage still be excluded from income? The IRS did not specifically address this issue but we note that it the cost of coverage may not qualify for exclusion under 106 in that instance. If not, the benefit would not constitute a qualified benefit that can be offered under the cafeteria plan – thereby jeopardizing the tax status of the cafeteria plan.*

[3]*It is unclear why there would be a charge for wellness plan incentives or why an employee would pay for such incentives. The essence of wellness plans is that the employee receives the incentives by taking certain actions specified in the program. The incentive can be taxable (e.g., cash or a gift card) or non-taxable (e.g., a contribution to the employee's HSA or a reduction in health plan premiums). In some cases, the Wellness Plan may offer limited health benefits, such as health screenings or a limited number of doctor's visits that qualify the plan as an accident or health plan.*

[4]*In very limited circumstances, the May 27 IRS Guidance indicates that certain wellness rewards may be excludable as a de minimis fringe benefit under Code Section 132. A tee-shirt is given as an example of such a benefit. However, cash (other than overtime meal money and local transportation fare) is never excludable as a de minimis fringe benefit. Note, also, that such benefits are not qualified benefits under the cafeteria plan rules.*