COMPLIANCE BULLETIN

IRS Addresses Taxation of Fixed Indemnity Benefits

HIGHLIGHTS

- The tax treatment of payments under fixed indemnity health coverage depends on how the premiums are paid.
- If employees are taxed on the premiums, the fixed indemnity payments are not taxable.
- Fixed indemnity payments are taxable when premiums are paid by the employer or by employees on a pre-tax basis.

EMPLOYER ISSUES

- When fixed indemnity payments are taxable, employers may need to work with insurance carriers to implement a process for tax withholding.
- Employers should consider providing this health coverage outside of their cafeteria plans to avoid these tax issues.

Provided By:
Sullivan Benefits

OVERVIEW

The Internal Revenue Service (IRS) has released an internal memorandum addressing the tax treatment of payments from fixed indemnity health coverage.

According to this guidance, if an employee is not taxed on the premiums for fixed indemnity health coverage (the premiums are paid by the employer or by employees on a pre-tax basis through a cafeteria plan), any payments from the coverage must be included in the employee's gross income and wages. These same rules also apply to wellness programs that provide fixed indemnity benefits for engaging in wellness activities.

ACTION STEPS

The IRS' memorandum does not address how employers should administer fixed indemnity payments that are taxable to employees. When employees are not taxed on the premiums for fixed indemnity coverage, employers should work with their carriers to implement a process for tax withholding and reporting.

To avoid these tax issues, employers should consider requiring that employees pay for their fixed indemnity coverage on an after-tax basis outside of their cafeteria plans.

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Fixed Indemnity Health Coverage

Fixed indemnity health coverage pays a fixed dollar amount for certain health-related events (for example, $100 for each medical office visit and $200 for each day in the hospital), regardless of the amount of medical expenses that the individual actually incurs. Employers sometimes offer fixed indemnity health coverage to their employees in addition to their group medical plan.

Unless employees pay for fixed indemnity coverage on an after-tax basis, any benefits paid under the coverage must be included in employees' gross income and wages.

Section 105(b) of the Internal Revenue Code (Code) states that the amounts that an employee receives through employer-provided accident or health insurance are not taxable if the amounts are paid to reimburse medical care expenses that were actually incurred. Because benefits under a fixed indemnity plan are not related to medical expenses that were actually incurred, there has been some confusion regarding the tax treatment of these payments.

According to the IRS' memorandum, the tax status of the payments under fixed indemnity health coverage **depends on how the premiums are paid**.

- ✓ The payments are not taxable if the coverage is paid by employees on an after-tax basis. For example, if a fixed indemnity plan with premiums paid on an after-tax basis paid $200 for an office visit and the covered individual's unreimbursed medical costs for the visit were $30, the $200 would be excluded from income.
- ✓ However, if the coverage is paid by the employer tax-free or if employees pay for the coverage on a pre-tax basis through a cafeteria plan, any payments from the plan are taxable and must be included in employees' gross income and wages (regardless of the amount of medical expenses actually incurred).

Payment Method	Premiums Taxed?	Payments Taxed?
Employee paid, after tax (or employer paid and imputed as taxable income to employees)	Yes	No
Employee paid, pre-tax (through a Section 125 plan)	No	Yes
Employer paid (without imputing payment as taxable income to employees)	No	Yes

When payments from fixed indemnity health coverage are taxable, they are subject to income tax and employment tax withholding. This may raise administrative issues for employers because the payments under fixed indemnity coverage are usually controlled by the insurance carrier, not the employer. Thus, when fixed indemnity payments are taxable, employers may need to work with the carriers to determine a process for tax withholding.

Wellness Programs

The IRS' memorandum also addresses wellness programs where employees pay a pre-tax premium to participate. Because this type of wellness program design is uncommon, the IRS' guidance appears to be targeted at fixed indemnity plans that label themselves as wellness programs. These wellness programs pay fixed indemnity benefits for participating in the program (for example, $100 for completing a health risk assessment), without regard to the amount of medical expenses incurred by the employee. The IRS concluded that these fixed indemnity benefits are taxable and should be included in employees' gross income and wages.