

**Office of Chief Counsel
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Memorandum**

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to: Jeremy Fetter, Area Counsel
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from: Stephen Tackney
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subject: Tax Treatment of Benefits Paid by Fixed-Indemnity Health Plans

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

Are payments received by an employee from an employer under a fixed indemnity health plan excludible from the employee's income under § 105 of the Code?

Are payments received by an employee from an employer under a fixed indemnity health plan excludible from the employee's income under § 105 of the Code if the amounts paid by the employee (employee premiums) for coverage under the fixed indemnity health plan were made by salary reduction through a § 125 cafeteria plan (and thereby not included in the employee's compensation income at the time the amounts were paid)?

CONCLUSION

An employer may not exclude from an employee's gross income payments under an employer-provided fixed indemnity health plan if the value of the coverage was excluded from the employee's gross income and wages.

An employer may not exclude from an employee's gross income payments under an employer-provided fixed indemnity health plan if the premiums for the fixed indemnity health plan were originally made by salary reduction through a § 125 cafeteria plan.

FACTS

Situation 1. An employer provides all employees, regardless of enrollment in other comprehensive health coverage, with the ability to enroll in coverage under a fixed indemnity health plan that would qualify as an accident and health plan under § 106 of the Code. Employees pay premiums for the plan by deducting the amount of the premium each pay period from the employee's salary; the amount of the deducted premium is included in gross income and wages for federal tax purposes, notwithstanding that the plan would qualify as an accident and health plan under § 106. The fixed indemnity health plan pays employees \$100 for each medical office visit, and \$200 for each day in the hospital, without regard to the amount of medical expenses otherwise incurred by the employee.

Situation 2. The same facts as *Situation 1*, except the employer provides the coverage to the employees at no cost to the employee.

Situation 3. The same facts as *Situation 1*, except the employees electing to participate in the fixed indemnity health plan pay premiums by salary reduction through a § 125 cafeteria plan (and therefore the amount of the salary reduction is not included in compensation income at the time the salary would otherwise have been paid).

Situation 4. An employer provides all employees, regardless of enrollment in other comprehensive health coverage, with the ability to enroll in coverage under a "wellness plan" that qualifies as an accident and health plan under § 106. Employees electing to participate in the wellness plan pay an employee contribution by salary reduction through a § 125 cafeteria plan (and therefore the amount of the salary reduction is not included in compensation income at the time the salary would otherwise have been paid). The wellness plan pays employees a fixed indemnity cash payment benefit of \$100 for completing a health risk assessment, \$100 for participating in certain prescribed health screenings, and \$100 for participating in other prescribed preventive care activities, without regard to the amount of medical expenses otherwise incurred by the employee.

Situation 5. An employer provides all employees, regardless of enrollment in other comprehensive health coverage, with the ability to enroll in coverage under a wellness plan that qualifies as an accident and health plan under § 106. Employees electing to participate in the wellness plan make an employee contribution by salary reduction through a § 125 cafeteria plan (and therefore the amount of the salary reduction is not included in compensation income at the time the salary would otherwise have been paid). The wellness plan pays employees a fixed indemnity cash payment benefit each pay period (for example, equal to a percentage of the salary payable for the pay period)

for participating in the wellness plan, without regard to the amount of medical expenses otherwise incurred.

LAW AND ANALYSIS

Income and Statutory Exclusions from Income

Section 61(a)(1) of the Code and § 1.61-21(a)(3) provide that, except as otherwise provided in subtitle A, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.

In general, § 106(a) provides that gross income of an employee does not include employer-provided coverage under an accident or health plan. Under § 106(a), an employee may exclude from income premiums for accident or health insurance coverage that are paid by an employer. Also, under § 105(b), an employee may exclude amounts received through employer-provided accident or health insurance if those amounts are paid to reimburse expenses incurred by the employee for medical care (of the employee, the employee's spouse, or the employee's dependents, as well as children of the employee who are not dependents but have not attained age 27 by the end of the taxable year) for personal injuries and sickness. To the extent amounts received through employer-provided accident or health insurance are paid without regard to the amount of expenses incurred by the employee for medical care, the amounts are not excluded from gross income because the amounts are not paid to reimburse expenses incurred by the employee for personal injuries and sickness.

Generally, amounts received through accident or health insurance for personal injuries or sickness are excluded from gross income under § 104(a)(3). This exclusion does not apply, however, if the amounts are either (1) attributable to contributions by the employer that were not includible in the gross income of the employee or (2) paid by the employer. See § 1.104-1(d); for this purpose, salary reduction under a § 125 cafeteria plan is treated as an employer contribution, and not an employee contribution.

Generally, an employee choice between two or more benefits consisting of taxable benefits such as cash and nontaxable benefits such as employer-provided health coverage results in a cafeteria plan the taxable benefits under which are included in income unless the choice is provided in accordance with the rules under § 125. Under § 125, an employer may establish a cafeteria plan that permits an employee to choose among two or more benefits, consisting of cash (generally, salary) and qualified benefits, including accident or health coverage. Pursuant to § 125, the amount of an employee's salary reduction applied to purchase such coverage is not included in gross income, even though it was available to the employee and the employee could have chosen to receive cash instead. If an employee elects salary reduction pursuant to § 125, the coverage is excludible from gross income under § 106 as employer-provided accident or health coverage.

Application of Employment Taxes

Sections 3101 and 3111 impose FICA taxes on “wages” as that term is defined in § 3121(a), with respect to “employment,” as that term is defined in § 3121(b). Section 3121(a) defines the term “wages” for FICA purposes as all remuneration for employment, with certain specific exceptions. Section 3301 imposes FUTA tax on wages paid with respect to employment. The general definitions of the terms “wages” and “employment” for FUTA purposes are similar to the definitions for FICA purposes. See § 3306(b) and (c).

Section 3402(a), relating to federal income tax withholding, generally requires every employer making a payment of wages to deduct and withhold upon those wages a tax determined in accordance with prescribed tables or computational procedures. The term “wages” is defined in § 3401(a) for federal income tax withholding purposes as all remuneration for services performed by an employee for his employer, with certain specific exceptions.

To the extent amounts are excluded from gross income under §§ 105(b) or 106(a), they are also excluded from wages subject to income tax withholding under § 3401. In addition, amounts paid to reimburse expenses incurred by the employee for medical care (of the employee, the employee’s spouse, or the employee’s dependents, as well as children of the employee who are not dependents but have not attained age 27 by the end of the taxable year) for personal injuries or sickness are excepted from wages for FICA and FUTA tax purposes under §§ 3121(a)(2) and 3306(b)(2), respectively.

Section 3121(a)(5)(G) provides an exception from FICA wages for any payment to or on behalf of an employee under a cafeteria plan (within the meaning of § 125) if such payment would not be treated as wages without regard to such plan and it is reasonable to believe that (if § 125 applied for purposes of § 3121) § 125 would not treat any wages as constructively received. Section 3306(b)(5)(G) contains a similar exception from wages for purposes of FUTA tax.

Application to Wellness Programs and Fixed Indemnity Health Plans

The value of coverage by an employer-provided wellness program that provides medical care (as defined under § 213(d)) generally is excluded from an employee’s gross income under § 106(a), and any reimbursements or payments for medical care (as defined under § 213(d)) provided by the program is excluded from the employee’s gross income under § 105(b). However, any reward, incentive or other benefit provided by the medical program that is not a payment for or reimbursement of medical care (as defined under § 213(d)) is included in an employee’s compensation income, unless excludible as an employee fringe benefit under § 132. That is because under § 1.105-2, the exclusion under § 105(b) does not apply to amounts which a taxpayer would be entitled to receive irrespective of whether or not the taxpayer incurs expenses for medical care, including amounts paid irrespective of the amount of expense incurred by a taxpayer.

A fixed indemnity health plan is a plan that pays covered individuals a specified amount of cash for the occurrence of certain health-related events, such as office visits or days in the hospital. The amount paid is not related to the amount of any medical expense incurred or coordinated with other health coverage. Consequently, while the payment by the employer for coverage by a fixed indemnity health plan is excludible from gross income under § 106, any payments by the plan are not excluded under § 105(b). Moreover, to the extent the premiums are paid with pre-tax dollars through a § 125 cafeteria plan or otherwise excluded from income, any payments by the plan are not excluded under § 105(b) or 104(a)(3). However, to the extent that premiums are paid with after-tax dollars, payments by the plan are excluded under § 104(a)(3), without regard to the amount of any medical expense incurred by the event upon which the payment is conditioned. For example, if the 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 as the result of the visit were \$30, the \$200 would be excluded from income.

DISCUSSION

In *Situation 1*, because the premiums for the fixed indemnity health plan are included in the employee's gross income and wages (and thus paid with after-tax dollars), amounts paid by the plan are excluded from gross income and wages under § 104(a)(3).

In *Situations 2*, and *3*, because the premiums for the fixed indemnity health plan are paid with amounts that are not included in the employee's gross income and wages, the exclusions under §§ 105(b) and 104(a)(3) do not apply to the payments and any amount paid by the plan are included in the employee's gross income and wages, regardless of the amount of any medical expenses incurred by the employee upon which the payment is conditioned.

In *Situations 4* and *5*, because the premiums for the wellness plan are paid with amounts that are not included in the employee's gross income and wages, the exclusions under §§ 105(b) and 104(a)(3) do not apply to the fixed indemnity cash benefit payments and any payments are included in the employee's gross income and wages, regardless of the amount of any medical expenses incurred by the employee upon which the payment is conditioned.

Please call me at (202) 317-6000 if you have any further questions.