

Wellness Tax Schemes

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Many vendors are aggressively marketing programs that appear to provide significant tax savings for employees and employers. Are these programs "too good to be true"? We think they are. We recommend that employers steer clear of these types of programs as we don't think these offerings work as advertised from a tax perspective.

Program Overview

The programs generally hinge on the assumption that an employee's taxable income can be significantly reduced in exchange for participating in a wellness program and, in some cases, by purchasing other products. These arrangements generally start with the employee paying a "premium" for the program on a pre-tax basis through the employer's cafeteria plan. This premium is set very high (e.g. \$1,000+ per month), reducing the employee's taxable income and the employer's payroll taxes. Then supposedly employees either receive such amounts back as incentives or reimbursement for participating in a wellness program or can purchase other products available via the program (e.g., fixed indemnity plans). There is also often a monthly or annual fee that is withheld from such amounts by the vendor to cover the cost and administration of the program. The program descriptions of exactly how much and on what terms the money will be available to employees is often vague.

Tax Implications

An employee's taxable income cannot be magically reduced without being used toward something that the Code recognizes as a tax-favored benefit. The following table lists common examples of benefits that can be provided by employers to employees and excluded from employees' taxable income or paid for by employees on a pre-tax basis through a cafeteria plan.

Benefits Qualifying for Tax-Favored Treatment
Group medical, dental, and vision benefits
Reimbursement of qualifying medical expenses via a health FSA, HRA or HSA
Dependent care account program (DCAP)
Qualified transportation benefits (e.g., parking and transit)
Employee life insurance (up to \$50,000 in benefit)
Adoption assistance
Disability and indemnity premiums, BUT then any benefits paid are taxable

Many of the programs offer incentives to engage in various healthy behaviors (e.g., annual physicals, vaccinations, screenings) along with access to telehealth, counseling, and preventive care. IRS guidance indicates an incentive under a wellness program is excludable from an employee's income only if it pays for or reimburses qualifying medical care. Reimbursement solely for participating in various wellness activities should therefore be included in taxable income. Payments (or premiums) for access to telehealth, counseling, and preventive care might qualify for tax-favored treatment, but it

seems unlikely such costs would reach \$500+/month; and for those covered under an individual or group health plan, arguably preventive coverage is already available at no cost under such plans.

In addition, the programs may offer some flavor of fixed indemnity product(s), with a portion of the employees' pre-tax contributions covering the premiums. However, the IRS has clarified many times that if premiums for a fixed indemnity plan are paid for on a tax-favored basis, then any benefits paid out by the plan need to be included in the employee's taxable income. See IRS Memorandum from 2017 here - <https://www.irs.gov/pub/irs-wd/201703013.pdf>

If all payments/reimbursements via these programs were for qualifying medical expenses, or other benefits qualifying for tax-favored treatment, the programs may be okay. But the amounts handled on a pre-tax basis through the employer's cafeteria plan instead appear to regularly provide reimbursement in excess of actual unreimbursed medical expenses. When that's the case, employees would then owe income taxes on such amounts and employers would likely owe additional payroll taxes.

IRS Guidance

In final regulations, the IRS stated that "an increasing number of arrangements, some involving fixed indemnity plans and policies, that distribute cash benefit payments, purportedly for medical expenses, even if any expenses incurred may already have been reimbursed through other coverage, or participants do not incur any medical expenses within the meaning of section 213(d) of the Code. In some cases, no medical expenses are incurred and participants simply complete certain health-related activities. Benefit payments from such accident and health plans that are not made on account of medical expenses incurred generally would not qualify for exclusion from gross income, FICA, FUTA, or Federal income tax withholding." The IRS indicated they intend to issue more detailed guidance on the taxability of these types of arrangements in the future. The final regulations can be found here – <https://info.groom.com/27/1454/uploads/2024-06551.pdf>

Summary

Vendors are continuously tweaking their programs to try and get around the IRS' latest pronouncement on why these arrangements do not work, but the IRS has repeatedly advised in a series of letter rulings and regulations that these programs claiming to save taxes by having employees pay for "wellness" or other unsubstantiated expenses on a tax-favored basis would result in at least some of the benefits being treated as taxable income to the employee. Without the promised tax advantage, the entire scheme collapses. The risk is that if the program (or participating employees) were audited by the IRS, employees may owe a significant amount of additional income taxes, late penalties and interest; and the employer may then owe additional payroll taxes, penalties and interest on such amounts.

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