

**Office of Chief Counsel
Internal Revenue Service
memorandum**

Number: **202323006**

Release Date: 6/9/2023

CC:EEE:EB:HW

PRESP-100769-23

UILC: 105.00-00, 125.00-00

date: May 09, 2023

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subject: Tax Treatment of Employer-Funded, Insured, Fixed-Indemnity Wellness Policy

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

ISSUES

Whether wellness indemnity payments under an employer-funded, fixed-indemnity insurance policy (including where the premium for the coverage is paid by employee salary reduction through a cafeteria plan under section 125 of the Internal

Revenue Code (Code)) are includible in the gross income of the employee if the employee has no unreimbursed medical expenses related to the payment.

Whether the wellness indemnity benefits that are includible in gross income (taxable wellness indemnity benefits) are wages for purposes of Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) taxes, and federal income tax withholding (FITW) (collectively, "employment taxes") with respect to the payments of benefits in the situation described below.

FACTS

An Employer provides comprehensive health coverage for its employees through a group health insurance policy. The comprehensive health coverage provides preventive care benefits, such as reimbursements for the cost of flu shots and other vaccinations, without any cost sharing for covered individuals. The coverage constitutes accident or health coverage for purposes of the exclusion for employer-provided accident or health coverage under § 106(a).

In addition to the health coverage, the Employer provides all employees, regardless of enrollment in other comprehensive health coverage, with the ability to enroll in coverage under a fixed-indemnity health insurance policy that would qualify as an accident and health plan under § 106. Employees pay monthly \$1,200 premiums for the fixed-indemnity health insurance policy by salary reduction through a § 125 cafeteria plan. The only payments that the insurance company receives with respect to the insurance provided to the employees are the premium payments. In other words, the

Employer has no liability for any costs incurred by the insurance company that may exceed the premiums paid by its employees.

The Employer's fixed-indemnity health insurance policy is a voluntary program primarily intended to supplement its employees' other health coverage through the provision of wellness benefits. The first type of wellness benefit provided by the fixed-indemnity health insurance policy is a payment of \$1,000 if an employee participates in certain health or wellness activities. This benefit is limited to one payment per month. Use of preventive care, such as vaccinations, under a comprehensive health plan in which an employee is enrolled, qualifies the employee for the payment for the month. The fixed-indemnity health insurance policy provides wellness counseling, nutrition counseling, and telehealth benefits at no additional cost. The employee is responsible for any costs associated with receiving any health-related activity, although in many cases all or part of the cost of the health-related activity will be provided at no cost or is covered by other insurance. The fixed-indemnity health insurance policy also provides a benefit for each day that the employee is hospitalized. Under the fixed-indemnity health insurance policy, the wellness benefits are paid from the insurance company to the Employer, which then pays out the wellness benefit to employees via the Employer's payroll system.

LAW AND ANALYSIS

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 gross income premiums for accident or health insurance coverage that are paid by an employer.

Section 105(a) provides that generally amounts received by an employee through accident and health insurance for personal injuries or sickness are included in gross income to the extent the amounts (1) are attributable to contributions by the employer which are not includable in the gross income of the employee or (2) are paid by the employer.

Section 105(b) provides that gross income does not include amounts paid by an employer to reimburse an employee for expenses incurred by the employee for medical care as defined in § 213(d). The exclusion under § 105(b) is limited to amounts paid solely to reimburse expenses incurred for medical care and does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether expenses for medical care are incurred.

Treasury Regulation § 1.105-2 provides that section 105(b) does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether the expenses are incurred for medical care. Section 1.105-2 also provides that if the amounts are paid to the taxpayer solely to reimburse expenses which were incurred for the prescribed medical care, section 105(b) is applicable even though such amounts are paid without proof of the amount of the actual expenses incurred by the taxpayer, but section 105(b) is not applicable to the extent that such amounts exceed the amount of the actual expenses for such medical care.

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 of the Code. 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 through a cafeteria plan applied to purchase health 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 to pay for health coverage, the coverage is excludable from gross income under § 106 as employer-provided accident or health coverage.

Section 104(a)(3) provides that gross income does not include amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness. This exclusion does not apply, however, if the amounts are either (1) attributable to contributions by the employer that were not includable in the gross income of the employee, or (2) paid by the employer. See Treas. Reg. § 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.

A fixed-indemnity health insurance policy is an insurance policy 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. Similarly, a critical disease or specific disease policy pays a specific amount for the diagnosis of a particular disease. The amount paid is not related to the amount of any medical expense incurred or coordinated with other health coverage. The amount of the payment is not based on the

employee's actual absence from work on account of the health-related event. The exclusion from gross income under § 104(a)(3) applies to amounts received through accident or health insurance, or through an arrangement having the effect of accident or health insurance, for personal injuries or sickness. The exclusion under § 104(a)(3), however, does not apply to the extent that amounts paid are attributable to contributions by the employer which were not includable in the gross income of the employee, or paid by the employer.

EMPLOYMENT TAXES

Sections 3101 and 3111 impose FICA taxes (comprised of social security tax and Medicare tax) on "wages" as that term is defined in section 3121(a). Section 3121(a) defines wages as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions.

Section 3301 imposes federal unemployment (FUTA) tax on "wages" as that term is defined in § 3306(b). Section 3306(b) defines wages as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions.

Treasury Regulation § 31.3121(a)-1(b), relating to FICA tax, provides that the term "wages" means all remuneration for employment, unless specifically excepted under § 3121(a) of the Code or the regulations thereunder. Treasury Regulation § 31.3306(b)-1(b) contains a similar provision for purposes of FUTA.

Section 3121(a)-1(c) of the Code and Treasury Regulation § 31.3306(b)-1(c) provide that the name by which the remuneration is designated is immaterial. Salaries, fees, and bonuses, for example, are all wages if paid as compensation for employment.

Sections 31.3121(a)-1(d) and 31.3306(b)-1(d) provide that, generally, the basis upon which the remuneration is paid is immaterial in determining whether the remuneration constitutes wages.

Section 3121(a)(5)(G) of the Code 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.

Section 3121(a)(2) provides an exception from FICA wages for:

the amount of any payment (including any amount paid by an employer for insurance or annuities, or into a fund, to provide for any such payment) made to, or on behalf of, an employee or any of ... [the employee's] dependents under a plan or system established by an employer which makes provision for ... [its] employees generally (or for ... [its] employees generally and their dependents) or for a class or classes of ... [its] employees (or for a class or classes of ... [its] employees and their dependents) on account of

(A) sickness or accident disability (but, in the case of payments made to an employee or any of ... [the employee's] dependents, this subparagraph shall exclude from the term "wages" only payments which are received under a [workers'] ... compensation law);

(B) medical or hospitalization expenses in connection with sickness or accident disability....

Section 3306(b)(2) contains an exception similar to § 3121(a)(2) that applies for purposes of FUTA wages.

Temporary Treasury Regulation § 32.1(a), in effect, provides that payments to or on behalf of an employee on account of sickness or accident disability are not excluded from the term wages unless they are received under a workers' compensation law or qualify for the exception from wages provided under § 3121(a)(4) of the Code, which provides an exception for any payment on account of sickness or accident disability made after the expiration of 6 calendar months following the last calendar month in which the employee worked.¹

Temporary Treasury Regulation § 32.1(d) provides that for purposes of determining the payments subject to FICA taxation under Temporary Treasury Regulation § 32.1(a):

a payment made on account of sickness or accident disability includes any payment for personal injuries or sickness includible in gross income under section 105(a) and the regulations thereunder and thus does not include—

(1) any amount which is expended for medical care as described in section 105(b) and section 1.105-2,

(2) any payment which is unrelated to absence from work as described in section 105(c) and section 1.105-3, or

(3) any payment or portion thereof which is attributable to a contribution by the employee as determined in paragraphs (d) and (e) of section 1.105-1.

A payment made on account of sickness or accident disability does not include any payment which is excludable from gross income under section 104(a)(2), (4), or (5).

¹ Although § 7805(e)(2) provides that any temporary regulation shall expire within 3 years after the date of issuance of such regulation, that paragraph is effective only for temporary regulations issued after November 20, 1988, and thus does not apply to this temporary regulation issued in 1982. Temporary Treasury Regulation § 32.1 was amended in 2005 by TD 9233, 70 FR 74198 (December 15, 2005) confirming its continuing authority.

APPLICATION OF EMPLOYMENT TAXES**FICA**

The taxable wellness indemnity benefits are provided by employers to employees as remuneration for employment under benefit plans funded by employers and, thus, fit within the basic definition of wages under § 3121(a). To the extent the taxable wellness indemnity benefits are not paid under a worker's compensation law, they do not qualify for the exception from wages provided by § 3121(a)(2)(A). Although the payments are made on account of sickness or accident disability, the parenthetical in § 3121(a)(2)(A) removes the payments from the exclusion because they are not received under a workers' compensation law. Moreover, the taxable wellness indemnity benefits cannot qualify for the § 3121(a)(2)(B) exception because the payments are not made on account of medical or hospitalization expenses in connection with sickness or accident disability.

Temporary Treasury Regulation § 32.1(d) specifically bases inclusion in the definition of "payments on account of sickness or accident disability" subject to FICA tax on the payment being "includible in gross income under § 105(a)." All the exceptions from treatment as payments on account of sickness or accident disability that are specifically mentioned in § 32.1(d) support the conclusion that the payments subject to FICA taxes under the regulations are only those payments that are includible in gross income under § 105(a) of the Code. The specifically listed numbered exceptions in Temporary Treasury Regulation § 32.1(d) and the amounts excludable under § 104(a)(2), (4), and (5) of the Code are all amounts that are excludable from gross income. It is, therefore, clear that Temporary Treasury Regulation § 32.1(d) was not

intended to provide an exception from FICA wages for payments that are includible in gross income. The taxable wellness indemnity benefits would be excludable under § 32.1(d)(1) to the extent that they are expended for medical care as described in § 105(b) of the Code and Treasury Regulation § 1.105-2. However, because the taxable wellness indemnity benefits do not qualify for the Temporary Treasury Regulation § 32.1(d)(1) exception, and no other exception applies, they are subject to FICA.

A similar analysis applies for purposes of the similar exception under § 3306(b)(2)(A) of the Code with respect to FUTA taxes. Thus, the taxable wellness indemnity benefits are also subject to FUTA taxation.

Federal Income Tax Withholding

Section 3402(a) of the Code, relating to U.S. Federal Income Tax Withholding (FITW), 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 FITW purposes as all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash with certain specific exceptions. Among the specific exceptions are several exceptions related to the provision of medical insurance and benefits. See § 3401(a)(20), 3401(a)(21), and 3401(a)(22). No statutory exception applies to the taxable wellness indemnity benefits.

The taxable wellness indemnity benefits are not sick pay (because they are not dependent upon an absence from work), and there is no exception from the definition of wages under § 3401(a) that applies to the payments. Thus, as wages under § 3401(a),

the taxable wellness indemnity benefits are subject to FITW under the general FITW rules rather than the rules applicable to sick pay.

CONCLUSIONS

Wellness indemnity payments under an employer-funded, fixed-indemnity insurance policy (including where the premium for the coverage is paid by employee salary reduction through a cafeteria plan under section 125 of the Internal Revenue Code (Code)) are includible in the gross income of the employee if the employee has no unreimbursed medical expenses related to the payment.

The exclusion under § 105(b) is limited to amounts paid solely to reimburse expenses incurred for medical care and does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether expenses for medical care are incurred. The exclusion from income in § 105(b) does not apply to payments when the employee has no unreimbursed medical expense either because the activity that triggers the payment does not cost the employee anything or because the cost of the activity is reimbursed by other coverage.

The fixed indemnity health insurance policy pays \$1,000 per month without regard to whether the employee has any unreimbursed health insurance expenses. Thus, the payment is included in the employee's gross income. Because the payment is provided in connection with the employee's employment, it is included in remuneration and treated as "wages" for employment tax purposes. The exclusions from "wages" for medical expenses would not apply because the payments are not for medical expenses.

Thus, under the facts described above, when the insured plan pays \$1,000 because the employee used a wellness benefit, the \$1,000 is included in the employee's income and wages. Accordingly, taxable wellness indemnity benefits are wages for purposes of FICA, FUTA, and FITW with respect to the payments of benefits in the situation described above.

Please call (202) 317-5500 if you have any further questions.