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EY Payroll NewsFlash™

IRS ruling explains when wellness benefits are included in taxable wages

In a recent IRS Chief Counsel Advice Memorandum, the Internal Revenue Service (IRS) clarified the extent that employer-provided wellness benefits are included in wages subject to federal income tax (FIT), federal income tax withholding (FITW), Social Security/Medicare (FICA) and federal unemployment insurance (FUTA). The ruling gives particular focus to wellness benefits that are provided under an IRC §125 cafeteria plan. ***(TAM No. 201622031, 4-14-2016.)***

While a TAM or information letter may not be cited as precedent, these do provide important insight into how the IRS may rule under a similar set of facts and circumstances.

Free health screenings

Under the facts in the ruling, an employer's wellness program provided employees with free health screenings as well as other accident and health plan benefits that are excluded from taxable wages under IRC §106. These wellness benefits are available to employees even if they are not enrolled in the employer's health insurance coverage plan.

The IRS held that the value of employer-provided health screenings is excluded from wages subject to FIT, FITW, FICA and FUTA.

Under IRC §105(b), an employee may exclude from taxable wages amounts received through employer-provided accident or health insurance if those amounts reimburse expenses incurred by the employee (including the employee's spouse, dependents and children who not yet attained age 27) for personal injuries and sickness.

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Wellness benefits under a cafeteria plan

Under the facts in the ruling, all employees, including those who are not covered under the employer's health insurance plan, may elect to buy into the wellness program by making a pretax contribution through the employer's IRC §125 plan. In addition, employees who participate in the wellness program may receive benefits that do not qualify as medical expenses under IRC §213(d), such as gym memberships.

The IRS held that benefits provided under an employer's wellness program that provides medical care as defined under IRC §213(d) are generally excluded from wages subject to FIT, FITW, FICA and FUTA under IRC §105(b) and IRC §106(a). Under IRC §125, an employee's pretax contributions for coverage under the plan are also excluded from wages subject to FIT, FITW, FICA and FUTA.

- *Taxable wellness benefits.* Any other benefit provided by the wellness program that is not medical care as defined under IRC §213(d) is included in taxable wages subject to FIT, FITW, FICA and FUTA unless it qualifies as an exempt fringe benefit under IRC §132.

  For example, the value of an athletic facility operated by or on behalf of the employer and available on the employer's premises is excluded from wages subject to FIT, FITW, FICA and FUTA; however, reimbursement of an employee's cost for athletic facilities not operated by the employer is included in wages subject to FIT, FITW, FICA and FUTA. (IRS Reg. §1.132-1(e).)

Reimbursement of pretax contributions for the wellness program

Under the facts in the ruling, *employees* may receive reimbursement of all or a portion of their cafeteria plan pretax contribution towards the cost the wellness program.

The IRS held that any employer reimbursement of employee pretax contributions toward the cost of the wellness program is included in wages subject to FIT, FITW, FICA and FUTA.

The scheme whereby employers reimburse employees for a portion of their pretax contributions, also referred to as "double dipping," was addressed by the IRS in Rev. Rul. 2002-3 (2002-3 I.R.B. 316). In that ruling the IRS states that if an employer makes payments to employees that reimburse a portion of the amount of health insurance premiums paid by an IRC §125 pretax deduction, such payments fail to meet the exclusions under IRC §106(a) and IRC §105(b) and are therefore included in taxable wages subject to FIT, FITW, FICA and FUTA.

Cash incentives under a wellness plan

Under the facts in the ruling, employees participating in the wellness program are eligible for cash incentives.

The IRS held that cash incentives are included in wages subject to FIT, FITW, FICA and FUTA because under IRS Reg. § 1.132-6(c), a cash award (other than overtime meal money and local transportation fare) never qualifies as an exempt de minimis fringe benefit.

Ernst & Young LLP insights

Since the implementation of the Affordable Care Act, a diverse range of health insurance and wellness products have been designed and marketed to employers as options that may lessen the impact of rising health care costs. It is sometimes the case that these products tout "tax benefits" that would likely be denied if subject to IRS scrutiny. For this reason, employers should be certain to have health and wellness plan proposals reviewed by an employment tax advisor before purchasing or implementing them.

Businesses that currently offer wellness programs should carefully review the various components with an eye to those that may be included in wages for FIT, FITW, FICA and FUTA purposes. Where taxable benefits are offered under a cafeteria plan, employers should confirm that such benefits do not cause the plan to lose its tax-qualified status.

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