Fixed Indemnity Health Benefits – Federal Tax Rules

Fixed indemnity health coverage pays insured individuals a specified amount of cash 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 expense actually incurred.

According to internal memos released by the IRS' Chief Counsel's office, the tax treatment of payments from fixed indemnity coverage generally depends on how premiums for the coverage are paid.

- Payments are *not taxable* if premiums are paid by employees with after-tax dollars (or paid by the employer and imputed to employees as taxable income).
- Payments are *taxable* (to the extent they exceed the cost of medical care) when premiums are paid by employees on a pre-tax basis or paid by the employer and not imputed to employees as taxable income.

When fixed indemnity payments are taxable, employers should confirm that income and employment taxes are being properly withheld.

LINKS AND RESOURCES

- IRS Chief Counsel Advice Memorandum 201703013 (Dec. 12, 2016)
- IRS Chief Counsel Advice Memorandum 201719025 (April 24, 2017)

Key Points

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

Employer Reminders

- When fixed indemnity payments are taxable, income and employment taxes should be withheld.
- To avoid tax withholding, employers should consider requiring employees to pay for fixed indemnity coverage on an after-tax basis.

General Tax Rules

In general, Internal Revenue Code (Code) Section 106(a) provides that gross income of an employee does not include employer-provided coverage under an accident or health plan.

To avoid withholding taxes on fixed indemnity payments, employers should require employees to pay premiums on an after-tax basis or, if the employer pays the premiums, it should impute the premiums to employees as taxable income.

Code Section 105(b) states that the amounts an employee receives through employer-provided accident or health insurance are not taxable if they are paid to reimburse medical care expenses actually incurred by the employee, a spouse, a child (through the end of the year in which the child attains age 26) or other tax dependent. However, to the extent amounts received through employer-provided accident or health insurance exceed the amount of medical expenses incurred, the amounts are not excluded from gross income.

"Employer-provided" accident or health insurance refers to an arrangement where the employer pays the premium (and does not impute the payment to the employee as taxable income) or the employee pays the premium on a pre-tax basis under a Section 125 cafeteria plan.

Tax Rules for Fixed Indemnity Coverage

Because benefits under a fixed indemnity plan are not related to medical expenses that were actually incurred, there was some uncertainty regarding the tax treatment of these payments. Thus, the IRS released internal memos from its Chief Counsel's office addressing the tax treatment of payments from fixed indemnity coverage. Although these memos do not constitute official tax guidance, they provide insight into how the IRS views this tax issue. *Employers that offer fixed indemnity plans may want to consult with their tax advisers regarding the tax consequences of their specific plans*.

According to IRS Memorandum 201703013 (dated Dec. 12, 2016), the tax status of payments under fixed indemnity health coverage generally **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 Section 125 cafeteria plan, payments from the plan are **taxable** and must be included in employees' gross income and wages. In Memorandum 201719025, the IRS provides that fixed indemnity payments attributable to pre-tax contributions are taxable only to the extent that they exceed otherwise unreimbursed medical expenses.
- For example, if a fixed indemnity health plan with premiums paid on a pre-tax basis through a Section 125 cafeteria plan paid $200 for a medical office visit and the covered individual's unreimbursed medical costs as the result of the visit were $30, $30 would be excluded from gross income under Code Section 105(b), and the excess amount of $170 would be included in gross income.

The following table summarizes the tax treatment of payments from fixed indemnity coverage, as explained in the IRS memos.