COMPLIANCE CHRONICLE

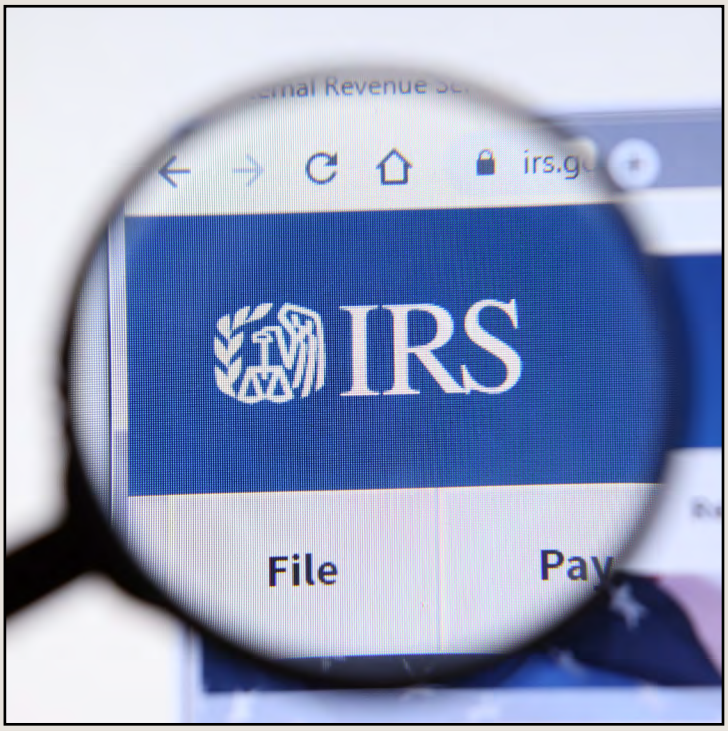
REGULATIONS | POLICIES | STANDARDS | REQUIREMENTS | LAWS

Navigating the ever-evolving landscape of compliance can be challenging and time-consuming. Warner Pacific is happy to share monthly updates to help your organization stay informed about new requirements and minimize compliance risks.

Let us handle the complexities, so you can focus on what matters most — your business.

We have received a number of questions lately about whether plans that use Section 125 to create dollars to fund supplemental benefits are legal.

The IRS has issued clear guidance on wellness programs that use pretax payments to fund the purchase of supplemental benefits under employer-sponsored plans — particularly those involving fixed-indemnity insurance policies.



Key Points from IRS Guidance:

1. **IRS Memorandum 202323006 (May 2023):**
   - The IRS addressed wellness programs where employees make **pretax contributions** (often through a Section 125 cafeteria plan) to purchase fixed-indemnity insurance.
   - These plans often promise tax savings by reimbursing employees for participating in wellness activities or receiving preventive care.
   - The IRS concluded that cash benefits received under such plans are **taxable income** if the employee does **not incur unreimbursed medical expenses** related to the payment.
2. **Tax Implications:**
   - If an employee pays premiums pretax and then receives **cash reimbursements** (e.g., $1,000/month) for using wellness services, the IRS considers this a **double tax benefit** — which is not allowed.
   - Therefore, these reimbursements are **subject to employment taxes** (FICA, FUTA and income tax withholding).
3. **IRS Concerns:**
   - The IRS has flagged these arrangements as **potential tax avoidance schemes.**
   - They caution employers to be wary of vendors promoting these programs as a "win-win" for tax savings, as they often do not comply with tax law.

Summary:

The IRS does not support wellness programs that use pretax contributions to fund supplemental benefits if those benefits result in cash reimbursements not tied to **actual, unreimbursed medical expenses.** Such payments are considered **taxable income.**

Several vendors and consultants have been marketing wellness or fixed-indemnity plans that use pretax payroll deductions to fund supplemental benefits, often promising significant tax savings for both employers and employees. These plans typically involve:

- Employees making **large pretax contributions** (e.g., $1,200/month) through a Section 125 cafeteria plan.
- Receiving monthly cash payments (e.g., $1,000/month) for participating in wellness activities like preventive care, telehealth or wellness counseling.
- The promise that employees' after-tax take-home pay remains the same or increases, while employers save on payroll taxes.

IRS Viewpoint:

The IRS has flagged these arrangements as non-compliant and considers the cash payments to be taxable income unless tied to unreimbursed medical expenses. These schemes are often marketed as a "win-win," but the IRS has consistently ruled that they do not work as advertised.

Vendors:

While the IRS guidance and legal commentary do not always name specific vendors, they do mention that consultants and third-party administrators are actively promoting these plans across the country.

These vendors often rebrand or repackage the same core concept, which has been repeatedly disallowed by the IRS over the years.

These plans are often structured under **Section 125 cafeteria plans** and marketed as a way to:

- Reduce employer payroll taxes
- Increase employee take-home pay
- Provide wellness-related benefits like telehealth, counseling or preventive care

However, the **IRS has issued multiple warnings —** including Memorandum 202323006 — stating that such arrangements do not comply with tax law if:

- The benefits are paid in **cash,**
- The payments are **not tied to unreimbursed medical expenses,** and
- The premiums are paid **pretax.**

In these cases, the IRS considers the payments to be **taxable wages,** subject to income tax and employment taxes (FICA, FUTA).

What This Means for Employers:

If an employer is considering or currently using a Capstone plan (or a similar one), it's important to:

- **Review the plan structure carefully** with legal and tax advisors
- Ensure that any wellness payments are **not treated as tax-free** unless they meet IRS criteria
- Be aware that the IRS is actively scrutinizing these arrangements and may impose **back taxes, penalties and interest**

Check out all of our compliance and legislative resources at warnerpacific.com.