



Compliance Update - 07/27/2016

Tax Treatment of Wellness Programs

Beware of wellness programs that sound too good to be true in that they promise incredible tax savings for employers and tax-free reimbursement of already tax-free payroll deductions.

In an Office of Chief Counsel Internal Revenue Service (IRS) Memorandum, the IRS steps through the facts, law, and analysis to clearly spell out their conclusion on wellness programs that provide cash awards for participation or provides tax-free reimbursements of required employees' contributions paid with untaxed dollars. And, although this advice may not be used or cited as a precedent, it unmistakably demonstrates the IRS thought process for these types of wellness programs.

Facts

An employer provides employees with certain benefits under a wellness program at no cost. The wellness program provides health screening and other health benefits that would be considered eligible medical expenses that could be treated on a tax-favorable basis. The program also provides cash rewards that do not qualify as section 213(d) medical expenses, such as gym membership fees.

A second employer situation contains the same circumstances as the first, but in this scenario, employees elect to participate in the wellness plan by making salary reductions through a cafeteria plan.

And a third scenario contains the same facts as situation 2, except that the program includes a reimbursement of all or a portion of the required employees' contributions made through salary reduction.

Law and Analysis

Generally, IRC Section 106(a) excludes employer-provided coverage under an accident or health plan from employees' income. Under IRC Section 105(b), employees may exclude amounts received through employer-provided accident or health insurance if the reimbursement is for medical care incurred by the participant. There is also an exception to paying FICA on wages for any payment to or on behalf of an employee under a cafeteria plan.

However, there is no exclusion from income for amounts received as a reward, incentive, or other benefit provided by the wellness program that is not medical care as defined under IRC Section 213(d). These

amounts are included as income, unless excludable as an employee fringe benefit under IRC Section 132, and taxed as such. Under IRC Section 132-6(c), a cash fringe benefit (other than overtime meal money and local transportation fare) is never excludable as a de minimis fringe benefit.

The Memorandum provides a good example of a de minimis fringe benefit. A wellness program that provides a tee-shirt to every participant would be considered a de minimis fringe benefit and excludable from taxable income. Note however, that a tee-shirt is not an eligible medical expense as described under IRC Section 213(d). In addition, an employer payment of gym membership fees, which also does not qualify as medical care, would be includable in employees' income, regardless if provided through a wellness plan or program.

The IRS has seen similar schemes in the past. Revenue Ruling 2002-3 addresses this situation known as double-dipping. The employer has an arrangement under which employees reduce their salaries on a pre-tax basis to pay health insurance premiums. In addition, the employer makes untaxed payments to employees that reimburse a portion of the health insurance premiums paid by salary reduction. Revenue Ruling 2002-3 holds that the exclusions under sections 106(a) and 105(b) do not apply to amounts that the employer pays to employees to reimburse employees for amounts paid by employees for health insurance coverage excluded from gross income under section 106(a) (including salary reduction amounts pursuant to a cafeteria plan).

Conclusion

An employer may not exclude from an employee's gross income payments of cash rewards for participating in a wellness program. Also, employers may not exclude from an employee's gross income reimbursements of premiums for participating in a wellness program if the premiums for the wellness program were originally made by salary reduction through a section 125 cafeteria plan.

Who Loses?

Ultimately, both the employer and employees lose. The employee will be taxed on these amounts and must file amended returns and pay any resultant penalties for underpayment of taxes. The employer will also lose because they will have to re-characterize the amounts as taxable, pay appropriate employer taxes, issue amended W-2s, and pay failure to withhold penalties.

Want to read the entire Memorandum, including all the applicable IRS code section references? [IRS Memorandum number 201622031](#).

Sincerely,
Your Team at WageWorks



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