

Benefits BRIEF



Tax Avoidance Schemes: A Cautious Approach for Health Plan Sponsors

• February 2023 •

Absent an exception, all benefits provided by employers to their employees must be included in taxable income. Fortunately, the Internal Revenue Code (IRC) provides several exceptions that allow health benefits to be provided on a tax-free basis. However, the rules surrounding these benefits can be complicated and in recent years have been exploited to market to employers tax-savings programs. These programs promise attractive tax savings but leverage impermissible methods to deliver them, presenting a significant risk to employers who buy in.

A Familiar Design with Dubious Claims

Within the context of health plans, the advantage of tax savings commonly relies upon IRC Sections 105 and 125. Under Sec. 125, employees are permitted to pay for all or part of the cost of qualified benefits by making pre-tax payroll deductions through a cafeteria plan established by the employer. Separately, Sec. 105 allows employers to provide employees with tax-free reimbursements for incurred medical expenses.

Promoters of tax-savings programs capitalize on the legitimate tax advantages available under Secs. 105 and 125, but package them in a way that renders the programs little more than tax avoidance schemes. For example, early iterations of these programs sold a simplistic approach to employers: offer employees a wellness program that they make pre-tax premium contributions to participate in, and through the wellness program provide a tax-free reimbursement or reward of roughly the same amount as the pre-tax contribution. Promoters sold this program as a win-win by reducing employees' taxable wages (and employers' employment taxes) without affecting their take-home pay.

The flaw with such an arrangement, as detailed by the Internal Revenue Service (IRS) in various memos as early as 2016, is that the program allows for an impermissible double-dip into tax savings. Simply put, the programs provide a tax-free reimbursement of an expense that was paid on a tax-free basis, thereby impermissibly excluding from income amounts paid to employees.

Enforcement Efforts

The IRS and Department of Labor (DOL) are primarily responsible for enforcement and have participated in joint initiatives to identify, investigate, and shut down fraudulent tax-savings schemes. **While the vendors of these programs may be the most obvious targets, employers – and employees – are at risk, as well.**

This is because **these programs result in the employer underpaying employment taxes and employees underreporting income**, which can present problems on both the federal and state levels. Not only will the employer and employees be responsible for making up any tax underpayments, but the administrative and employee relations fallout that follow may be severe.

Unfortunately, despite efforts taken by the IRS and DOL, these programs persist. Vendors often adapt the details of the design enough to distinguish them from the types of programs that have been shut down or highlighted in IRS memos. Consequently, it can be difficult to evaluate the legitimacy of a purported tax-savings program.

Promoters of tax-savings programs capitalize on the legitimate tax advantages available under Secs. 105 and 125, but package them in a way that renders the programs little more than tax avoidance schemes.

Tips for Employer Sponsors

When reviewing a tax-savings benefit program, employer-sponsors should take the time to critically examine the vendor's claims to determine how compliant the program is and how likely it is to achieve the advantages advertised. Specifically:

- ✓ Request from the vendor **all marketing materials** that describe the program and ask for an explanation of how the program's design has been evaluated for compliance.
- ✓ **Take note of any disclaimers** included in the program's materials, particularly those that relate to the tax treatment of the benefits offered.
- ✓ **Engage tax or benefit-expert advisors** to provide an opinion on the program's claims.

- ✓ Be realistic about **how employees stand to benefit** from the program.
- ✓ **Consider the risk tolerance of your company** before committing to the program.

Given the abundance of tax-savings programs that are marketed, employers should expect that few will be discernable as flatly fraudulent – and few will be clearly and undoubtedly compliant. Rather, the majority of programs likely fall somewhere in the middle. As a result, employer-sponsors will be wise to approach such programs with a healthy amount of skepticism and to keep in mind the adage, “If it sounds too good to be true, it probably is.”

LINKS AND RESOURCES

[Employer’s Tax Guide to Fringe Benefits](#)

IRS Publication 15-B

[Revenue Ruling 2002-3](#)

RR-125834-00, Part I

[Memorandum 201622031](#)

Office of Chief Counsel, IRS

[Memorandum 201719025](#)

Office of Chief Counsel, IRS