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Memorandum**

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subject: Tax Treatment of Wellness Program Benefits and Employer Reimbursement of Premiums Provided Pre-tax Under a Section 125 Cafeteria Plan

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

May an employer exclude from an employee's income under section 105 or section 106 cash rewards paid to an employee for participating in a wellness program?

May an employer exclude from an employee's income under section 105 or section 106 reimbursements of premiums for participating in a wellness program if the premiums for the wellness program were originally made by salary reduction through a section 125 cafeteria plan?

CONCLUSION

An employer may not exclude from an employee's gross income payments of cash rewards for participating in a wellness program.

An employer 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income reimbursements of premiums for participating in a wellness program if the premiums for the wellness program were originally made by salary reduction through a section 125 cafeteria plan.

FACTS

Situation 1. An employer provides all employees, regardless of enrollment in other comprehensive health coverage, with certain benefits under a wellness program at no cost to the employees. In particular, the wellness program provides health screening and other health benefits such that the program generally qualifies as an accident and health plan under section 106. In addition to those benefits, employees who participate in the program may earn cash rewards of varying amounts or benefits that do not qualify as section 213(d) medical expenses, such as gym membership fees.

Situation 2. An employer provides all employees, regardless of enrollment in other comprehensive health coverage, with certain benefits under a wellness program. Employees electing to participate in the wellness program pay a required employee contribution by salary reduction through a section 125 cafeteria plan. The wellness program provides health screening and other health benefits such that the program generally qualifies as an accident and health plan under section 106. In addition to those benefits, employees who participate in the program may earn cash rewards of varying amounts or benefits that do not qualify as section 213(d) medical expenses, such as gym membership fees.

Situation 3. The same as *Situation 2*, except that one of the benefits available under the wellness program includes a reimbursement of all or a portion of the required employee contribution for the wellness plan that the employee made through salary reduction.

LAW AND ANALYSIS

Section 61(a)(1) of the Internal Revenue Code and § 1.61-21(a)(3) of the Income Tax Regulations provide that, except as otherwise provided in subtitle A, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.

In general, section 106(a) provides that gross income of an employee does not include employer-provided coverage under an accident or health plan. Under section 106(a), an employee may exclude from income premiums for accident or health insurance coverage that are paid by an employer. Also, under section 105(b), an employee may exclude amounts received through employer-provided accident or health insurance if those amounts are paid to reimburse expenses incurred by the employee for medical care (of the employee, the employee's spouse, or the employee's dependents, as well as children of the employee who are not dependents but have not attained age 27 by the end of the taxable year) for personal injuries and sickness.

Sections 3101 and 3111 impose FICA taxes on “wages” as that term is defined in section 3121(a), with respect to “employment,” as that term is defined in section 3121(b). The term “wages” is defined in section 3121(a) for FICA purposes as all remuneration for employment, with certain specific exceptions.

Section 3301 imposes FUTA tax on wages paid with respect to employment. The general definitions of the terms “wages” and “employment” for FUTA purposes are similar to the definitions for FICA purposes. See section 3306(b) and 3306(c).

Section 3402(a), relating to federal income tax withholding, generally requires every employer making a payment of wages to deduct and withhold upon those wages a tax determined in accordance with prescribed tables or computational procedures. The term “wages” is defined in section 3401(a) for federal income tax withholding purposes as all remuneration for services performed by an employee for his employer, with certain specific exceptions.

To the extent amounts are excluded from gross income under sections 105(b) or 106(a), they are also excluded from wages subject to income tax withholding under section 3401. In addition, amounts paid to reimburse expenses incurred by the employee for medical care (of the employee, the employee’s spouse, or the employee’s dependents, as well as children of the employee who are not dependents but have not attained age 27 by the end of the taxable year) for personal injuries or sickness are excepted from wages for FICA and FUTA tax purposes under sections 3121(a)(2) and 3306(b)(2), respectively.

Section 3121(a)(5)(G) provides an exception from FICA wages for any payment to or on behalf of an employee under a cafeteria plan (within the meaning of section 125) if such payment would not be treated as wages without regard to such plan and it is reasonable to believe that (if section 125 applied for purposes of section 3121) section 125 would not treat any wages as constructively received. Section 3306(b)(5)(G) contains a similar exception from wages for purposes of FUTA tax.

Under § 1.105-2, the exclusion under section 105(b) does not apply to amounts which a taxpayer would be entitled to receive irrespective of whether or not the taxpayer incurs expenses for medical care.

Coverage by an employer-provided wellness program that provides medical care as defined under section 213(d) is generally excluded from an employee’s gross income under section 106(a), and any section 213(d) medical care provided by the program is excluded from the employee’s gross income under section 105(b). However, any reward, incentive or other benefit provided by the medical program that is not medical care as defined under section 213(d) is included in an employee’s income, unless excludible as an employee fringe benefit under section 132.

Section 132(e) defines a de minimis fringe as any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable. Under § 1.132-6(c), a cash fringe benefit (other than overtime meal money and local transportation fare) is never excludable as a de minimis fringe benefit.

A wellness program that provides employees with a de minimis fringe benefit, such as a tee-shirt, that would satisfy the requirements to be excluded under section 132(e) would provide a benefit that would be excluded from an employee's income notwithstanding the fact that the de minimis fringe benefit (the tee-shirt) is not medical care under section 213(d). However, the employer payment of gym membership fees that does not qualify as medical care as defined under section 213(d) would not be excludible from the employee's income, even if provided through a wellness plan or program, because payment or reimbursement of gym fees is a cash benefit that is not excludable as a de minimis fringe benefit. Cash rewards received from a wellness program do not qualify as the reimbursement of medical care as defined under section 213(d) or as an excludible fringe benefit under section 132, and therefore are not excludible from an employee's income.

Generally, an employee choice between two or more benefits consisting of taxable benefits such as cash and nontaxable benefits such as employer-provided health coverage results in a cafeteria plan the benefits under which are included in income unless the choice is provided in accordance with the rules under section 125. Under section 125, an employer may establish a cafeteria plan that permits an employee to choose among two or more benefits, consisting of cash (generally, salary) and qualified benefits, including accident or health coverage. Pursuant to section 125, the amount of an employee's salary reduction applied to purchase such coverage is not included in gross income, even though it was available to the employee and the employee could have chosen to receive cash instead. If an employee elects salary reduction pursuant to section 125, the coverage is excludible from gross income under section 106 as employer-provided accident or health coverage.

Revenue Ruling 2002-3, 2002-3 I.R.B. 316, addresses the situation in which an employer has an arrangement under which employees may reduce their salaries and have the salary reduction amounts used to pay health insurance premiums for the employees. In addition, that employer makes payments to the employees that reimburse a portion of the amount of 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 the employees for amounts paid by the employees for health insurance coverage that was excluded from gross income under section 106(a) (including salary reduction amounts pursuant to a cafeteria plan under section 125 that are applied to pay for such coverage). Accordingly, the reimbursement amounts are included in the employee's gross income under section 61, and are wages subject to employment taxes under sections 3121(a), 3306(b), and 3401(a).

DISCUSSION

In *Situations 1, 2, and 3*, the coverage provided by the wellness program is excluded under section 106(a) as coverage under an accident and health program. The health screenings and other medical care as defined under section 213(d) provided to employees by the program are excluded from the employees' income under section 105(b). If an employee earns a cash reward under the program, the amount of the cash reward is included in the employee's gross income under section 61 and is a payment of wages subject to employment taxes under sections 3121(a), 3306(b), and 3401(a). Similarly, if the employee earns a reward of a benefit not otherwise excludible from the employee's income, such as the payment of gym membership fees, the fair market value of the reward is included in the employee's gross income under section 61 and is a payment of wages subject to employment taxes under sections 3121(a), 3306(b), and 3401(a).

In addition, in *Situation 3*, that the payment to employees of reimbursements for all or a portion of the premiums paid by salary reduction is made through a wellness plan does not distinguish this arrangement from the arrangement addressed in Revenue Ruling 2002-3. Accordingly, the exclusions under sections 106(a) and 105(b) do not apply to amounts paid to employees as reimbursements of a portion of the premium for the wellness program that is excluded from gross income under section 106(a) (including salary reduction amounts pursuant to a cafeteria plan under section 125 that are applied to pay for such coverage). Accordingly, the reimbursement amounts are included in the employee's gross income under section 61 and are payments of wages subject to employment taxes under sections 3121(a), 3306(b), and 3401(a).

Please call me at (202) 317-6000 if you have any further questions.