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## **Employer Penalty Alert for Reimbursing Employee Health Coverage**

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The *Affordable Care Act* (ACA) established a number of so-called "market reform" restrictions on employer-provided group health plans, starting with plan years beginning in 2014. These restrictions generally apply to all employer-provided group health plans -- including those furnished by small employers with less than 50 workers. Even worse, there's a punitive penalty for running afoul of the market reform restrictions. The penalty, under Internal Revenue Code Section 4980D(b)(1), equals \$100 per-day per-employee, which can amount to up to \$36,500 per-employee over the course of a full year.

In fact, according to the IRS and the U.S. Department of Labor (DOL), the market reform restrictions can penalize employers for offering plans that simply reimburse employees for premiums paid by them for individual health insurance policies. We will call such plans "employer payment arrangements." This article explains what you need to know to avoid the punitive market reform penalty on such arrangements.

But first, let's cover some necessary background information.

### **Employer Payment Arrangement Basics**

Employer payment arrangements have long been a popular way for smaller employers to help their employees to obtain health coverage without the hassle and expense of furnishing a full-fledged company health insurance plan. Another advantage is that employees are free to select coverage that meets their specific needs instead of being stuck with a one-size-fits-all company plan.

Under an employer payment arrangement, the employer reimburses participating employees for premiums paid for their individual health insurance policies. To qualify for tax-free treatment under the federal income tax rules, the employer must:

1. Make the reimbursements under a written Section 105 medical reimbursement plan; and
2. Verify that the reimbursements are spent for health insurance coverage.

## **Market Reform Restrictions and Recent Government FAQ**

In 2013, the IRS guidance (*Notice 2013-54*) that stipulates tax-free employer payment arrangements are considered group health plans subject to the ACA market reform restrictions. With a few limited exceptions, such plans fail to meet ACA requirements because, among other reasons, group health plans that are used to purchase coverage in the individual market cannot be integrated with individual market policies.

However, many business owners hoped that plans that reimburse employees on an after-tax basis (instead of on a tax-free basis) would not be treated as employer plans that are subject to the market reform restrictions and the punitive penalty. Those hopes have now been dashed.

According to frequently asked questions (FAQ) posted on the DOL website in November, an employer arrangement that reimburses employees for individual market policies is considered to constitute a group health plan, subject to the market reform restrictions and the punitive penalty, whether the reimbursements are treated as tax-free or after-tax (meaning taxable).

More specifically, the FAQ states:

*If an employer arrangement provides cash reimbursements to employees for the purchase of individual market policies, the arrangement will be considered for ACA purposes to be a plan established or maintained for the purpose of providing medical care to employees. It doesn't matter if the employer treats the premium reimbursements as a tax-free benefit or as additional taxable wages.*

As stated earlier, such an employer payment arrangement doesn't comply with the ACA market reform rules because cash payments from an employer cannot be integrated with an individual market policy. Therefore, an employer payment arrangement can trigger the punitive penalty, whether the arrangement is treated by the employer as tax-free or taxable.

### **Impact on S Corporations**

Many S corporations have set up employer payment arrangements to reimburse employees who own more than 2 percent of the company stock (more-than-2 percent shareholder-employees) for their individual health insurance premium costs. Under existing IRS rules, the reimbursements are treated as additional taxable wages that are not subject to Social Security or Medicare taxes. Qualifying more-than-2 percent shareholder employees can then deduct their premiums on their individual federal income tax returns under the special break for self-employed health insurance premiums. The company can deduct the reimbursements as compensation expense.

Unfortunately, such employer payment arrangements run afoul of the ACA market reform restrictions and can, therefore, trigger the punitive penalty. Therefore, unless and until something changes, such arrangements need to be reconsidered.

## Limited Exception for One-Employee Employer Arrangements

About the only good news here is that the ACA market reform restrictions and the punitive penalty do not apply to employer payment arrangements, including S corporation arrangements, which have only one participating employee. Therefore, according to *IRS Notice 2013-54*, such arrangements can still be used to reimburse one employee for his or her individual health insurance premiums without triggering the expensive market reform penalty.

**Warning:** Employer payment arrangements generally must cover all full-time employees in order to avoid IRS non-discrimination rules, under Internal Revenue Code Section 105(h). That said, the non-discrimination rules under Treasury Regulation 1.105-11(c) allow employers to exclude workers who:

1. Have less than three years of service;
2. Have not attained age 25; or
3. Meet the definition of part-time or seasonal employees.

### Conclusions

The ACA market reform restrictions penalize the use of employer payment arrangements to subsidize or reimburse employees for individual market health insurance policies -- if more than one employee participates in the arrangement. Similarly, employers cannot directly pay premiums for individual market policies on behalf of their employees without triggering the penalty.

***The bottom line is that the market reform penalty is so punitive that employer payment arrangements are basically off limits unless they only cover one worker.*** However, employers can still choose one of the following options without triggering the market reform penalty:

- Provide a tax-free fringe benefit by paying for an ACA-approved employer-sponsored group health plan. Small employers with 50 or fewer employees can provide a group health plan through the SHOP Marketplace. Under Internal Revenue Code Section 125, employers can also set up cafeteria benefit plans to allow employees to pay for their shares of the cost of coverage with tax-free salary reductions.
- Increase employees' taxable wages to help them pay for individual health insurance policies. However, the employer cannot require that the funds be used for that purpose. In these cases, the employer can claim compensation deductions for the additional wages, but the wages will be subject to federal income tax at the employee level and federal employment taxes at both the employee and employer levels. Qualifying employees can claim itemized medical expense deductions for the premiums, subject to the tax-law limitations on those write-offs.

If you have any questions about your company's health coverage and the tax implications under the Affordable Care Act, consult with your tax or your benefits advisor.