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## **Employee Healthcare Benefit Plans**

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There are different types of employer-sponsored healthcare benefit plans. They include:

- premium only plans (POPs),
- flexible spending accounts (FSAs),
- health reimbursement arrangements (HRAs), and
- health savings accounts (HSAs).

In this article we will introduce these plans very briefly, and in the articles that follow we will explore them in more detail.

### **Premium Only Plans (POPs)**

A premium only plan (POP) is an employee benefit plan in which the employer pays all or part of the premium on behalf of employees. Not only health insurance, but also disability income insurance, group life insurance, and other coverages may be offered under a POP. Employer premium payments and benefits are not included in an employee's taxable income, but employees may not in theory deduct their own premium payments unless they are able to claim a large amount of medical expenses. In practice, however, POPs are usually offered under a Section 125 cafeteria plan, in which case employee contributions to premiums are paid by means of pretax salary reductions and excluded from income. (We'll look at the tax treatment of employee healthcare benefit plans in next week's article.)

### **Flexible Spending Accounts (FSAs)**

A trend in employee healthcare benefits is the growing popularity of flexible spending accounts (FSAs). They work like this: Employees, and sometimes employers, pay money into the FSA, and employees draw funds from it to pay for deductibles, copayments, coinsurance, and medical expenses not covered by their health insurance plan. Employer contributions are not taxable to employees, and assuming that the FSA is structured under a cafeteria plan, employee contributions take the form of pretax salary reductions and are not included in employees' taxable income.

#### **EXAMPLE**

*Charlie works for Big Trucks, Inc. Big Trucks sponsors an FSA under a cafeteria plan and contributes \$1,000 to it annually for each employee. Employees may also contribute, and Charlie elects to place \$1,200 per year in the FSA. Each month, \$100 is deducted from his paycheck, reducing his taxable wages from \$2,000 to \$1,900. When Charlie incurs medical expenses not covered by his health insurance, he is reimbursed from the FSA, and he may draw as much as*

*\$2,200 from his FSA account each year. Of course, Charlie is paying his uninsured expenses partly with his own FSA contributions, but he benefits because this money is untaxed.*

### **Health Reimbursement Arrangements (HRAs)**

In a health reimbursement arrangement (HRA), an employer pays a set amount into an account for each employee, and (as with an FSA) the employee is reimbursed from the account for out-of-pocket healthcare expenses. Employer contributions to an HRA are excluded from employee income; employee contributions are not allowed.

#### **EXAMPLE**

Big Five Company pays \$1,000 annually into an HRA account for each employee. Judith, a Big Five employee, uses this money to pay the deductible of her health plan, copayments and coinsurance, and medical expenses not covered by the plan. The \$1,000 is not included in Judith's income for tax purposes.

### **Health Savings Accounts (HSAs)**

The health savings account is the newest entrant in the field of employee healthcare benefits. It was created by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, which included IRC Section 223 governing its operation. The first HSAs were established in 2004.

Like an FSA, an HSA is an account into which both the employer and employees may contribute and from which employees draw funds to pay certain expenses. As with an FSA, employer contributions to an HSA are not included in employee income, and employee contributions are not taxable. But there are also significant differences between the two types of plans, the most important of which are the following:

- An HSA need not be sponsored by an employer—an individual may establish one for his or her own use.
- To be eligible to participate in an HSA, an individual must be covered by a qualified high-deductible health plan (as defined in the regulations).
- Funds can be drawn from an HSA for any reason, not just uninsured medical expenses (although withdrawals are tax-free only if they are for medical purposes).

## **The Taxation of Employer-Sponsored Health Insurance**

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The federal tax laws have generally been written with the goal of encouraging employer sponsorship of healthcare benefit plans and employee participation in such plans. To this end, tax benefits are offered to both employers and employees.

In this article, we'll describe the basic legal and regulatory framework that governs the taxation of health insurance. We offer a broad overview of key sections of the Internal Revenue Code (IRC) related to employer-sponsored health insurance, with a focus on the following topics:

- the exclusion of employer-paid health insurance premiums from employee income,
- the exclusion of health insurance benefits from employee income,
- the deduction of health benefit expenditures by employers,
- the deduction of health insurance premiums by employees, and
- cafeteria plans.

*Examples in italics.*

## **Exclusions from Employee Income**

In general, health insurance premiums paid by an employer on behalf of an employee are excluded from the employee's income.

*Workhard Corporation pays 80 percent of the premium for the health insurance it provides its employees. The annual premium attributable to one employee, Marion, is \$5,000, of which Workhard pays \$4,000. This \$4,000 is not included as wages in Marion's W2 Form and is not subject to income tax.*

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Health insurance premiums paid by employers on behalf of employees are also generally excluded from wages for purposes of employment taxes—that is, FICA (Social Security) and Medicare taxes.

*The \$4,000 that Workhard pays for Marion's health coverage is not included in her Social Security and Medicare wage base. No FICA or Medicare taxes are withheld from Marion's pay for this amount, and Workhard does not have to pay employment taxes on it.*

Benefits paid by employer-sponsored health insurance are also generally excluded from income, provided they are reimbursements for medical care expenses as defined in the IRC.

*Marion incurs \$750 in medical expenses that are reimbursed by Workhard's health insurance plan. This amount is not included in Marion's taxable income, and it is subject to neither income nor employment taxes.*

## **Employer Deductions**

Amounts paid by an employer to provide health benefits to its employees are generally deductible by the employer as reasonable and ordinary business expenses. This deduction is available whether the employer pays health insurance premiums on employees' behalf or pays health benefits to employees from its own funds.

*DEFECO earned \$100,000 in profits last year. The company also paid \$10,000 in health insurance premiums on behalf of its employees. It deducts this \$10,000, reducing earnings to \$90,000. Assuming a 30 percent rate, DEFECO's taxes are \$27,000. If DEFECO had not been able to deduct the premiums, its taxes would have been \$30,000.*

## **Employee Deductions**

As a general rule, health insurance premiums paid by employees are not deductible. However, such premiums are considered medical care expenses, and to the extent the total of all medical care expenses exceeds 7.5 percent of adjusted gross income (AGI), an itemized deduction is allowed.

*Max and Edith have an adjusted gross income of \$30,000. During the year they paid \$2,000 for their share of the premium for employer-sponsored health insurance. They also paid \$3,000 for deductibles, copayments, coinsurance, and prescription drugs (which are not covered by their health plan). Their medical care expenses total \$5,000, and this amount exceeds 7.5 percent of their AGI (\$2,250) by \$2,750. They can claim \$2,750 as an itemized deduction.*

## **Cafeteria Plans**

However, employees can deduct their own health insurance premium payments if, as is often the case, the health coverage is offered under a **Section 125 cafeteria plan** (named for the IRC section that authorizes it). Under such a plan, employees may elect certain benefits (including not only health insurance but also group life insurance, disability income insurance, and other coverages) and pay their portion of the cost by means of pretax salary reductions. The amount an employee pays is deducted from the employee's paycheck and excluded from his or her income for purposes of both income and employment taxes.

*Spiral Services offers health insurance to its employees under a Section 125 cafeteria plan. Spiral pays 80 percent of the premium, and employees pay the balance. Sam enrolls and agrees to a \$150 monthly salary reduction to cover his share of the premium. Spiral deducts this amount from Sam's paycheck, reducing it from \$2,000 to \$1,850. For purposes of income and employment taxes, Sam's monthly income is \$1,850.*

To learn more about employee healthcare benefits plans, read the AHIP book [Employee Healthcare Benefits: An Introduction to POPs, FSAs, HRAs, and HSAs](#).