OEA **EDUCATION POLICY RESEARCH & MEMBER ADVOCACY Bulletin**

Update on Providing Cash Incentives for Employees Who Choose to Waive Health Insurance Coverage Under the Affordable Care Act

July 2015

Following several issues in recent contract negotiations, EPRMA was requested to clarify the status of "in-lieu-of" payments. For purposes of this bulletin, "in-lieu-of" payments are payments made by an employer to an employee who chooses to waive employer-provided health insurance coverage. These payments are also sometimes referred to as cash-in-lieu payments, rebates, and waivers.

Executive Summary:

- Following changes made by the Affordable Care Act ("ACA"), in-lieu-of payments must be made through a Section 125 cafeteria plan, or the employees who choose not to receive such payments will be treated, for federal tax purposes, as having received the payments;
- These payments are sometimes referred to as cash-in-lieu payments, rebates, and waivers. Any payment from an employer to an employee in return for the employee not taking the employer's health insurance plan, regardless of its particular label in a contract, should now be listed as an option in the 125 plan document;
- If cash in-lieu-of payments made to employees in return for their voluntary waiver of employer-provided health insurance are not part of a Section 125 cafeteria plan, the employees who select the health benefits instead of the cash payments will be treated, for tax purposes, as having elected the cash regardless of the employee's actual selection under the doctrine of constructive receipt;
- These payments should also not be made for the purpose of the employee(s) using the payments to purchase health insurance elsewhere;
- Contract language should be examined to make sure in-lieu-of payments are being listed as an option in the Section 125 cafeteria plan document or that the payments are being made in compliance with federal law to avoid the doctrine of constructive receipt. The language should also not make purchasing health insurance elsewhere as the purpose of the payments.

Employer-sponsored Section 125 cafeteria plans are the only way that the Internal Revenue Code allows employees to elect and make pretax payments for certain benefits through salary reduction. A Section 125 cafeteria plan provides participants an opportunity to receive certain benefits on a pretax basis. Participants must be permitted to choose among at least one taxable benefit (such as cash) and one qualified, untaxed benefit (such as health coverage). Following changes made by the ACA, in-lieu-of payments must be listed as an option offered to employees under a Section 125 cafeteria plan to avoid employees facing serious tax issues under the doctrine of constructive receipt.[1]

Under the doctrine of constructive receipt, when an employee is offered the option between nontaxable benefits and taxable benefits, and there is no Section 125 cafeteria plan available, even if the employee chooses the nontaxable benefit(s), the IRS can take the position that the employee had constructive receipt of the cash and that this cash amount must then be included in the employee's personal income for the taxable year, even though s/he elected not to actually receive the cash. As a result, every employee given the option between taxable and nontaxable benefits must report the value of the benefits as additional income for the year that benefit was made available to them.[2]

Section 125 cafeteria plans provide a partial exemption to the doctrine of constructive receipt.[3] Because of the limitations placed on benefits under a Section 125 cafeteria plan, employees who elect benefits rather than cash under the plan are not subject to the doctrine of constructive receipt and do not need to report the value of the benefits as income. Only those employees who select the payments, either by choosing not to allocate money pre-tax to benefits or by receiving an in-lieu-of payment, need to include the amount as additional income. Therefore, by offering health benefit options through a Section 125 cafeteria plan, an employer is able to avoid the consequences of the doctrine of constructive receipt. Regardless of whether there is a Section 125 cafeteria plan in place, employees selecting the cash benefit will be taxed on that cash.

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1 *See* 26 Code of Federal Regulations 1.451-2(a) for a more detailed summary of the constructive receipt rule.

2 *Id*.; *see also* Internal Revenue Code § 451 (general rule about what items must be included in taxable income for a particular year).

3 26 Code of Federal Regulations 1.451-2(a).

A table is provided below to aid in understanding:

Scenario	Benefit Should be Taxed (Yes/No)
Cash is given to an employee who voluntarily waives employer-provided insurance	Yes
Employee chooses to enroll in employer-provided insurance, but the employer offers in-lieu-of payments without a Section 125 cafeteria plan listing such benefits as an option	Yes
Employee chooses to enroll in employer-provided insurance and any in-lieu-of payment is mentioned as an option in the employer-sponsored Section 125 cafeteria plan	No

Example: District Local Schools provides in-lieu-of payments as part of its collective bargaining agreement, but does not have a Section 125 cafeteria plan in place. The amount of the payment is $2,500 annually. Employee A participates in the district-provided insurance. Because he is on the district's insurance, he does not receive the in-lieu-of payments provided for in his contract. Employee B is enrolled in other insurance through his spouse and chooses to take the in-lieu-of payments. Because there is not a Section 125 plan in place from which the in-lieu-of payments are made, *both* Employees A and B are treated, for federal tax purposes, as having received $2,500 more in income, even though Employee A never actually received the $2,500.

In addition, according to IRS Notice 2013-54, 2014 FAQ XXII, and 2015 FAQ XXIII, even when employers have set up a Section 125 cafeteria plan and have an in-lieu-of cash payment option listed therein, there may still be an issue in complying with the ACA market reforms, such as the ban on lifetime and annual dollar limits for essential health benefits and the mandate for non-grandfathered plans to cover preventive services, if the in-lieu-of payment is for the purpose of helping the employee purchase health insurance elsewhere. In this scenario, the payment is also referred to as premium reimbursement arrangement. Here, the payment may be considered a group health plan itself because the IRS can view this situation as the employer contributing towards the employee's health care coverage. As such, the arrangement would need to satisfy the ACA market reforms, which it will not because in-lieu-of payments, by their very nature, have annual dollar limits and most likely could not cover preventive services without cost-sharing requirements.

What would likely be permissible, and would most likely not be considered a group health plan by the IRS, would be when an employer makes a fixed, taxable in-lieu-of payment under a Section 125 cafeteria plan to employees who voluntarily opt out of the employer's group health plan and the cash is not required to be used to pay for other coverage.

Example: District Local Schools provides its employees, through the collective bargaining agreement, in-lieu-of payments offered as an option in a Section 125 cafeteria plan. However, the contract states that the payments are "for the purpose of purchasing health coverage elsewhere." The IRS would invalidate this arrangement.

Please also note that because employer-provided health insurance only needs to be *offered* to full-time employees (i.e., not *accepted*), in-lieu-of payments and employees opting out of employer-provided health coverage in general does not violate the ACA's employer mandate that requires all large employers to make health coverage available to 95% of all their full-time employees.

Field staff should review any contracts that provide for in-lieu-of payments to ensure these payments are listed as an option in a Section 125 plan sponsored by the employer. Alternatively, contract language could specify that these payments are made in compliance with federal law. In addition, the language in the contract should not indicate the purpose of these payments is for the purchase of health insurance elsewhere. For more information, contact Matt Whitman at whitmanm@ohea.org.

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