Employer Shared Responsibility
Cash in Lieu of Health Benefits
February 2016

In addition to Employer Shared Responsibility, this article also covers Individual Shared Responsibility, and Exchanges.

A growing number of employers offer a cash in lieu or pay in lieu of benefits option, under which the employer offers an employee a taxable cash incentive, or opt out amount, if the employee declines coverage under the employer’s group health plan. Some employers require employees to certify that they have other coverage in order to opt out of the group health plan, while others allow employees to opt out even if they do not certify they have other coverage. The rationale for such option is that it costs the employer less to pay the opt out amount than to subsidize the employee’s coverage under the group health plan.

Although it is legal to offer a cash incentive to employees who opt out of the employer’s group health plan, there are numerous important considerations:

1. The option should be offered through a Cafeteria Plan so employees who elect group health plan coverage will not have taxable income.
2. The cash in lieu amount may have to be counted in the affordability determination under the Affordable Care Act (ACA).
3. The option should not be provided to enable an employee to purchase an individual policy, whether on or off the exchange.
4. The option should be offered to all eligible employees, not just to a select few, and should not be offered primarily or exclusively to employees who have high claims.

Employers who are considering, or already have, an opt-out or cash in lieu option should consult with competent benefits counsel to ensure the option is offered in a way that will not result in taxable income to employees or penalties to the employer.

1. The option should be offered through a Cafeteria Plan so employees who elect group health plan coverage will not have taxable income.

The Cafeteria Plan regulations provide that IRC §125 “is the exclusive means by which an employer can offer employees an election between taxable and nontaxable benefits” without the election itself resulting in taxable income to the employees. If the choice is offered, but not through a Cafeteria Plan, there will be tax consequences for employees who did NOT opt out. Employees who did not opt out must include in gross income the value of the taxable benefit with the greatest value that they could have elected to receive. This is because these employees will be deemed to be in constructive receipt of the taxable amount they could have elected to receive, even though they declined it and elected nontaxable health benefits instead.

Example: Employer NiceCo will pay $450/month toward self-only medical coverage for each employee, and the employee must pay $60/month toward self-only coverage. This is a non-taxable benefit to employees. NiceCo also wants to allow employees who have coverage through a spouse’s plan to opt out of NiceCo’s coverage and instead receive an additional $60/month from the employer. The $60 opt-out amount, or cash in lieu option, would be taxable income to the employee.

- If this option is offered outside a Cafeteria Plan, the $60/month opt-out amount will be taxable to all employees who could have elected to opt out, even those who elected to have the non-taxable benefit of coverage under the
Additional, NiceCo will have to pay its share of employment taxes, i.e., FICA/FUTA, on the $60. If this option is offered inside a Cafeteria Plan, the $60/month opt-out amount will only be taxable to employees who elect it, and not to those who elect to have coverage under the NiceCo group health plan.

**Special Rule: When the cash in lieu option might not be taxable, even if offered outside a Cafeteria Plan.**

In limited circumstances, there is an argument that some employees would not have imputed income if the opt-out choice were offered outside a Cafeteria Plan. However, this arrangement would have administrative challenges and would result in additional taxes on those employees who did not meet the exception, so employers who offer a cash in lieu option should do so through a Cafeteria Plan.

It’s not entirely clear under the 2007 proposed Cafeteria Plan regulations, additional guidance would be helpful, but it appears under Example 4 of Prop. Regs. §1.125-1(b)(4)(iii), that the cash in lieu option, the additional $60/month in the example above, would not be taxable to certain employees (detailed below) even if it were offered outside a Cafeteria Plan, in the following circumstances:

- In order to receive the cash in lieu amount, an employee who opts out of employer group health plan coverage must provide proof of other coverage, and
- Employees who opt out but do not provide proof of other coverage are not eligible for the cash in lieu amount.

The employees who would not have to include the additional $60 as taxable income are:

- Employees who do not have other group health coverage available. Since they do not have other coverage available, they do not have the option of receiving the taxable cash in lieu amount instead of non-taxable coverage.
- Employees who simply decline coverage and do not provide proof of other coverage, whether or not they actually have other coverage available. These employees are not eligible to receive the taxable cash in lieu amount because they do not provide proof of other coverage.

In both the above cases, the employees’ only options are non-taxable health coverage or no coverage. Thus, Code §125 does not apply because they do not have a choice between taxable and non-taxable benefits, this is per Example 4 in the proposed Cafeteria Plan regulations cited above.

However, tax consequences would apply to an employee who elected non-taxable coverage through the employer’s group health plan, who is married and does have coverage available through his/her spouse’s employer’s group health plan. Such an employee would be a constructive receipt of the $60 cash in lieu amount, because (s)he made a choice between a non-taxable benefit and a taxable benefit, and the choice was not made through a Cafeteria Plan.

As noted, practical administration of this non-Cafeteria Plan option would be difficult, since many employers would not know from their health plan data whether or not an employee who opted out had coverage available through a spouse’s plan. Thus, it would make sense to offer the cash in lieu option through a Cafeteria Plan.

2. **Cash in Lieu amounts may have to be counted in the affordability determination under the Affordable Care Act (ACA).**

Under recent IRS guidance, IRS Notice 2015-87, the IRS will treat forgone unconditional opt-out credits as salary reduction amounts and thus, as part of the employee’s required contribution in the affordability determination under the employer mandate or employer shared responsibility (ESR) provisions of the ACA. This means that for employees who do elect coverage under the employer’s group health plan, the cash in lieu amount will be added to the required employee contribution for self-only coverage in determining if the self-only coverage is affordable. An unconditional arrangement is one under which an employee can receive the opt-out payment simply by waiving coverage; in contrast, under a conditional opt-out arrangement an employee must meet another condition, usually showing proof of other group coverage, in order to receive an opt-out payment. For opt-out arrangements that were adopted on or before December 16, 2015, the new IRS rule will not be effective until the 2017 plan year at the earliest (see details below).
Affordability is only an issue for applicable large employers (ALEs) who are subject to the employer mandate. It does not affect small employers. An ALE is an employer, or controlled group of employers, who employed on average at least 50 full-time employees or full-time equivalents in the prior calendar year. An ALE may be subject to penalties under the ACA if coverage offered to a full-time employee is not affordable or does not provide at least minimum value, and if that full-time employee qualifies for a subsidy to buy health insurance in an exchange. Coverage is deemed affordable for an employee if the employee’s required contribution for self-only coverage, in 2016, does not exceed 9.66% (subject to indexing adjustments) of the employee's household income or of one of three safe harbor amounts.

**Example:** Employer NiceCo, an ALE, will pay $450/month toward self-only medical coverage for each employee, and the employee must pay $50/month toward self-only coverage. NiceCo establishes a Cafeteria Plan and allows employees to elect through the Cafeteria Plan to either enroll in NiceCo’s group health plan or to opt out and receive $60/month.

Employee Daniel earns $10/hour. His required employee contribution of $50 per month for health coverage is affordable under the ACA affordability safe harbors, even under the Federal Poverty Level safe harbor of $95.63/month for 2016. However, since he is also eligible for an additional employer cash in lieu of payment of $60 per month if he waives coverage, Daniel might be treated as having coverage with a required employee contribution of $110 per month ($50 + $60) when determining whether the coverage is affordable. If the coverage is not affordable, NiceCo would be subject to a penalty under Code section 4980H(b) of $270/month if Daniel opted out of employer coverage and qualified for a subsidy to buy coverage in the exchange. Daniel is unlikely to do this if he is single, since he will likely pay at least $50/month for less generous coverage in the exchange. However, if Daniel has a family he may qualify for family coverage at a much lower cost through the exchange than through his employer’s plan.

**Effective Date:** As noted above, there is a delayed effective date for opt-out arrangements that were adopted on or before December 16, 2015. Such opt-out payments do not have to be included in the affordability calculation until an unspecified date which will be provided in future regulations, and at least through the end of plan years that begin before January 1, 2017. Additionally, the employer is not required to report the opt-out payment as an employee contribution on Form 1095-C until the date specified in future regulations.

An arrangement is considered to be adopted on or before December 16, 2015, if:

- The arrangement or a substantially similar one was offered for a plan year that includes December 16, 2015; or
- The arrangement was adopted by a board, committee or authorized officer on or before December 16, 2015; or
- Employees had received written communications on or before December 16, 2015, that the opt-out arrangement would be offered to employees in the future.

3. **The option should not be provided to enable an employee to purchase an individual policy, whether on or off the exchange.**

Employers who offer an opt-out payment should clearly state in all plan documents and communication materials that the opt-out payment is not made to reimburse employees for purchasing individual health insurance policies, whether on or off the exchange. The IRS has stated in four different sets of guidance that if an employer reimburses employees for purchasing individual policies, such arrangement is probably an employer payment plan that by its nature violates ACA’s prohibition on annual dollar limits and the ACA requirement to provide first-dollar coverage of preventive services.

4. **The option should be offered to all eligible employees, not just a select few.**

If the option is offered through a Cafeteria Plan, the opt-out option should be offered to all eligible participants, not just to a select few. The Cafeteria Plan non-discrimination rules generally require that all options be offered to all Cafeteria Plan participants.

Even if the cash-out option is offered outside a Cafeteria Plan, there are potential issues if it is available only to select employees.

**Example:** If an employer were to offer the opt-out option only to high-claims employees. An employer might do this to encourage high-claims employees to buy other insurance instead of enrolling in the employer's plan,
Employer Shared Responsibility
Cash in Lieu of Health Benefits
February 2016

thus reducing the employer’s costs. Opt-out incentives that are available only, or primarily, to employees who have a history or risk of high-cost claims are problematic under various laws.

In ACA FAQ 22, the IRS, DOL, and HHS jointly explained that this practice constitutes prohibited discrimination based on health status factors under the ACA and under HIPAA. The agencies rejected the argument that this practice is actually benign discrimination i.e., more favorable to employees with worse health status for two reasons:

First, the actual cost of coverage is greater for high-risk employees because it includes the forgone cash. FAQ 22 gives this example: If employees must pay $2,500 annually toward the cost of employee-only coverage under the plan, but the employer offers a high-claims-risk employee $10,000 in additional compensation if the employee declines the coverage, for purposes of the health status discrimination analysis, the effective required contribution by that high-claims-risk employee for plan coverage is $12,500.

Second, FAQ 22 says the cash-or-coverage offer is an eligibility rule that discourages participation in the group health plan based on a health factor. Thus, such arrangements violate the health status nondiscrimination provisions, regardless of whether (1) the employer pays the cash in lieu amount on a pre-tax or after-tax basis, (2) the employer is involved in the selection or purchase of any individual coverage, or (3) the employee even buys an individual policy.

Offering high-claims employees cash to opt out of the employer’s plan might also raise concerns under HIPAA’s privacy rules, that the employer may be improperly using PHI, i.e., health status or claims history of certain employees, for a non-plan use. There is also the risk that an employee who accepts the opt-out incentive might later claim it was coercive. For example, if the employee opted out and bought other coverage and later became dissatisfied with it, the employee might claim the employer interfered with the employee’s right to participate in the group health plan i.e., an ERISA §510 claim for an ERISA plan. Other federal laws could also be implicated, such as the Americans with Disabilities Act (ADA) or the Age Discrimination in Employment Act (ADEA), depending on how the employer defines the group that is eligible for the opt-out incentive.

Next Steps for Employers
Employers who offer or are considering an opt-out or cash in lieu option should consult with competent benefits counsel to ensure the option is offered in a way that will not result in taxable income to employees or penalties to the employer.

At a minimum, we advise that all employers:

• Only offer the option through a Cafeteria Plan.
• Clearly state in all plan documents and employee communications that the opt-out payment is not made to reimburse employees for buying individual health insurance policies.
• Offer the opt-out option to all eligible employees, not to just a select few.

Applicable large employers also should:

• Review the possible effect on the employer’s compliance with the affordability provision.
• Review existing opt-out arrangements to confirm if they were adopted on or before December 16, 2015.
• Determine whether the employer wants to implement a conditional opt-out arrangement if no opt-out arrangement was adopted on or before December 16, 2015.
• Keep in mind that any type of opt-out arrangement will have to be reviewed, and possibly revised or eliminated, once future regulations are issued.

This document is not intended to be exhaustive, nor should any information be construed as tax or legal advice. Readers should contact a tax professional or attorney if legal advice is needed. Although we have made every effort to provide complete, up-to-date, and accurate information in this document, such information is meant to be used for reference only. If there is any inconsistency between the information contained in this document and any applicable law, then such law will control.