



It seems as if, at least once a week, somebody asks me about running voluntary benefits such as critical illness or accident insurance through a section 125 cafeteria plan or a section 105 reimbursement account. In most cases, insurance brokers and carriers are not qualified to give tax advice, but many are wandering into CPA territory and sharing the first part of the pre-tax story – the FICA savings available to an employer. Let's assume an employee purchases a \$15,000 Critical Illness Policy for \$350 per year and pays with pre-tax premiums. The employer essentially reduces their payroll by \$350 saving 7.65% of that in payroll taxes (6.2% for Social Security and 1.45% for Medicare) or about \$27. With reasonable participation in the plan, this could add up to a sizeable dollar savings.

If that was the end of the story, then every employer would be pre-taxing all the voluntary benefits they could. In reality, this practice is one that many insurance carriers either refuse to support, or require employees and/or employers to sign disclosures and waivers to support. Why would many carriers take a stance against a promising sales strategy? When we take a closer look, it appears that capitalizing on the FICA tax savings could have some pretty serious consequences for employers and employees.

The trouble for the employee is fairly straightforward in the taxability of the benefit. Let's suppose the employee above is in the 20% tax bracket. Pre-taxing the premium saves them \$70 per year in income taxes. However, should they experience a claim, the benefit becomes taxable to the extent that the benefit exceeds their out of pocket medical costs. So if their out of pocket costs were \$3,000, the remaining \$12,000 would be considered taxable income by the IRS. Carriers usually do not withhold taxes on these benefits, so it is incumbent upon the employee to know of and plan for the tax burden coming next April 15th. The more likely outcome is an employee getting a January surprise in the form of a 1099 following a critical illness. This spike in taxable income could bump an employee into a higher tax bracket creating an even bigger tax problem for the employee. On the human front, the employee would be experiencing all this extra financial stress while recovering from a serious health crisis. In this scenario, that \$27 of FICA savings may have cost an employee their financial and emotional wellbeing.

The trouble for the employer is a little more complicated. With the Affordable Care Act surviving yet another Supreme Court challenge, though, this trouble is becoming more of a reality. I have written about [the unintended consequences of the Excise or Cadillac tax](#) in the past. This tax once again rears its head in the pre-taxing of voluntary benefits. The ACA establishes certain value thresholds for medical plans; any self-insured employer whose plan value exceeds these thresholds is subject to the excise tax. The employer's excise tax liability is 40% of the amount of excess, and is not tax deductible to the employer. According to recent Treasury guidance, offering voluntary benefits such as Critical Illness pre-tax means they probably will count toward the value of the plan. If the employer's plan is close to, or already surpasses the threshold, then the \$350 of premium will now be subject to the 40% tax. Offering the benefits post tax allows them to not be counted toward the threshold. The \$27 FICA tax savings resulting from pre-taxing could essentially cost the employer up to \$140 of AFTER TAX earnings (this calculation is actually much more complicated than I have indicated here, as a portion of the tax would be paid by the VB carrier). While experts disagree on how many plans will be impacted, the fact that the thresholds are indexed at the inflation rate of the CPI instead of at medical trend means that over time the problem is going to grow and more plans will be subject to the tax.

I admit it is entirely possible that there is another side of the pre-tax story that I am not seeing. Also, I am not a CPA and like most of the people pitching pre-tax voluntary benefit schemes, I am not remotely qualified to offer tax advice. But reading [this IRS publication](#) among others makes me wonder if the insurance industry is doing a disservice to employers and employees every time we talk about pre-taxing voluntary benefits.