

Double Dipping Scheme Ruled Illegal

Last Spring a "double-dipping" scheme where the employer reduces and employee's pay on a pre-tax basis for health insurance premiums and then reimburses the employee with untaxed dollars for those same premiums was making the rounds. The IRS investigated this type of arrangement and declared it **illegal**.

The facts of double dipping - how it was supposed to work

- The employer begins by deducting the entire amount of the insurance premium; let's say \$200.00 for this example, from the employee's paycheck on a pre-tax basis. This is perfectly legal under IRC Section 125.
- Citing the IRC Section 106 and Revenue Ruling 61-146 as its authority, the employer then reimburses the employee for part of the premium expenses deducted from his paycheck. The employer is instructed to reimburse only enough of the premium to increase the employee's paycheck back to the original take-home pay amount

Too Good to Be True

If looked at separately, parts one and two are perfectly legal. It is when they are combined that the issues arise. For an employee to be reimbursed on a nontaxable basis for the insurance premiums, the employee must incur the expense. But, because the premium is being paid with pre-tax dollars, the expense is deemed to have been paid by the employer.

Revenue Ruling 2002-3

IRS Revenue Ruling 2002-3 clearly acknowledges this type of arrangement and declares the reimbursement to be taxable as wages. The IRS holding is as follows: "The exclusions from gross income under §§106 (a) and §105(b) do not apply to amounts that an employer pays to employees to reimburse the employees for amounts paid by an employer for health insurance coverage that are excluded from gross income under §§ 106(a) (including salary reduction amounts pursuant to a cafeteria plan under §125 that are applied to pay for such coverage).

Accordingly, the reimbursement amounts that the employer pays to the employees are included in the employees' gross income under section 61 and are subject to employment taxes under §§ 3401, 3121(a), and 3306(b)."

The employment taxes referred to include federal withholding, federal unemployment and FICA.

***This IRS Revenue Ruling proves once again - if it sounds too good to be true.
It probably is.***

To view or print the entire revenue ruling, go to
<ftp.fedworld.gov/pub/irs-drop/rr-02-3.pdf>