

EMPLOYEE BENEFITS

Cash-in-Lieu of Benefits Arrangements

January 2023

A common question among employers is, “Can we offer employees cash to decline coverage under our employer-sponsored group health plan?” Employers asking this question are typically seeking to reduce benefit costs by incentivizing employees to opt out of coverage under their group health plan. These arrangements/payments, which are often referred to as opt-out credits, cash-out provisions or cash-in-lieu of benefits options, raise several employee benefit compliance considerations of which employers must be aware. Those compliance considerations, which are discussed below, involve some complicated legal issues and, as a result, employers should consult with their employee benefits legal counsel for guidance before implementing such an arrangement.

Cafeteria Plan Requirement

If an employer wishes to offer employees the choice between non-taxable qualified benefits (e.g., accident and health benefits) and taxable wages (e.g., cash), they must do so through a cafeteria plan that complies with section 125 of the Internal Revenue Code (IRC). It follows that if the employer wants to offer employees an additional cash incentive to decline coverage (i.e., offering the employee a choice between electing the employer-sponsored coverage on a pre-tax basis or receiving additional taxable compensation), the arrangement must also be included in a compliant cafeteria plan. Although the arrangement must be offered through the cafeteria plan, any incentive the employee receives in lieu of electing pre-tax coverage must be provided as taxable wages to the employee (i.e., it is subject to income and employment tax withholding). If language regarding the “cash-in-lieu of benefits” option is not included, an employer may need to amend its section 125 cafeteria plan document to incorporate the cash-out feature.

A cash-out arrangement not offered through the employer’s cafeteria plan will result in adverse tax consequences for employees under the doctrine of constructive receipt. In this case, any employee who elects coverage under the employer’s plan will be taxed on the amount of the cash incentive they could have received (despite the fact the employee elected the coverage instead of the cash).



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Nondiscrimination

Cash-out arrangements offered through the employer's cafeteria plan will be subject to the IRC section 125 nondiscrimination rules designed to prevent plans from discriminating in favor of highly compensated employees/individuals. Specifically, under the Contributions and Benefits Test, the employer contributions apportionable to nontaxable and taxable benefits (including cash incentives) must be available on a nondiscriminatory basis. Employers who do not offer the cash-in-lieu of benefits option to all similarly situated employees on an equal basis will need to ensure that the arrangement is not discriminating in favor of highly compensated employees/individuals.

Health Care Reform's Employer Shared Responsibility Provisions

Applicable large employers (ALEs) (defined as employers who averaged 50 or more full-time and full-time equivalent employees in the previous calendar year) will need to consider how an opt-out arrangement may affect the affordability for purposes of the employer shared responsibility penalties (ESRPs). According to the IRS' proposed regulations, unless the opt-out arrangement is considered an "eligible opt-out arrangement," the cash-in-lieu amount offered to employees who decline coverage under the employer's major medical plan increases the employee's premium contribution by the amount of the cash-in-lieu benefit, potentially causing a once affordable employee contribution to become unaffordable for some employees for purposes of ESRPs. This rule applies to employees who receive the cash-in-lieu option and those who enroll in the employer-sponsored plan.¹ An eligible opt-out arrangement is an arrangement in which the opt-

out payment is conditioned on the employee providing reasonable evidence that the employee and their "expected tax family"² has or will have minimum essential coverage/medical coverage (other than coverage in the individual market) during the period of coverage to which the opt-out arrangement applies. As an example, an acceptable opt-out arrangement under the rules is a health plan that only allows the opt-out credit to be paid to employees who sign an attestation stating that they (and members of their tax family) have coverage under a spouse's plan.

Notwithstanding the requirements summarized in the preceding paragraph, the IRS granted transition relief that continues to be available to some arrangements that do not qualify as eligible opt-out arrangements. The IRS initially indicated that the regulations regarding eligible opt-out arrangements would be finalized and effective for plan years beginning on or after January 1, 2017. However, no final regulations have been issued. [IRS Notice 2015-87](#) (Q/A-9) indicates that, if an opt-out arrangement was adopted on or before December 16, 2015, the opt-out payments made under the arrangement need not be treated as increasing the employees' required contributions for affordability purposes even if the arrangement does not qualify as an eligible opt-out arrangement.³ This transition relief is available "[f]or the period prior to the applicability date of regulations," meaning it remains available.

¹ Prop Reg §1.36B-2 Eligibility for premium tax credit.

² An employee's expected tax family is defined as "the employee and all other individuals for whom the employee reasonably expects to claim a personal exemption deduction for the taxable year or years that begin or end in or with the employer's plan year to which the opt-out arrangement applies..." Prop. Treas. Reg. §1.36B-2(c)(3)(v)(A)(7)(iii)(C)

³ Although the regulations have not been finalized, the preamble indicates that employers may rely upon them. As a result, an employer establishing an opt-out arrangement after December 16, 2015, can avoid the adverse impact on affordability by structuring the arrangement as an eligible opt-out arrangement.

HIPAA Special Enrollment

Employers offering a cash incentive to opt out of coverage under the major medical plan will need to consider the implications of an employee's HIPAA special enrollment rights. This will be especially important if the employer offers a lump-sum payment at the beginning of the plan year (instead of monthly payments) to employees who decline coverage through an opt-out program. Whether an employer can require an employee to waive their HIPAA special enrollment rights, or whether the waiver would be enforceable, is not specifically addressed in the regulations or guidance.

Medicare Secondary Payer (MSP) Rules

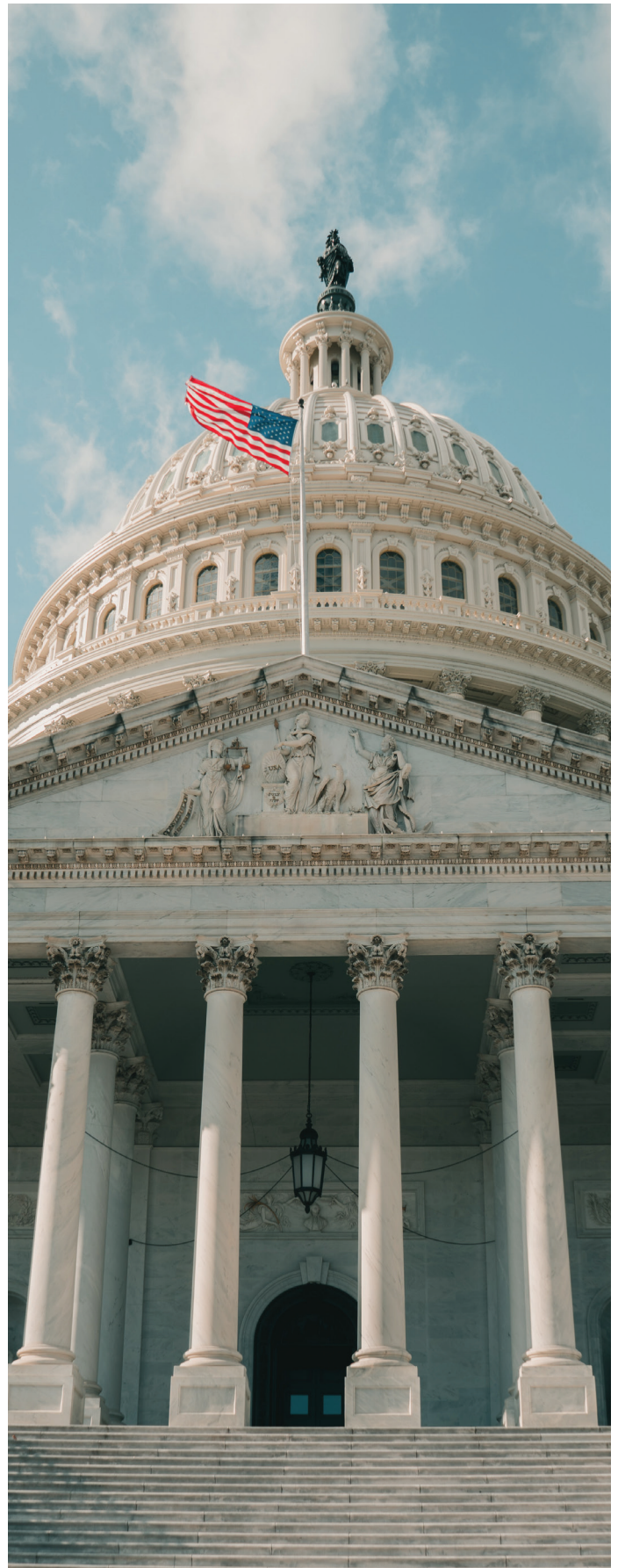
Employers subject to the MSP rules (generally, employers with 20 or more employees) are prohibited from offering any financial or another incentive for Medicare-eligible or entitled individuals to decline coverage (or to terminate enrollment) under a group health plan that would pay primary to Medicare.⁵ Therefore, employers will need to carefully consider whether any employees offered the cash-in-lieu of benefits are eligible for or entitled to Medicare because CMS may take the position that the cash-out option is a financial incentive not to enroll in employer-sponsored coverage even if it is offered to all employees. This may also be true of other government programs such as TRICARE.

Offering Cash to HSA-Ineligible Employees

While technically different than a cash-in-lieu of benefits arrangement under a major medical plan, employers may be able to offer cash-in-lieu of HSA contributions to employees who are HSA-ineligible (e.g., due to non-HDHP coverage under a spouse's plan). If the ability to receive the cash is tied to or dependent upon the employee's election for medical coverage, then the arrangement should be offered under the employer's cafeteria plan, as noted above.

⁴ FAQs About Affordable Care Act Implementation Part XXII, Q/A-2 (Nov. 6, 2014)

⁵ 42 U.S.C. §1395y(b)(3)(C)





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