Departments Propose Taxing Fixed Payments From Employer-Paid Fixed Indemnity Policies

Proposed regulations would tighten excepted benefit rules for fixed indemnity policies; reduce duration of STLDI policies to three months

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Proposed regulations issued by the Departments of Labor, Health and Human Services (HHS), and Treasury (the Departments) would clarify and implement certain changes to the treatment of short-term, limited-duration insurance (STLDI) policies, hospital indemnity or fixed indemnity insurance (fixed indemnity policies) in the group and individual markets, and to the income tax treatment of fixed benefit payments received under employer-provided fixed indemnity policies.

Impact of Proposed Regulations

The proposed regulations were issued on July 7, 2023, and would, if adopted in final form:

- Require taxpayers to include in gross income fixed benefit payments received from employer-provided fixed indemnity policies;
- Clarify and revise when fixed indemnity policies are "excepted benefits" not subject to consumer protections under the Affordable Care Act (ACA), making it more difficult for a fixed indemnity policy to be exempt from the health care mandates of the ACA; and
- Reduce the coverage term of an STLDI policy to an initial term of three months with a maximum duration of four months for renewals and extensions, significantly reducing the current 36-month maximum duration for an STLDI policy.

The proposed regulations relating to fixed indemnity policies and the tax treatment of certain benefits paid to employees under certain benefit plans will be of particular interest to group health plan sponsors who provide those benefits.

Taxable Treatment of Employer-Provided Fixed Indemnity Policies

Under the proposed regulations, payments for employer-provided fixed indemnity policies and other similar arrangements would not be excluded from a taxpayer's gross income, based on the Internal Revenue Service (IRS) and Treasury's interpretation of Section 105(b) of the Internal Revenue Code. The IRS and Treasury note that payment of benefits without regard to the actual amount incurred does not constitute a reimbursement of Section 213(d) medical expenses. Thus, the entire amount of the payment would be taxable income and would not be excluded from gross income under Section 105(b). The proposed regulations also clarify that amounts paid to reimburse medical expenses under Section 213(d) by employment-based health insurance must be substantiated to be excluded from gross income under Section 105(b).

Fixed Indemnity Policies and Excepted Benefits

A fixed indemnity policy is intended to provide an individual with income replacement. A fixed indemnity policy pays the covered individual a fixed amount in cash at predetermined levels, regardless of the actual health care costs incurred by the covered individual. Under current rules, a fixed indemnity policy meeting certain conditions qualifies as an "excepted benefit" that is not subject to certain group health mandates under the ACA and does not provide comprehensive coverage.

Individual Fixed Indemnity Policy. HHS proposes to amend the rules for determining when a fixed indemnity policy in the individual market qualifies as an "excepted benefit." An individual fixed indemnity policy would qualify as an "excepted benefit"—and thus exempt from the ACA's market reform rules—only if the benefits are paid on a per-period basis, without regard to the actual or estimated amount of expenses incurred or services received. Under this proposal, fixed indemnity benefits would be required to be paid in a fixed amount per day of hospitalization or illness (e.g., $100/day) and not on a per-item or per-service basis (e.g., $50 for a blood test or $100 per visit). The proposed rule would align the excepted benefit standard for an individual indemnity policy with the excepted benefit standard for group fixed indemnity policy.

Group Fixed Indemnity Policy. The Departments propose to add a new example to the current group market regulations emphasizing the prohibition against coordinating fixed indemnity coverage with group health plan coverage maintained by the same plan sponsor. This rule would clearly prohibit a benefit package that combines a group health plan providing only minimal coverage (e.g., coverage of preventive services only) with a fixed indemnity policy exempt from the ACA.

The Departments also propose to require a notice when offering fixed indemnity insurance excepted benefit coverage in the group market, which would align with the current notice requirements for fixed indemnity excepted benefit coverage in the individual market.

Reducing the Duration of STLDI

STLDI is a health insurance policy sold by a health insurance issuer that is primarily intended to fill a temporary coverage gap that arises when an individual changes health care plans. STLDI is generally not subject to group health mandates and does not provide comprehensive coverage. Under current regulations, the maximum coverage term of STLDI is 36 months.

These proposed regulations would reduce the maximum term of STLDI to three months from the original effective date, and no longer than four months from the original effective date in the case of any renewals and extensions. There is an exception for an STLDI policy sold or issued prior to the effective date of the final rules, which can still have an initial contract term of less than 12 months and a maximum duration of up to 36 months. Those policies, however, must comply with the revised notice requirements upon any renewal or extension on or after the effective date.

The Departments also propose to amend the notice requirement to make it easier for consumers to understand the difference between STLDI and comprehensive coverage and to emphasize more clearly that STLDI is not comprehensive coverage. The amended notice would apply to all STLDI policies sold or issued (and to extensions or renewals of existing STLDI policies) on or after the effective date of the final regulations.

Resources

A news release is available here.

The proposed regulations are available here.

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