

Benefits Insights

Brought to you by the insurance professionals at
STR Benefits Consulting

Medical Opt-out Payments

Some employers offer their eligible employees a cash incentive to waive coverage under the employer's group health plan. These arrangements, known as "opt-out payments" or "cash in lieu of benefits," are often aimed at employees with working spouses who are eligible for group health coverage through another employer. The employer benefits by avoiding the cost of paying for its share of the premiums while the employee receives the extra cash.

Most opt-out payments are significantly less than the amount the employer saves. Typically, opt-out payments are spread out over the plan year, and are not paid in a lump sum, which allows the employer to reduce its risk of loss in the event an employee terminates employment or experiences a HIPAA special enrollment event.

While medical opt-out payments are generally permissible, there are various legal issues that impact the design of these arrangements, including Affordable Care Act (ACA) compliance concerns. Before offering a health plan cash-out option, employers should consult with their advisors to confirm that the arrangement complies with applicable laws and insurance contract terms.

Taxability of Opt-out Payments

As cash compensation, opt-out payments are taxable to the employee. While coverage under a group health plan is generally nontaxable, opt-out payments are subject to the same tax rules as any other employee compensation.

The cash payments must be included in gross income on the employee's Form W-2 and are subject to federal income tax withholding. These payments are also generally subject to federal employment tax withholding (FICA and FUTA).

Section 125 Cafeteria Plan

Because opt-out payments give employees a choice between health care coverage and taxable compensation, they must be offered through a cafeteria plan under Section 125 of the Internal Revenue Code. The opt-out arrangement must be included under a cafeteria plan that meets IRS requirements in order to avoid taxation of participants who elect health care benefits. To be valid, a cafeteria plan must be established in a written plan document.

ACA Compliance

Proof of Other Coverage

A common design for medical opt-out payments is to require a certification or other form of proof that the employee has health coverage through another source, such as through a spouse's employer. Conditioning the availability of the cash incentive on an employee's purchase of an *individual insurance policy* likely creates an employer payment plan that violates the ACA's market reforms. Violating the ACA's market reforms can trigger penalties, including excise taxes of \$100 per day for each applicable employee.

Also, the ACA's [shared responsibility rules](#) for applicable large employers (ALEs) require certain ALEs to provide employees with an effective opportunity to decline health plan coverage. This requirement applies to ALEs whose health plan coverage does not meet the ACA's affordability and minimum value requirements. Employers may require employees to provide proof of other group health plan coverage to obtain a cash-out payment, but ALEs that do not offer affordable, minimum value coverage cannot require employees to provide this proof to decline the ALE's group health coverage.



Affordability Calculation

To avoid potential penalties under the shared responsibility rules, ALEs must offer affordable, minimum value health coverage to substantially all full-time employees. In general, the affordability of an employer's offer of health coverage depends on whether the employee's required contribution for self-only coverage exceeds a certain percentage of the employee's household income. The Internal Revenue Service (IRS) released [Notice 2015-87](#) and [proposed regulations](#) to provide guidance on how medical opt-out payments impact the affordability calculation. In general, until final regulations are issued, medical opt-out arrangements that were adopted before Dec. 16, 2015, will not increase the cost of employer-provided health coverage.

The IRS' guidance groups medical opt-out arrangements into two general categories:

- *Unconditional medical opt-out payments* – An arrangement where the opt-out payments are conditioned solely on an employee declining coverage under an employer's health plan and not on an employee providing proof of other coverage. According to Notice 2015-87, it is generally appropriate to treat unconditional opt-out payments as increasing an employee's contribution for health coverage beyond the amount of the employee's salary reduction contribution. For example, an employee whose required self-only contribution for health coverage is \$200 per month, but who is eligible for a cash payment of \$100 per month if coverage is waived would be treated as having a required contribution of \$300 per month when determining if the coverage is affordable. Until the proposed regulations are finalized, this guidance applies to unconditional opt-out arrangements that are adopted after Dec. 16, 2015.
- *Conditional medical opt-out payments* – An arrangement where the opt-out payments are conditioned on an employee declining coverage under an employer's health plan and providing proof of other coverage. According to the proposed regulations, these payments would increase an employee's salary reduction contribution when determining the health plan's affordability, unless the arrangement qualifies as an "eligible opt-out

arrangement." An eligible opt-out arrangement is one where the opt-out payments are available only to employees who decline employer-sponsored coverage and provide reasonable evidence that they and their expected tax dependents have or will have minimum essential coverage other than individual market coverage during the plan year. Payments under eligible opt-out arrangements will not be treated as increasing an employee's required contribution until the proposed regulations are finalized.

Other Legal Concerns

Offering opt-out incentives only (or primarily) to employees who have a history of high health claims may violate nondiscrimination rules under the Health Insurance Portability and Accountability Act (HIPAA). Depending on how an employer defines eligibility for the opt-out incentives, other federal laws, such as the Americans with Disabilities Act or the Age Discrimination in Employment Act, could be implicated. Opt-out incentives may violate the Medicare Secondary Payer rules for employers with Medicare-eligible employees (or employees who are married to Medicare-eligible persons).

Also, employers should consider how opt-out incentives may impact the calculation of overtime payments under the Fair Labor Standards Act (FLSA). The opt-out incentives may need to be factored into employees' regular pay when calculating overtime payments, depending on the facts of the specific opt-out incentive arrangement.

In addition, before offering a cash-out option for an insured plan, an employer should confirm that the cash-out does not violate minimum participation requirements or other insurance contract terms.

The following page is an example of a waiver-of-health-coverage form that can be used in a medical opt-out program. This form requires customization.

Sample Waiver of Health Coverage Form

ABC Company

Medical Plan Waiver Form

Plan Year Jan. 1, 20XX–Dec. 31, 20XX

Name: _____

Address: _____

_____ I waive coverage through ABC Company's group health plan for the plan year beginning on Jan. 1, 20XX, and ending on Dec. 31, 20XX. This waiver applies to me and my eligible dependents.

I am declining to enroll for the reason shown below:

Covered by spouse's (or domestic partner's) group coverage

Carrier name/member ID: _____

Enrolled in other group health insurance coverage

Carrier name/member ID: _____

Enrolled in Medicare

Covered by TRICARE

Other (Please explain) _____

I understand that, by declining health coverage through ABC Company, I authorize participation in the ABC Company Section 125 Cafeteria Plan. By waiving this health coverage for the plan year designated above, I acknowledge that I may be required to wait until the next plan year to enroll for group health coverage. In exchange for my waiver of health coverage, ABC Company will pay me \$_____ per pay period (24 pay periods per plan year) for the plan year of Jan. 1, 20XX, through Dec. 31, 20XX, for a total annual deposit of \$_____. I understand that these payments are taxable compensation.

Signed: _____

Date: _____