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Employee Benefits – Question of the Month

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Q: We have decided to offer voluntary accident, critical illness, and hospitalization benefits to our employees – at their cost – and are confused about the tax treatment of such benefits. The carrier's representative is here to sign up employees and is advising them to pay the premiums on a pre-tax basis. She says that because the plans pay "scheduled benefits" rather than a lump sum, employees can both pay the premiums pre-tax and receive non-taxed benefit payments.

That doesn't sound right to me. For our other voluntary benefits (short-term and long-term disability), we make sure employees pay their premiums on an after-tax basis so that any benefits they eventually receive will not be taxed. What am I missing?

A: For the benefit of our readers who may not know, the "worksite" benefits you're describing generally pay policyholders a predetermined amount of money upon the occurrence of certain types of medical problems, such as an accident, cancer, or hospitalization. For example, an employee might receive $1,500 upon first being admitted to the hospital due to an accident, plus $300 for each day in the hospital thereafter.

Your understanding of the tax principles that apply to these types of "worksite" and other voluntary benefits is generally correct: When premiums are paid pre-tax, the benefits themselves are taxed, and when premiums are paid after-tax, the benefits are not taxed.

For the coverages you describe, it is possible that employees could pay premiums pre-tax and still receive some portion of the benefits paid as nontaxable income. However, only the portion of the benefits received that covers unreimbursed medical expenses may be considered nontaxable income. Employees would have to pay taxes on amounts received in excess of unreimbursed medical expenses.

My concern is this: when employees receive these payments from the carrier, how are they going to determine what portion of the benefits is taxable as opposed to nontaxable income? And will they know how or bother to keep track of unreimbursed medical expenses and then use that information to calculate the taxable portion of the benefits and report it on their tax returns? It seems to be a safer bet for employees to pay the premiums after-tax, receive benefits that are clearly nontaxable, and avoid the issue altogether.

With that said, we recommend you talk to an accountant or attorney to see if there are other ways of handling this to optimize the tax treatment for your employees.