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Determining the Taxability of Employer-Provided Executive Health Examination Programs

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Employers historically have maintained executive health examination programs to provide a convenient and efficient means for executives to visit several doctors in one visit, including for vision and annual health checkups. Generally, these programs are covered under employers' self-insured health policies. This article discusses the taxability of employer-provided executive health examination programs and the associated employment tax withholding and reporting requirements.

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Section 61(a) of the Internal Revenue Code of 1986, as amended, provides a list of items included in gross income, among them fringe benefits provided by an employer unless otherwise specifically excluded.

One such exclusion is Code Section 105(b), which applies to amounts paid directly or indirectly to an employee to reimburse expenses incurred for the medical care of the employee, his or her spouse, or the employee's dependents. Code Section 213 defines "medical care" to include "the diagnosis, cure, mitigation, treatment, or prevention of disease." Therefore, costs associated with annual physical examinations of employees generally are excluded from employees' income.

However, pursuant to Code Section 105(h), an exclusion from income is not available where a self-insured health plan discriminates in favor of highly compensated employees with respect to eligibility and/or the level of benefits provided. In other words, benefits provided by a discriminatory self-insured health plan are taxable wages to highly compensated employees and are subject to employment tax withholding and reporting requirements.

A "highly compensated" employee is defined as an individual who is

- one of the five highest-paid officers;
- a shareholder who owns more than 10 percent in value of the employer's stock (taking into account the constructive stock ownership rules described in Code Section 318); or
- among the highest-paid 25 percent of all employees (other than certain excluded employees who are not participants).

Eligible executives receiving benefits under health examination programs may fall within this definition of highly compensated employees.

Medical Diagnostic Procedures

Regulations issued by the U.S. Department of the Treasury, however, include an exception for plans that provide "medical diagnostic procedures." That is, a medical diagnostic procedure arrangement may be designed to discriminate in favor of highly compensated employees (but not their dependents) without causing any taxable income to such employees (Treas. Reg. § 1.105-11(g)).

In order to qualify for the medical diagnostic procedure exception, the program must meet all three of the following requirements:

- The procedures must be performed at a facility that provides only medical or ancillary services.
- The procedures must be for routine medical examinations, blood tests, X-rays, or similar tests.
- The procedures cannot be for the treatment, cure, or testing of a known illness or disability, or the treatment or testing for a physical injury, complaint, or specific symptom of a bodily malfunction.

These requirements may contain some pitfalls for employers that offer executive medical diagnostic procedure programs. For example, employers often arrange physical examinations for executives at temporary structures or unused conference spaces located at their facilities. Though this may be convenient for executives, such arrangements may not satisfy the requirement that diagnostic procedures be performed at a facility that provides only medical or ancillary services.

Further, employers may want to assess the scope of examinations and tests offered to executives. The Treasury Department regulation provides guidance on the kind of examinations that will be considered diagnostic in nature:

"For example, a routine dental examination with X-rays is a medical diagnostic procedure, but X-rays and treatment for a specific complaint are not. In addition, such diagnostic procedures do not include any activity undertaken for exercise, fitness, nutrition, recreation, or the general improvement of health unless they are for medical care as defined in [Code] section 213(e)."

Therefore, if a physical examination program includes specific tests based on an executive's known illnesses, disabilities, injuries, or complaints, it will probably fail to meet the exception. An employer may

also want to consider ensuring that the program does not offer any diagnostic procedures related to exercise, fitness, nutrition, recreation, or the general improvement of health.

Consequences of Taxability

The value of a fringe benefit is taxable as wages and subject to employment tax withholding unless specifically excluded by Code Sections 3121(a) and 3401(a). These sections provide exclusions from wages for amounts received in connection with sickness and medical care available under a nondiscriminatory self-insured medical reimbursement plan.

If a discriminatory program fails to satisfy the medical diagnostic procedure exception, the costs associated with such examinations would be considered income to participating executives and trigger the associated employment tax withholding and reporting obligations for the employer.

On the contrary, if a program meets the exception, the entire amount reimbursed or paid by the employer will be excluded from wages, employment tax withholding, and reporting requirements. However, such amounts should be reported in Box 12 of Form W-2, using the code DD (cost of employer-sponsored health coverage).

Employer Considerations

Fringe benefits, especially those that discriminate in favor of highly compensated employees, are commonly reviewed by the Internal Revenue Service (IRS) during employment tax examinations. Failure to subject a taxable fringe benefit to employment tax withholding and reporting may result in the assessment of unpaid taxes, penalties, and interest. In addition, the IRS typically requires employers to issue Form W-2c to impacted employees (in this case, executives) to account for understated wages, which may require amended employment tax and personal income tax filings.

In order to mitigate those risks, employers that offer executive health programs may want to consider whether the programs fall within the medical diagnostic procedure exception. For example, does the program's written policy describe and limit the scope of the health examinations being offered to those that are diagnostic in nature? Additionally, does the written policy identify the eligible executives, as well as any tax implications?

To the extent a program does turn out to have taxation issues, the employer may need to prepare Form W-2c and amend its employment tax returns to include the associated costs as taxable wages. In the event employers do not want to restrict their programs to comply with the exception, they may also consider a tax gross-up for participating executives to mitigate the tax impact.

Note: *This article has not discussed any responsibilities and reporting requirements that an employer may have under health benefits laws such as the Affordable Care Act and the Employee Retirement Income Security Act.*

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