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Risking a Health Insurance Strategy the I.R.S. May Not Approve

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Rick Lindquist, president of Zane Benefits, which offers businesses an online claims reimbursement service. Credit Jeffrey D. Allred for The New York Times
When it came time to renew his company's health plan last fall, Jerry Eledge found himself in a bind that many small-business owners know all too well.

On one hand, "it's kind of a moral obligation" to offer insurance, said Mr. Eledge, who runs Community Quick Care, a growing chain of primary health care clinics in the Nashville area. And yet, premiums for his existing plan were going up 20 percent, while other group plans promised as much as a 50 percent increase, even as deductibles and co-pays were becoming less generous. "We found no really good alternatives for 2014 at all," he said. "Before Gary came along, we weren't sure what we were going to do."

Gary is Gary Adkins, an insurance agent in Brentwood, Tenn., who introduced Mr. Eledge to Zane Benefits, a company in Park City, Utah, that offers businesses an online claims reimbursement service. With help from Zane's software, Mr. Eledge created a new health plan for Community Quick Care. The plan, known as a defined contribution plan, has obvious appeal.

It largely frees the company from the headaches of arranging health coverage by reimbursing employees for insurance they buy on their own. At the same time, it allows the company to help its employees find affordable, often cheaper, options on the individual market through Zane. And, importantly, it promises that the contribution the company makes to its employees' coverage is tax-free for the employees and excluded from payroll taxes for the employer.

That, however, is a promise Zane Benefits may not be able to keep.

In a technical guidance issued last year and reiterated in May, the Internal Revenue Service issued a clear warning about such health reimbursement arrangements, according to eight health and tax lawyers as well a half-dozen lobbyists and analysts who have followed the Affordable Care Act's adoption. The guidance "makes it very difficult, if not impossible, for an employer to pay for an employee's individual insurance with tax-free dollars," said Seth Perretta, a health and tax lawyer with the Groom Law Group in Washington.

The issue, at least on the surface, is language in the health law meant to make sure there are no dollar limits on the coverage for a person's basic medical needs, which the law calls essential health benefits. The I.R.S. asserts that a plan reimbursing employees for insurance they buy on their own cannot comply with this prohibition on annual limits because the company's contribution is by definition limited - even though the health insurance the employee ends up buying would have no annual limits.

The president of Zane Benefits, Rick Lindquist, 29, said Zane's plan did not violate the prohibition on limits because premiums were not an essential health benefit. "We've designed an arrangement that takes into account the guidance, and complies with the statutes and regulations as written," he said.

Before this year, most companies that wanted to make sure their employees had insurance had little choice but to select and manage the plans because they could not be certain their employees would be able to obtain insurance individually. Now, as the Affordable Care Act creates more options on the individual market, the question of whether to continue offering health insurance has intensified, especially for small businesses.

And Zane Benefits is emerging as the leader of a handful of companies - including TASC, HR Simplified and Freedom Services - hoping to facilitate that transition. According to Mr. Lindquist, about 2,600 small businesses use Zane's software to create and manage health reimbursement arrangements, as these plans are commonly called - lured at least in part by the tax exclusion. Community Quick Care pays Zane $12 a month for each of its 30 employees to administer the plan. Mr. Adkins estimates that employees can buy their own plan for as much as 40 percent less than the same coverage

would cost as part of a group. Should they receive government subsidies to buy that insurance - and Mr. Eledge estimated up to a quarter of his employees qualify - the savings to the employer can double, Mr. Adkins said.

Lawyers following the issue called Zane's approach risky at best. "It is abundantly clear that the I.R.S. thinks that you cannot use one of these arrangements to use tax-free dollars to pay for individual health insurance," said Amy B. Monahan, a law professor at the University of Minnesota.

But Mr. Perretta said the Zane plan exploited a weakness in the guidance, which does not specify whether insurance premiums are an essential health benefit. "The Zane arrangement tries to thread a needle," he said. "It really lives or dies on that ambiguity." Elsewhere, he added, the I.R.S. and other agencies have implied that a premium is not an essential health benefit, so for now, Mr. Perretta said, the Zane plan could be legal, "but regulators don't like it."

Officials from the Treasury Department and the I.R.S. declined to answer questions about the regulations or Zane's plan, but a Treasury Department official wrote in an emailed statement, "This type of reimbursement plan generally would fail to comply with the A.C.A.'s prohibition on annual dollar limits."

Several lawyers who had spoken with I.R.S. officials said the Obama administration was concerned that self-insuring companies could use the plans to shift sicker workers to the individual market, which might destabilize it. Nor do regulators want employees with tax-preferred reimbursement accounts to also have access to exchange subsidies, which the lawyers said would constitute "double-dipping." Because the tax-free benefit would not appear on an employee's tax return, an exchange could not consider it when determining whether the employee's income was low enough to qualify for a tax credit. As a result, employees receiving reimbursements could be treated more generously by an exchange than the law intends.

In fact, it is not clear that employees who sign up for Zane's plan would be eligible for a subsidy. Zane said they would. All of the lawyers interviewed said they would not. Under the law, employers will report to the I.R.S. who has signed up for company health plans, including reimbursement arrangements. Beginning in 2016, the agency will use these employer statements to determine whether an individual who received a subsidy in the previous year was entitled to it - and if not, the employee will have to pay the government back. Said Linda Mendel, a tax lawyer with Vorys, Sater, Seymour and Pease: "There'll be some nasty surprises when all this stuff comes together in 2016."

The Treasury official said the government planned to issue further guidance on the matter. But ultimately, it may be up to one of Zane's clients to persuade a court that the arrangements are legal. The penalty for an employer violating the market reform rules is $100 a day, or $36,500 a year, for each affected employee, though never more $500,000 total.

Mr. Lindquist said his agents walked clients through all of the legal risks, but he was confident the plan would withstand scrutiny. "If we were worried about that, we wouldn't offer it," he said. Mr. Adkins, the insurance agent, said he told his small-business clients who had adopted Zane's software - there are 150 of them - that they had little to fear. "The purpose of the Affordable Care Act is to get people covered in this country," he said. "Do you really believe the government is going to penalize that small-businessman $36,000 a year per employee because he had the heart to actually help his employees get as much coverage as they could get?"

And Mr. Eledge, of Community Quick Care, said Mr. Adkins satisfied him, and his accountant, that the plan would stand up. "We like it very clear that everything we do as a company is aboveboard and legal," he said. "I'm not the kind of guy who says, 'I.R.S., come get me.' "