COMPLIANCE ALERT

Considerations for Compliant Family-Building Programs

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Quick Facts

- Family-building programs, also commonly referred to as fertility or infertility benefit programs, are becoming a common component of employer-sponsored benefit packages. While these programs provide important benefits to employees, they have unique compliance issues particularly surrounding taxation, that employers should consider prior to implementation.
- Services that are "qualified medical expenses" as defined in the Internal Revenue Code (IRC) §213, are available on a tax-favored basis.
- Employers commonly use health reimbursement arrangements (HRAs) to provide fertility benefits to employees, but fertility-specific HRAs have explicit compliance requirements.
- Employers may provide reimbursement for certain qualified expenses tax-free to employees through an adoption assistance program, while benefits offered through an employer-sponsored surrogacy program must be included in taxable income.

Introduction

Family-building programs, also commonly referred to as fertility or infertility benefits programs, are becoming a common component of employer-sponsored benefit packages. These programs often take shape as part of the medical plan, as a separate fertility HRA, an adoption assistance program or a surrogacy assistance program. As more employers begin to offer some level of coverage for family-building to employees, they face difficult and often confusing compliance issues, particularly around the issue of taxation.

Medical Expenses

To the extent that a fertility program provides medical care for employees that is reimbursed by an employer, the program is a group health plan and is subject to laws that govern health and welfare benefits such as the Affordable Care Act (ACA), the Health Insurance Portability and Accountability Act (HIPAA), the Consolidated Omnibus Budget Reconciliation Act (COBRA) and the Employee Retirement Income Security Act (ERISA).

Employers may want to provide fertility benefits to plan participants through their major medical plan. While this may sound like a simple solution, employers, particularly those with fully insured plans, may experience barriers to coverage due to the scope of benefits offered and provider networks. Self-funded plan sponsors must review their state benchmark plan to determine whether fertility benefits are an essential health benefit (EHB) subject to ACA's lifetime and annual limit rules.

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Fertility HRAs

Employers commonly use HRAs to provide fertility benefits to employees enrolled in the employer's major medical plan. Fertility HRAs have their own unique compliance considerations. Under ACA, an HRA must be integrated with a major medical plan to avoid violations of the ACA market reform requirements. To ensure compliance, employers should only offer the fertility HRA to individuals enrolled in the employer's major medical plan or alternatively confirm that the individual has enrolled in their spouse's employer-sponsored major medical plan.

Plan sponsors should also remember that an HRA is a group health plan, subject to ERISA, HIPAA and COBRA. Plan sponsors offering this type of benefit must have a fertility plan document and summary plan description (SPD), maintain claims and appeals procedures in accordance with ERISA, and complete a Form 5500 filing. Plan sponsors must maintain compliance with the HIPAA privacy and security rules to the extent that the plan sponsor has access to protected health information (PHI). As a self-funded HRA, the plan must comply with ACA Patient Center Outcomes Research Institute (PCORI) fee and filing requirements, and complete non-discrimination testing under IRC §105(h) Additionally, the fertility HRA is subject to COBRA continuation which is discussed in more detail below.

Fertility HRA Interaction with HDHPs

A fertility HRA is a group health plan and therefore must comply with IRS rules for high deductible health plans (HDHPs) and corresponding health savings accounts (HSAs). Just like a general-purpose HRA, a fertility HRA cannot pay for non-preventive services before satisfying the deductible on a qualified HDHP or the plan participant will be HSA-ineligible. Plan sponsors should design their fertility benefit HRA to pay expenses post-deductible to preserve HSA eligibility.

COBRA Considerations for Fertility Benefits Programs

As a group health plan, a fertility HRA must comply with COBRA continuation requirements. COBRA participants must be afforded the same level of medical benefits as active employees. Note that these requirements only apply to fertility benefits that are medical benefits, and any non-medical benefits may be excluded.

Plan sponsors will need to set COBRA premiums for the fertility HRA. Generally speaking, COBRA premiums for an HRA-type benefit are determined by calculating the amount the plan spent on medical costs in the previous year plus a portion of the administrative costs attributed to the medical benefit and then divide by the number of plan participants The number of participants includes everyone who is eligible for the benefit regardless of whether they actually used the benefit. Then, divide by twelve to get a monthly amount and add the 2% COBRA administration fee. The fertility benefit vendor may be able to assist with this calculation.

Taxation of Fertility Programs

A fertility program that pays for "medical expenses" as defined by **IRC §213(d)** can provide those expenses tax free; however, often times, fertility benefit programs offer coverage for expenses that are not §213(d) medical expenses. When the program reimburses participants for such expenses, they are a taxable benefit to the employee. Expenses that are taxable should be included in an employee's W-2 as income and are subject to tax withholding.

IRC §213 permits a taxpayer to deduct all medical expenses in excess of 7.5% of adjusted gross income (AGI). Medical care is defined by the Internal Revenue Service (IRS) as amounts paid for "the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body." The IRS takes a narrow interpretation of this definition, allowing

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only costs and fees directly attributable to the body of the taxpayer, their spouse or their dependent qualify as eligible medical expenses.

Taxation of IVF for Third Parties

The definition of "medical care" is important particularly for taxation of in-vitro fertilization (IVF) treatments for a third party. **IRS Publication 502**, provides guidance for claiming a tax deduction for "Fertility Enhancement" stating:

"You can include in medical expenses the cost of the following procedures performed on yourself, your spouse, or your dependent to overcome an inability to have children.

- Procedures such as in vitro fertilization (including temporary storage of eggs or sperm)
- Surgery, including an operation to reverse prior surgery that prevented the person operated on from having children."

Based on this language, various tax court decisions, and other IRS guidance, there is some question as to what circumstances create an "inability to have children." Particularly for unmarried individuals, individuals in same-sex marriages, or transgender individuals, it is unlikely that IVF and surrogacy expenses incurred for an unrelated third party are tax deductible.

In **IRS Public Letter Ruling (PLR) 202114001**, The IRS concludes that costs related to fertility services such as expenses involving egg donation, IVF procedures, and gestational surrogacy incurred for third-parties do not qualify as deductible medical expenses because these costs are not directly attributable to a function of the body for the taxpayer, their spouse or dependent; however, medical costs and fees directly attributable to the taxpayer, are deductible. The IRS concedes that the list of costs attributable to the taxpayer is much shorter than the list that is not.

Within the PLR, the IRS describes two cases where an employee sought favored tax treatment for IVF benefits under an employer fertility program.

In the case, *Longino v. Commissioner,* the Court considered the validity of various deductions claimed by the taxpayer, including the medical expense deduction for IVF costs attributed to IVF procedures for the taxpayer's former fiancée. In this case, the court ruled against Longino, stating that a taxpayer cannot deduct IVF costs of an unrelated person if the taxpayer does not have a defect that prevents him from naturally conceiving children.

In the case, *Morrissey v. United States*, Morrisey, a male in a same-sex relationship sought to deduct costs he incurred to retain, compensate, and care for the woman serving as an egg donor and gestational surrogate for him and his same-sex partner. The Court found that the IVF costs were not tax deductible under IRC §213(d) because "the costs were not for purposes of materially influencing or altering an action for which the taxpayer's own body was specifically fitted, used or responsible." The Court stated that the costs were not deductible because the taxpayer was able to use his own function in the reproductive process to produce healthy sperm without the IVF or surrogacy procedures.

Adoption Assistance Programs

Family-building benefits may also include financial assistance for the adoption of a child. These employer-sponsored programs are provided exclusively for the benefit of active employees and are commonly referred to as adoption assistance programs (AAPs). In order to provide tax-free

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reimbursement for adoption expenses, the employer-sponsored AAP must comply with specific requirements.

A key AAP requirement is reimbursement for “qualified adoption expenses.” Under **IRC §137**, expenses paid or incurred by an employee for “qualified adoption expenses” in connection with the adoption of an employee's child are excluded from the employee's gross income if furnished pursuant to an employer-sponsored AAP. The definition of “qualified adoption expenses” under IRC §137 includes expenses that:

- Are reasonable and necessary;
- Are directly related to and for the principal purpose of the legal adoption of an eligible child by the taxpayer, with “eligible child” defined to mean a child under 18 or physically or mentally incapable of self-care;
- Include but are not limited to adoption fees, court costs, and attorney's fees;
- Do not violate state or federal law;
- Are not incurred in any surrogate parenting arrangement;
- Are not incurred in connection with a stepparent adoption; and
- Are not reimbursed elsewhere

“Qualified adoption expenses” commonly include expenses for items such as adoption placement fees, attorney fees and travel expenses, but this is not an exhaustive list. While the IRS does require participants to provide expense substantiation to receive reimbursement, they have not provided specific guidance on expense substantiation.

In addition to reimbursing only those expenses allowed by the IRS, an AAP must have a written plan document that outlines the plan terms such as the amount of benefit available and plan eligibility. Employers sponsoring an AAP should be specific in their plan document as to what expenses are covered. Plan sponsors have the discretion to reimburse only items on a specific list of approved expenses or cover all expenses that the employer determines are likely to be considered qualified adoption expenses.

The amount of tax-free benefit available to employees is indexed for inflation and is not available to taxpayers with an adjusted gross income (AGI) over a set amount. In 2023, the tax-free benefit maximum is $15,950. The tax-free benefit begins to phase out for married couples with an AGI of at least $239,230 and is completely phased out for those with an AGI of $279,230 or more.

While AAPs are not ERISA plans, nor group health plans, other state and federal laws may require compliance. Because these plans fall outside the reach of ERISA, they are not preempted, and state laws will apply.

AAPs are governed by the IRS Code and therefore must comply with specific nondiscrimination requirements including annual eligibility and benefits testing to ensure the plan does not favor highly compensated individuals as defined by the IRS. Additionally, federal employment laws, such as the Age Discrimination in Employment Act (ADEA), the Americans with Disabilities Act (ADA) and Title VII of the Civil Rights Act apply and require that adoption benefits provided through an AAP be provided on a nondiscriminatory basis.

Because amounts paid or expenses incurred by an employee for qualified adoption expenses under an AAP are not subject to federal income tax withholding, they are not reportable in box 1 of Form W-2 as wages; however these amounts are subject to withholding for federal Social Security and Medicare tax (FICA), and federal unemployment tax (FUTA). Accordingly, the funds must be reported

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in boxes 3 and 5 of Form W-2. **IRS Pub. 15-B** directs employers to report all qualified adoption expenses paid or reimbursed by the employer's AAP for the year in box 12 of the employee's W-2 using Code T to identify the amounts.

Surrogacy Programs

Some employers have begun to add surrogacy benefits to their family-building programs. Surrogacy programs reimburse plan participants for expenses such as:

- Administrative fees associated with locating and choosing a surrogate
- Agency fees for surrogacy management
- Legal fees associated with contract negotiation and parental rights
- Travel fees associated with the surrogacy
- Reasonable and necessary medical expenses of the surrogate

Employers reimbursing medical expenses should seek guidance from their counsel to ensure the plan is structured in a manner that does not create an impermissible group health plan.

Surrogacy programs are not group health plans and therefore not subject to ACA, HIPAA or COBRA. Further, they are outside the scope of ERISA and therefore do not require a written plan document, SPD or Form 5500 filing. Nor do any of the ERISA claims and appeals rules apply. However, as these are not ERISA plans state laws will apply.

Reimbursements for surrogacy expenses, meaning medical expenses of the surrogate, are not considered medical care under IRC §213 and are therefore taxable wages added to an employee's W-2 as taxable income and subject to regular payroll withholding. In **IRS Information Letter 2002-0291** released in December 2002, the IRS clearly stated that surrogacy costs do not constitute medical care because a surrogate mother is neither the taxpayer nor the taxpayer's spouse and "an unborn child" is not a dependent.

Surrogacy plans should be administered in accordance with IRC §409A which allows taxable reimbursements. IRC §409A applies to "deferred compensation," in situations where an employee has a legally binding right to compensation during a taxable year that may be payable in a later taxable year.

IRS Code §409(A) has specific requirements that must be outlined in a written document. Those requirements are:

- An objectively determinable non-discretionary definition of the expenses eligible for reimbursement;
- An objective and specific time period for which expenses are incurred, generally the period of employment;
- The amount of expenses eligible for reimbursement in one year will not affect the expenses eligible for reimbursement in another year;
- The reimbursement must be made on or before the last day of the employee's tax year following the year in which the expense was incurred; and
- The right to reimbursement cannot be exchanged for another benefit.

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Summary

Family-building programs are becoming a common component of employer-sponsored benefits packages. Employers offering these benefits have many different compliance hurdles to consider. Many of the issues surrounding family-building benefits, particularly those surrounding taxation of services for IVF and surrogacy are murky, and employers should seek guidance from their ERISA counsel before implementing any of these benefits. Family-building plans that offer both taxable and non-taxable benefits may require a written plan document. Employers should consider having separate written plan documents for different programs to mitigate compliance issues and avoid plan participant confusion.

EPIC Employee Benefits Compliance Services

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