VOLUME 77 ◆ NUMBER 2

Employee Benefit Plan Review

Ask the Expert

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Family-Building Benefits

Q We are considering providing our employees family-building benefits that would offer assistance for costs associated with infertility, adoption and surrogacy. What legal issues should our company be examining?

A Adoption, surrogacy, fertility treatments, in-vitro fertilization (IVF), egg freezing and the like have become increasingly popular over the years as families have become more diverse and as medical technology has become more widely available. The costs associated with these family-building processes can be steep, often amounting to tens of thousands of dollars.

While self-insured health plans may have more flexibility to provide for coverage of certain family-building benefits, most fully-insured health plans do not offer comprehensive coverage for family-building. Typically, insured health plans require a clinical infertility diagnosis for participants to access fertility-related benefits under the plan. Nevertheless, companies with insured and self-insured health plans are increasingly offering programs that cover a variety of family-building services without requiring a clinical infertility diagnosis. There are many options available to employers that wish to provide such benefits to their employees.

With respect to adoption, the Internal Revenue Code (IRC) provides two important tax incentives: an income exclusion for employer-provided adoption assistance (IRC Section 137) and an individual income tax credit for qualified adoption expenses (IRC Section 23). Adoption assistance plans can work together with the adoption income tax credit, but the same expenses cannot be claimed under both the adoption assistance plan and the adoption tax credit. Employer-sponsored adoption assistance programs are for the sole purpose of providing employees with adoption benefits. To qualify under IRC Section 137, these programs must satisfy certain minimum requirements related to eligibility, employee notification, and limitations on payments to owner-employees. For both the tax credit and the income exclusion, qualified adoption expenses are defined as reasonable and necessary adoption fees, court costs, attorneys' fees, travel expenses (including meals and lodging) and other expenses. Other expenses may qualify if they are directly related to and have the principal purpose of adopting an eligible child.

At a high level, the IRC rules require that: an adoption assistance program be a separate written plan; all employees who are eligible to participate in the program be given reasonable notice of the terms and availability of the program; the program must benefit employees generally who qualify under a classification set up by the employer that does not discriminate in favor of highly compensated employees or their dependents; shareholders or owners (or their spouses or dependents) receive no more than 5% of all the adoption assistance reimbursements or expenses paid by the employer during the year; and participating employees must provide to the employer reasonable substantiation that payments or reimbursements made under the program constitute qualified adoption expenses. Employers may provide adoption assistance by making payments directly to third parties, making payments to employees to reimburse substantiated qualified adoption expenses or providing a salary reduction option that allows employees to make contributions for future qualified adoption expenses. Employers have wide latitude in structuring adoption assistance plans but should consider whether to coordinate the plan with an existing Section 125 cafeteria plan.

The adoption tax credit under IRC Section 23 is a federal income tax credit that reduces the federal income tax liability of adoptive parents. If an employee pays or incurs unreimbursed qualified adoption expenses, the employee may claim a tax credit equal to the amount of such unreimbursed expenses up to a specified dollar limitation. The adoption tax credit is nonrefundable (meaning that it is not allowed in excess of the taxpayer's tax liability) and may be carried forward for up to five years.

Importantly, both the adoption assistance program and the adoption tax credit are subject to the same dollar and income limitations, which may reduce or eliminate the availability of the tax benefits for the taxpayer in any given year. The dollar limitation per child for 2023 is $15,950. The dollar amount per child is reduced and eliminated under phase-out provisions tied to the taxpayer's modified adjusted gross income (MAGI). For 2023, the tax-favored treatment begins to phase out when MAGI reaches $223,410 and is fully phased out when MAGI equals $263,410.

With respect to fertility treatments and procedures, such as diagnostic testing, IVF and preservation, including egg procurement, embryo transfer and freezing, to the extent they are not covered under an employer's group health plan, the employer may offer such benefits by obtaining supplemental insurance coverage. Alternatively, employers may provide funds for fertility expenses through a flexible spending account (FSA) or a health savings account (HSA). However, there are limitations on the dollar amounts that an employer may contribute annually to these types of accounts, and there may be penalties for reimbursement of expenses that are not qualified medical expenses.

Additionally, employers may provide fertility benefits through a health reimbursement arrangement (HRA). There are no limits on the amount that an employer may contribute to an HRA, and employers may define the parameters of the benefit, including coverage and dollar limits. Notably, because HRAs are entirely employer-funded, contributions to an HRA may not be pursuant to a salary reduction or otherwise provided under a cafeteria plan. In addition, HRAs are subject to certain important rules and limitations. For example, where an employee contributes to an HSA, they can participate in only certain types of HRAs (e.g., a post-deductible HRA). Further, an HRA provides tax-free reimbursement only to the extent that all reimbursements under the HRA are for medical expenses under Section 105 or 106 of the IRC (this includes medical expenses under IRC Section 213). Consequently, if an HRA reimburses employees for any non-medical expenses (as defined by IRC Section 213), all reimbursements under the HRA will be taxable to all employees.

Medical expenses are 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 of the employee, employee's spouse or employee's dependent. Where there is no third party involved in the fertility treatments or where there is a medical diagnosis of infertility that requires the involvement of a third party, most of the expenses incurred with respect to the treatments are likely to constitute medical expenses. Accordingly, including such expenses as eligible for reimbursement under an HRA would not cause the HRA reimbursements to be taxable.

The same considerations that apply with respect to fertility treatments also apply with respect to surrogacy, except that surrogacy is more complicated because a third party is always involved and certain expenses are not considered "medical expenses" for purposes of IRC Sections 105, 106 and 213. The costs related to surrogacy that could be reimbursed tax-free are generally limited to the expenses incurred to affect the body of the employee, employee's spouse or employee's dependent, such as expenses incurred for sperm or egg retrieval/donation directly attributable to the employee or their spouse. Expenses incurred for third parties, such as payments to a gestational surrogate (even for the surrogate's medical expenses), are not "medical expenses" because they are not incurred for the treatment of the employee, spouse or dependent. Consequently, reimbursement of these costs would be taxable and could jeopardize the tax status of all reimbursements under the HRA. Employers might consider offering such taxable benefits under a separate, stand-alone program in order to maximize the tax benefits for employees.

Separate from, or in conjunction with, the options previously discussed, employers may provide taxable reimbursements or payments to employees in connection with family-building. Such benefits may not be provided through a Section 125 cafeteria plan, and employers should consider the implications of other applicable laws, such as ERISA, HIPAA and state laws.

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