

**ALERT:
HEALTH CARE REFORM BILL**

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**IRS GUIDANCE REGARDING
TAX-FREE HEALTH COVERAGE
FOR ADULT CHILDREN**

Recently enacted health care reform legislation* brings dramatic and virtually immediate changes for employers. Perhaps foremost among these changes is a provision requiring employer-sponsored group health plans that provide coverage for employees' children to make that coverage available until the child reaches age 26, regardless of that child's marital or student status. (For details of this mandate, see **Willis' Human Capital Practice Alert, Vol. 3, No. 3, "First Things First: Health Care Reform in 2010 and 2011."**)

* Please note: The final enacted version of the health care reform legislation incorporates three component pieces: 1) The Patient Protection and Affordable Care Act (PPACA), 2) a PPACA "manager's amendment" and 3) the "fixer" measure passed through the budget reconciliation process (HR 4872), the Health Care and Education Affordability Reconciliation Act of 2010 (HCEARA). For purposes of simplicity though, we will refer to the entire package of law as health care reform.

BACKGROUND

The health care reform laws require those group health plans that cover dependent children to provide health coverage for such children until they reach age 26 (i.e., the law does not mandate coverage for dependent children, but if dependent coverage is available, then eligibility must be extended until a child turns 26). This requirement is effective for plan years beginning on or after September 23, 2010 (January 1, 2011 for calendar-year plans).

The expansion of health coverage eligibility for adult children applies to group health plans regardless of whether the coverage is insured or self-funded. Important exemptions apply for certain types of plans, such as stand-alone vision or dental. (These distinctions are detailed in other Willis publications, including the *Alert* noted above.)

Even though the mandate directs coverage through the last day the adult child is 25, the health care reform law also includes a provision that changes Internal Revenue Code §105(b) and makes health coverage provided to an employee's child nontaxable until the end of the year in which the child turns 26. Although the mandate directs coverage to age 26 and the tax exclusion shields parents for a child that "has not attained age 27" as of the end of the tax year, we believe the two references are not in conflict. Group health plans often allow enrolled dependent children to keep health coverage until the end of the month in which they attain the age that excludes further coverage under the health plan. By structuring tax code protections past age 26, Congress ensured that parents would be able to continue coverage of a dependent child without risking negative tax consequences. The language of the federal tax code should also help in situations where a state insurance law directs coverage of an adult child even beyond age 26.

NEW GUIDANCE

In the first of many anticipated pieces of health care reform-related guidance, the Internal Revenue Service (IRS) recently published information about the tax exclusion that applies to health coverage provided to adult children. The new guidance, IRS Notice 2010-38, addresses this tax exclusion and makes clear that it (as noted above) applies more broadly than does the federal mandate. An employee's adult children who have coverage under an employer's health plan will have nontaxable coverage so long as they *have not attained age 27 by the end of the taxable year* – even if that coverage is not required by the federal health care reform mandate.

EFFECTIVE DATE

Although the mandate requiring coverage for dependents to age 26 is not yet effective (it is effective for plan years beginning on or after September 23, 2010), the change to the tax code for purposes of health coverage provided to an employee's adult children was effective as of the date the legislation was signed, March 30, 2010. This means that the tax benefits are available now. This is good news for those employers who currently provide coverage to dependent children who do not meet the federal tax code definition of dependent and must tax employees on the value of the coverage provided to such dependents.

WHAT'S CHANGED: OLD TAX RULES

Several sections of the Internal Revenue Code (IRC) allow employers to extend benefits to employees, spouses and dependents on a tax-preferred basis.

- **§105(b):** Generally excludes from an employee's gross income employer-provided reimbursements made directly or indirectly to the employee for the medical care of the employee, employee's spouse or employee's dependents.
- **§106:** Excludes from an employee's gross income, coverage under an employer-provided accident or health plan. The

regulations under §106 provide that the exclusion applies to employer-provided coverage for an employee and the employee's spouse or dependents.

- **§125:** Permits employees to elect cash or certain qualified benefits (e.g., health plans, accident plans and health flexible spending arrangements). For more information about cafeteria plans and qualified benefits, please see Chapter 3 of the Willis on-line *Compliance Manual*.

The tax code defines dependents at §152 of the IRC. Loosely explained, an individual must be either a qualifying relative or a qualifying child to qualify for health plan coverage as a dependent.*

- * The Working Families Tax Relief Act of 2004 (WFTRA) significantly changed the §152 dependent definition. To soften the impact on plan sponsors the IRS issued Notice 2004-79, which gave employers the option of using a modified §105(b) definition that omits problematic prongs of the IRC §152 definition in administering their group health plan benefits.

A person is an employee's "qualifying child" for the tax year if the following five requirements are met: (1) the child is the employee's child, sibling or step-sibling, or is a descendant of any of these relatives; (2) the child has the same principal abode as the employee for more than one-half of the year; (3) at the end of the year, the child is under 19 years old (24, if a "student") or is permanently disabled; (4) the child does not provide more than one-half of his or her own support for the year; and (5) the child must not have filed a joint tax return (other than for a refund claim) with his or her spouse for the year.

A "child" is defined as an individual who is the son, daughter, stepson or stepdaughter of the employee and includes both a legally adopted individual of the employee and an individual who is lawfully placed with the employee for legal adoption by the employee. A child also includes an "eligible foster child," defined as an individual who is placed with the employee by an authorized placement agency or by judgment, decree or other order of any court of competent jurisdiction. This definition of child forms the basis of the expanded tax exclusion discussed in this article.

A person is an employee's "qualifying relative" if the following three requirements are met: (1) the individual is a "relative" (defined in list below) by either blood or marriage, or the person is an individual (other than the spouse) who has the same principal abode as the employee and is a member of the employee's household for the tax year; (2) the employee provides over one-half of the individual's support for the year; and (3) the individual is not, for the taxable year, anyone else's "qualifying child" as defined above. The definition of "qualifying relative" also includes a gross income limit (\$3,650 for 2010) that cannot

be equaled or exceeded if the individual is to be considered a qualifying relative; but this income limit is generally disregarded for health plan purposes under the rules contained in IRS Notice 2004-72 (see above).

“Relative” is limited to the following groups: (1) a child, stepchild, foster child or descendant of any of these; (2) a brother, sister, stepbrother or stepsister; (3) the father or mother, or an ancestor of either; (4) a stepfather or stepmother; (5) a son or daughter of a brother or sister of the taxpayer; (6) a brother or sister of the father or mother of the taxpayer; (7) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law. (It’s worth noting that under some circumstances, a child might fail to meet the technical definition of “qualifying child” but still qualify as a dependent under the “qualifying relative” prong of the §152 definition.)

WHAT'S CHANGED: NEW TAX RULES

The health care reform laws do not alter the definition of a spouse or dependent for any purpose other than health benefits provided by the employer. This change will not affect whether a taxpayer is able to claim an individual as a dependent on his annual tax return.

CHANGES TO §105(B)

The health care reform laws now extend the §105(b) tax exclusion for employer-provided medical care expenses incurred by the employee for the medical care of the employee’s child as defined by the tax code (definition of child provided above) who has not attained age 27 as of the end of the taxable year. This exclusion applies even if the employee’s child is not the employee’s tax dependent within the meaning of §152 of the tax code. This means that the age limit, residency, support and other tests described in the dependent definition for a qualifying child and qualifying relative do not apply with respect to such a child.

The exclusion applies only for reimbursements for medical care of individuals who are not age 27 or older at any time during the taxable year. The taxable year is the employee’s taxable year and employers may assume that an employee’s taxable year is the calendar year. A child attains age 27 on the 27th anniversary of the date the child was born and employers may rely on the employee’s representation as to the child’s date of birth.

CHANGES TO §106

Prior to the changes made under the health care reform legislation, the exclusion for employer-provided accident or health plan coverage under IRC §106 always paralleled the rules under §105(b). Now, even though the health care reform legislation made no specific reference or changes to §106, the IRS thought it prudent to incorporate new changes to §106 and to keep things parallel. In other words, so as not to provide a broader exclusion in §105(b) than in §106, the IRS and Treasury have decided to amend the regulations under §106 retroactively to March 30, 2010 to clarify that health coverage provided by an employer for an employee’s child under age 27 is also excluded from gross income.

Therefore, effective on and after March 30, 2010, both coverage under an employer-provided accident or health plan, and amounts paid or reimbursed under such a plan for medical care expenses of an employee, an employee’s spouse, an employee’s dependents or an employee’s child who has not attained age 27 as of the end of the employee’s taxable year are excluded from the employee’s gross income.

CHANGES TO §125

IRS Notice 2010-38 addresses important aspects of the way that the tax code exclusion affects cafeteria plans. Due to the way the tax code is written, the changes made to IRC §105(b) and 106 regarding the exclusion of coverage and reimbursements from an employee’s gross income for an employee’s child who has not attained age 27 as of the end of the employee’s taxable year will automatically apply to the definition of qualified benefits for §125 cafeteria plans (including health flexible spending accounts (FSAs)). As a result, a benefit will not fail to be considered a qualified benefit under a cafeteria plan just because it provides coverage or reimbursements that are excludible under §105(b) and 106 for a child who has not attained age 27 as of the end of the employee’s taxable year.

Under the cafeteria plan rules, once an election is made, it is generally considered irrevocable for the full coverage period (e.g., plan year). A cafeteria plan, however, can allow an employee to revoke an election during the period of coverage and to make a new election under certain limited, prescribed circumstances (e.g., birth, marriage, death, etc.). One of these specifically recognized IRS-approved events is a change in the number of an employee's tax dependents.

Consequently, even though the mid-year election adjustment rules do not currently permit election changes for children under age 27 who are not the employee's tax dependents, the IRS and Treasury intend to amend the regulations to address this issue. Effective retroactively to March 30, 2010, the mid-year election rules will be amended to include change-in-status events affecting nondependent children under age 27. This will include the adult child becoming newly eligible for coverage or eligible for coverage beyond the date on which the child otherwise would have lost coverage. To the extent that the employer's cafeteria plan allows, this may provide employees an opportunity to make certain changes to their current health FSA election.

EXAMPLE ABC Company provides health care coverage for its employees and their spouses and dependents and for any employee's child (as defined in the IRC) who has not attained age 27 as of the end of the taxable year. For the 2010 taxable year, ABC Company provides health care coverage to George and to George's daughter, Grace. Grace will not attain age 27 until after the end of the 2010 taxable year. During the 2010 taxable year, Grace earns \$35,000 per year, is not eligible for health care coverage from her employer, and she does not live with George. Grace is not George's tax dependent (she is neither a qualifying child nor qualifying relative) because Grace does not live with her father and he does not provide more than one half of her support.

However, because Grace is a child of George within the meaning of the IRC and she will not attain age 27 during the 2010 taxable year, the health care coverage and reimbursements for Grace under ABC Company's plan are excludible from George's gross income for the period on and after March 30, 2010 through the end of the 2010 taxable year. In addition, if ABC Company's cafeteria plan allows, the coverage may be provided on a pre-tax basis.

WHICH BENEFITS ARE AFFECTED?

This tax exclusion for a child who has not reached age 27 by the end of the taxable year will extend to health benefits provided by the employer. These will include such benefits as:

- Health benefits such as medical, dental, and vision
- Reimbursements under health FSAs
- Reimbursements under Health Reimbursement Arrangements

Though unlikely to affect most employer benefit programs, the expanded tax exclusion also applies to health care accounts in pension plans (§401(h)), voluntary employee benefits associations (VEBAs) (§501(c)(9)), and the self-employed medical tax deduction (§162).



PAYROLL TAXES

Coverage and reimbursements under an employer-provided accident and health plan for employees and their dependents are already excluded from wages for Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) tax purposes. For purposes of these payroll taxes, any child of the employee is deemed a dependent. This means that coverage and reimbursements under a plan for employees and their dependents that are provided for an employee's child under age 27 are not wages for FICA or FUTA purposes and are also exempt from income tax withholding. (Note: A similar exclusion applies for Railroad Retirement Tax Act (RRTA) tax purposes.)

WHAT DO EMPLOYERS DO NEXT?

Regardless of this recent tax code change, employers that currently provide dependent coverage will need to amend their group health plan by the law's effective date to comply with health care reform in regards to covering adult children up to age 26. To the extent that employees are permitted to purchase coverage for dependents on a pre-tax basis, cafeteria plans may need to amend the current dependent definition to include the children of employees who have not attained age 27 as of the end of the taxable year. Employers should also review their plan documents to determine how they currently define an eligible dependent. If the plan refers to §105(b), it will already include the expanded definition of an adult child. (For reasons explained in the Note above.)

Although the proposed cafeteria plan regulations generally only allow cafeteria plan amendments to be effective on a prospective basis, IRS Notice 2010-38 specifically authorizes employers to permit employees (as of March 30, 2010) to immediately make a pre-tax election for accident or health benefits under a cafeteria plan (including a health FSA) for children under age 27, even if the cafeteria plan has not yet been amended to cover these individuals. However, in order to do this, a retroactive amendment must be made no later than December 31, 2010. It also must be effective retroactively to the first date in 2010 when employees are permitted to make pre-tax salary reduction contributions to cover children under age 27 (but in no event before March 30, 2010).

STATE INSURANCE MANDATES FOR COVERAGE OF ADULT CHILDREN

For those employers who already provide health coverage to adult children who do not meet the tax code's dependent definition (such as those employers who provide coverage to adult children due to a state insurance mandate), the expanded tax exclusions may relieve it of the obligation to tax the employee on the value of the adult child's health coverage. However, it would still need to tax the employee on the value of any coverage for the adult child that is received prior to March 30, 2010 (before the effective date of the change). Employers in this position should review their current eligibility to determine to what extent the benefits provided to an employee's adult children no longer need to be included in the employee's gross income.

The observations, comments and suggestions we have made in this publication are advisory and are not intended nor should they be taken as legal advice. Please contact your own legal adviser for an analysis of your specific facts and circumstances.

KEY CONTACTS

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