HUMAN CAPITAL PRACTICE
ALERT:
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STATE TAX ISSUES RAISED BY ADULT CHILD RULE

When discrepancies arise between federal and state laws that affect employee benefits plans, federal regulations typically trump the states'. However, when it comes to state taxes, this is not the case, as we have discovered since the passage of the Patient Protection and Affordable Care Act (PPACA). The PPACA includes a provision that mandates employer-sponsored group health plans providing coverage for employees' children to make that coverage available until the child reaches age 26, regardless of that child's marital or student status. In order to avoid unintended tax consequences, Congress also provided that those children could get that coverage tax-free until the end of the taxable year in which they attain age 26 (to allow room for maneuvering Congress extended the tax status until the year in which the child attained age 26). (For additional information about these requirements please see Willis Human Capital Practice *Alert*, Vol. 3, No. 8, "**Adult Children Health Coverage Extension: Regulations Published**" and Willis Human Capital Practice *Alert*, Vol. 3, No. 6, "**IRS Guidance Regarding Tax-Free Health Coverage for Adult Children**.")

However, since state income tax policies did NOT necessarily change to comply with that rule, we now have quite a mess on our hands as we approach 2011. Several states have not yet enacted conforming legislation (and may never do so). **This means that at the state tax level there is imputed income, while that is not the case at the federal level**. Employers will need to consult with their accountants and other tax advisers on the various state tax regulations relative to this issue, as they vary from state to state. The American Payroll Association compiled a **list** of those states that do not automatically conform to federal income tax law (the majority do).

There is no one state-required way for employers to impute that income. In fact, there is no set method that the IRS uses either. The only guidance that has ever been issued is that the imputed income must reflect the fair market value. See Willis Human Capital Practice *Alert*, Issue No. 63, "**Taxation of Benefits for Domestic Partners**." In that *Alert* we discussed the various options of valuing the benefits for domestic partners, and we believe the same general principals likely hold true for the imputed income at the state level for those adult children who do not meet the requirements as dependents for the particular state.

As a general matter, Willis' National Legal Research Group recommends the most conservative view in the determination of the imputed income amount. That amount would be the equivalent of the COBRA rate (less the 2% administrative fee) for the level of coverage that is provided (with NO offsets other than for any after-tax amounts that the employee may pay, which is typically none, and with no reference to the various incremental differences between the tiers of coverage). While that may overstate the actual tax, we are not aware of a method that would be foolproof. If your payroll provider has a different methodology that is substantiated, that will likely withstand scrutiny as well.

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