

Health Care Reform Update

Expanded Tax Treatment of Health Care Benefits Provided to Children under Age 27

Health care reform legislation¹ makes two significant changes regarding health benefits provided to an employee's adult-aged child:

1. Extends group health plan eligibility to children up to age 26 effective with the first plan year following September 23, 2010; and
2. Amends the Internal Revenue Code (Code) to provide favorable tax treatment of health plan coverage provided to an employee's child who has not attained the age of 27 as of the end of the taxable year (generally January 1 – December 31), effective on and after March 30, 2010.

The Internal Revenue Service (IRS) issued Notice 2010-38, providing the first guidance on the expansion of favorable tax treatment of health benefits provided to children up to age 27. This summary focuses on the Code changes as they impact employer-sponsored health plans.²

Prior law

Prior to March 30, 2010, only the employee, the employee's opposite-sex spouse and the employee's *tax dependents* were eligible to receive employer-provided health coverage on a tax-favored basis.

A *tax dependent* is defined under Code § 152 as either a "qualifying child" or a "qualifying relative" of the taxpayer.³

New law

Health care reform legislation does not change the definition of a *tax dependent* under § 152. Instead, the legislation expands the exclusion from gross income for medical reimbursements and accident and health coverage by amending § 105(b) (and parallel provisions under § 106) to include expenses incurred by, and coverage provided to, the *employee's child* who has not attained the age of 27 as of the end of the taxable year.

The term *employee's child* is defined under § 152(f) to include the son, daughter, stepson or stepdaughter of the employee. It also includes the employee's legally adopted child, a child placed for adoption and

¹ Health care reform legislation encompasses two bill – *The Patient Protection and Affordable Care Act (Public Law No. 111-149)* and the *Health Care and Education Reconciliation Act of 2010 (Public Law No. 111-152)* enacted March 23, 2010 and March 30, 2010 respectively.

² *IRS Notice 2010-38* also provides guidance on the Act's parallel amendments to § 401(h) for retiree health accounts in pension plans, to § 501(c)(9) for VEBA's and to §162(l) for deductions by self-employed individuals. These provisions are not discussed in detail in this summary but generally extend the same tax-favored treatment to children up to age 27.

³ See *Code § 152; IRS Notice 2004-79; 2004-49 IRB 898 (11/17/2008)*. For purposes of health coverage, the determination of a tax dependent is made without regard to subsections (b)(1), (b)(2), and (d)(1)(B).

eligible foster children. It does not require that the child satisfy the definition of a *tax dependent* under § 152, thus avoiding application of the residency, age and support tests.

Generally, this means that on and after March 30, 2010, an employee may pay premiums on a pre-tax basis for coverage provided to a child who has not attained age 27 in the taxable year. Any employer contribution on behalf of these children will not be treated as income to the employee. Further, the child's qualified medical expenses are eligible for reimbursement from a health FSA and HRA.

However, if a child is provided coverage under a group health plan and is age 27 or older in the taxable year, the child must be the a *tax dependent* of the employee in order for coverage to be provided on a tax-favored basis.⁴

Further, the legislation does not change the tax treatment of coverage provided to domestic partners and same-sex spouses. A domestic partner or same-sex spouse must be a *tax dependent* of the employee to receive tax-favored treatment.

Example

ABC Company provides health care coverage for its employees and their spouses and dependents and for any employee's child (as defined in § 152(f)(1)) who has not attained age 26. For the 2010 taxable year, ABC Company provides coverage to Employee Alice and Alice's son Chase. Chase will attain age 26 on November 15, 2010. During the 2010 taxable year, Chase is not a full-time student. Also, Chase has never worked for ABC Company and is not a *tax dependent* of Alice because prior to the close of the 2010 taxable year Chase had attained age 19 (and was also not a student who had not attained age 24).

Chase is a child of Alice within the meaning of § 152(f)(1). Accordingly, and because Chase will not attain age 27 during the 2010 taxable year, the health care coverage and reimbursements provided to him under the terms of ABC Company's plan are excludible from Alice's gross income under §§ 106 and 105(b) for the period on and after March 30, 2010 through November 15, 2010 (when Chase attains age 26 and loses coverage under the terms of the plan).

CAFETERIA PLAN ELECTIONS

Generally, a cafeteria plan election is irrevocable unless a permitted election change under 26 CFR § 1.125-4 applies in a particular scenario. Currently, there is no permitted election change for children under age 27 who are not the employee's *tax dependents*.

The IRS will amend the current regulations effective retroactively to March 30, 2010, to include change-in-status events affecting nondependent children under age 27, including becoming newly eligible for coverage or eligible for coverage beyond the date on which the child would otherwise have lost coverage.

This should allow for mid-year election changes for newly eligible children. However, clarification is needed as to whether or not the FSA contribution can be increased mid-year under this provision.

⁴ Health plan coverage provided to a non-tax dependent will not receive tax-favored treatment. Generally, this means that the fair market value of the coverage will be taxable as income to the employee less any employee after-tax contributions. Pre-tax contributions for a non-tax dependent's coverage are not permitted. If the value of the coverage is imputed as income to the employee (or paid with after-tax dollars), the benefits received by the non-tax dependent remain tax-free.

Transition rule for cafeteria plan amendments

Cafeteria plans will need to be amended to include children who have not attained the age of 27 as of the end of the taxable year. As of March 30, 2010, employers may permit employees to immediately make pre-tax salary reduction contributions for accident and health benefits under the cafeteria plan (including the FSA) for children under age 27, even if the plan has not been amended to reflect this change.

However, a retroactive amendment must be made no later than December 31, 2010 to reflect the first date in 2010 (no earlier than March 30, 2010) when employees are permitted to make pre-tax salary reduction contributions for children up to age 27.

OTHER CONSIDERATIONS

FICA and FUTA Taxes

Coverage and reimbursements under an employer-provided accident and health plan for employees and their dependents are generally excluded from wages of FICA and FUTA tax purposes. For these purposes, a child of the employee is a dependent and no age limit, residency, support or other test applies. Thus, 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.

What about HSAs?

Initially, it was thought that this change may allow an HSA account holder to seek reimbursement for expenses incurred by the account holder's children up to age 27. However, at this point the guidance does not reflect a similar change. Thus an HSA account holder will have income and a penalty assessed on any distribution from the HSA if the expenses are incurred by a child who is not the *tax dependent* of the HSA account holder.

Reliance on Notice 2010-38

The IRS indicates they will be amending various provisions in the regulations to conform to the changes outlined in this Notice. Taxpayers may rely on this Notice pending the issuance of amended regulations.

On the Horizon

It is important to remember that, effective with the first plan year following September 23, 2010, Federal law will require most plans to provide coverage for adult children until age 26.

Plans that are not already covering older children as a function of plan design or state law may need to make changes to comply with upcoming Federal requirements. When that time comes, the coverage provided to these newly-eligible children will be on a tax-favored basis.

WHAT DOES THIS MEAN FOR MY PLAN?

- Effective March 30, 2010, benefits may be provided on a tax-favored basis to an *employee's child* who does not attain the age of 27 during the taxable year. This means:
 - The employee may make a pre-tax salary reduction election to pay the premiums associated with the coverage.
 - Any employer contribution will not be imputed as income to the employee.
- Expenses of the *employee's child* who does not attain the age of 27 during the taxable year may be reimbursed through a health FSA or HRA. Such expenses are not eligible for reimbursement through the employee's HSA unless the child is the *tax dependent* of the employee.

- A permitted election change will apply for children who become newly eligible for coverage or eligible for coverage beyond the date on which the child would otherwise have lost coverage.
- Cafeteria plan documents must be amended to reflect the change no later than December 31, 2010.
- Domestic partners, same-sex spouses and children age 27 and older will still need to qualify as a *tax dependent* of the employee for tax-free benefits.
- Effective for the first plan year that begins on or after September 23, 2010, plans will need to comply with new Federal law requirements that extend group health plan eligibility to age 26.

For a copy of Notice 2010-38, see <http://www.irs.gov/pub/irs-drop/n-10-38.pdf>.

For more information, see <http://www.irs.gov/newsroom/article/0,,id=222193,00.html>.



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