Extending Health Benefits to Children and Domestic Partners Who Are Not Tax Dependents

Feb 16 2010

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Historically, employers extending group health plan coverage to the dependents of employees limited the availability of that coverage to individuals who qualified as dependents of employees for purposes of the federal income tax laws applicable to employer-sponsored group health plans. Either by choice or to comply with government mandates, however, employers are increasingly extending dependent coverage to individuals who do not qualify as dependents of employees for purposes of those tax rules ("Non-tax Dependents). Covering Non-tax Dependents can present some significant tax issues and complications for employers.

A. Background. The issue of covering Non-tax Dependents has been most frequently discussed in the context of domestic partners. It can also arise, however, based upon various state insurance mandates. For example, Wisconsin recently enacted Wisconsin Statute § 632.885. Under this Wisconsin law, health insurance policies issued in the State of Wisconsin (and certain self-insured health plans operating in Wisconsin) must extend dependent coverage to cover the unmarried child of the insured if:

- the child is over age 17 but under age 27; and,
- the child is not eligible for coverage under a group health benefit plan offered by his/her employer for which the child's premium contribution is no greater than the premium amount for his/her coverage as a dependent of the insured.

The coverage period under the Wisconsin statute is extended in certain circumstances if the child was called to active duty in the National Guard or a reserve component of the armed forces. This new Wisconsin law first applies to policies issued or renewed on or after January 1, 2010 (or, for collectively bargained agreements containing provisions for health plans or policies, the date the policies or plans are established, extended, modified, or renewed on or after January 1, 2010).

The self-funded gup health plans of employers generally are not subject to state law mandates because the Employee Retirement Income Security Act of 1974 ("ERISA") preempts state law as it relates to employee benefit plans. If a Wisconsin employer's health plan is insured, however, the insurance policy must comply with these state mandates. In addition, not all group health plans are subject to ERISA. For example, the health plans of local government agencies and municipalities are not subject to ERISA and can be subject to state coverage mandates whether they are insured or self-funded. Certain church plans are not subject to ERISA and can be subject to state law mandates that extend to church plans.

B. Tax Rules. Section 106 of the Internal Revenue Code (the "Code") provides that an employee's taxable gross income does not include amounts his/her employer pays to provide group health plan coverage to the employee, the employee's spouse, and the employee's dependents. Similarly, Code § 105 provides that an employee's taxable gross income does not include amounts reimbursed by an employer-sponsored health plan for medical expenses incurred by the employee, his/her spouse, and his/her dependents. For purposes of the Code, the term "spouse" does not include a same sex domestic partner. For purposes of Code §§ 105 and 106, the term "dependent" means a "qualifying child" or a "qualifying relative" as defined under Code § 152, *with certain modifications applicable to health benefits*.

In general, a "qualifying child" for purposes of the tax rules applicable to health plans is an individual who:

- Is (a) a child (or descendent of a child) of the employee, or (b) a brother, sister, step-brother, or step-sister (or a descendent of a brother, sister, step-brother, or step-sister) of the employee;
- Has the same principal place of abode as the employee for more than half of the taxable year (*note*—an exception to this requirement applies to children temporarily absent to attend school);
- Has not attained age 19 as of the close of the taxable year or, if a full-time student, has not attained age 24 as of the close of the taxable year (*note*—no age limit applies to a child who is permanently and totally disabled);
- Has not provided over half of his/her own support for the taxable year; and
- Has not filed a joint federal income tax return with his/her spouse.

In general, a "qualifying relative" for purposes of the tax rules applicable to health plans is an individual:

- Who is not the "qualifying child" of the employee or any other taxpayer;
- For whom the employee provides more than half of his/her support for the taxable year; and
- Who has one of the following relationships to the employee: child, descendent of a child, brother, sister, step-brother, step-sister, father, mother, ancestor of father/mother, step-father, stepmother, niece, nephew, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, sister-in-law, or non-spouse member of the employee's household (provided the relationship is not a violation of local law).

If a covered domestic partner or child is not a qualifying child or a qualifying relative (*i.e.,* is a Non-tax Dependent), the tax benefits of Code §§ 105 and 106 will not apply.

C. Analysis. If an employer provides group health plan coverage to the Nontax Dependent of an employee, there are a number of special tax considerations that the employer and the employee must keep in mind.

- The employee is subject to tax on the difference between the fair market value ("FMV") of the coverage provided to the Non-tax Dependent and the amount the employee pays (i.e., after-tax) for that coverage. This taxable amount is treated as wages for income tax, tax withholding, and FICA/FUTA tax purposes.
- An employee cannot pay his/her portion of the premiums for the coverage of a Non-tax Dependent pre-tax through a cafeteria plan, described under Code § 125. Pre-tax contributions under a cafeteria plan are considered **employer** contributions for this purpose. Therefore, if the employee pays his/her premiums pre-tax through a cafeteria plan, the full FMV of the coverage of the Nontax Dependent would be included in the employee's taxable income, effectively eliminating any tax benefit under the cafeteria plan related to the coverage of the Non-tax Dependent.
- The Internal Revenue Service ("IRS") has not, and will not, rule on the determination of the FMV of Non-tax Dependent coverage. It appears that employers use a variety of approaches to determine the value of coverage. For example, some employers use the amount of the COBRA premium (without the 2% increase for administrative costs permitted under the COBRA rules) for a single individual. Some employers have their actuary or insurer calculate a value for the coverage.

It might not be appropriate to use the additional premium that must be paid to obtain coverage for a Non-tax Dependent as a measure of the FMV of that coverage. For example, assume an employee has family coverage and coverage of a child of the employee continues under that family plan after the child ceases to qualify as a tax dependent. Even if the family premium remains unchanged after the child ceases to be a tax dependent, IRS representatives have taken the position that the employee must include in taxable income the amount by which the FMV of that coverage exceeds the employee's after-tax contribution for that coverage. In other words, the coverage has potentially taxable value even if there is no premium increase.

- For tax purposes, an employer can generally rely on the employee's certification that a child or domestic partner satisfies the tests to qualify as the employee's dependent for purposes of the federal tax rules applicable to health plans.
- If, with respect to the coverage of a Non-tax Dependent, the employee properly included in his/her taxable income the difference between the FMV of that coverage and the after-tax dollars the employee paid for that coverage, then the benefits paid with respect to medical expenses incurred by that Non-tax Dependent under the plan would not be taxable.
- In general, health reimbursement account ("HRA") and flexible spending account ("FSA") benefits should **not** be extended to Non-tax Dependents. These arrangements can cover only expenses incurred by spouses and tax dependents. Covering non-tax dependents could cause all benefits for all employees under the arrangement to be taxable.

An employer who anticipates providing health plan coverage to the Non-tax Dependents of employees should consider the effect on other benefit programs the employer sponsors and other obligations. For example, assume an employer in Wisconsin with an insured health plan continues its normal practice of contributing toward the cost of an employee's family coverage. Under the insurance contract, a child of an employee continues to be covered under the employee's family plan pursuant to Wisconsin Statute § 632.885 even though the child ceases to be a dependent for purposes of the federal tax rules applicable to health plans. As a result, the employee's taxable wages are increased by the imputed FMV of that coverage. This increase in the employee's taxable wages will increase the employer's and the employee's employment tax liability. This increase in the employee's taxable wages also could increase the employee's wages for purposes of the employer's retirement plan, resulting in a larger retirement plan contribution or benefit accrual for employees with covered Non-tax Dependents. Therefore, the employer might want to review its retirement plan with counsel to consider its options.

An employer could avoid the issues noted above by requiring employees to pay the entire cost of coverage of Nontax Dependents from their own pockets with after-tax dollars. For plans not subject to ERISA, state law should be reviewed to determine if the employer could require the employee to pay the entire amount.
