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## Tax Implications of Dependent Coverage After Health Care Reform

# Presenters



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# Agenda

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- ▶ Coverage Mandate
  - Who *must* be covered?
  - Who *can* be covered?
- ▶ Tax Implications
  - Who is *entitled* to tax-free coverage?
  - Who must be *taxed* for coverage?

# Coverage Mandate vs. Tax Exclusion

- ▶ Different Effective Dates:
  - Coverage: 1<sup>st</sup> PY after Sept. 23, 2010 (i.e., 1-1-2011 for calendar year plans)
  - Tax Change: March 30, 2010
- ▶ Different Age Limit
  - Coverage: Up to child's 26<sup>th</sup> birthday
  - Tax Change: Through 12/31 after 26<sup>th</sup> birthday
- ▶ Plan eligibility does not necessarily mean coverage will be tax free

# Overview of Coverage Mandate

- ▶ Section 2714 of the Public Health Service Act (corollary provisions in ERISA and the Tax Code)
- ▶ Added by Patient Protection and Affordable Care Act (“ACA”)
- ▶ Interim Final Regulations issued by DOL, HHS, and Treasury

# Dependent Coverage Mandate

- ▶ *If* a plan makes coverage available to dependent children, such coverage must be available up to the child's 26<sup>th</sup> birthday
  - The last required coverage date is the day *before* the child's 26th birthday
  - Even if married
  - Regardless of student status (Michelle's law obsolete)
  - Need not reside with parents
  - Need not be financially dependent on parents

# Dependent Coverage Mandate- Applicability

- ▶ Applies to group health plans and health insurance issuers
- ▶ Insured and self-funded
- ▶ Medical and prescription drug
- ▶ Dental and vision (unless “excepted benefit” under HIPAA)
- ▶ ERISA and non-ERISA

# Definition of “Child”

- ▶ Child is not defined in recent tri-agency regulations (for this purpose) but *may* include an employee’s:
  - Son or daughter
  - Stepson or stepdaughter
  - Lawful foster child
  - A child legally adopted by or placed for adoption with the employee
- ▶ Child does not include the spouse or children of the adult child (i.e., the employee’s son-in-law, daughter-in-law, or grandchildren)

# Verification of Eligible Dependents

- ▶ Ask employee to certify
- ▶ Require documentation (e.g., birth certificate)
- ▶ Dependent eligibility audit

# Dependent Coverage Mandate-Grandfathered Plans

- ▶ Prior to the plan year beginning in 2014, “Grandfathered plans” are not required to provide this coverage to an adult child who is eligible for other employer-provided coverage (other than coverage through a parent)
- ▶ Other coverage may be from adult child’s own employer, or his or her spouse’s employer
  - How does a plan administrator know whether child is eligible for other coverage?
- ▶ Adult child who is eligible for coverage under the plans of the employers of both parents may not be excluded by either plan based on the fact that the adult child is eligible to enroll in the plan of the other parent’s employer

# Cost and Terms of Dependent Coverage

- ▶ Regulations restrict employers' ability to charge for extended dependent coverage
- ▶ Employers' contribution structure for other dependents must be extended to adult children now covered under the mandate
- ▶ Neither contributions nor benefit eligibility can vary based on a child's age

# Cost and Terms of Dependent Coverage (cont.)

- ▶ Tiered or per dependent contributions are permitted
- ▶ Employers may have to enroll and cover additional dependents under current family contribution rates, or they may consider adopting new contribution structures, such as charging per dependent, regardless of age
- ▶ Adult child surcharge not allowed
- ▶ Benefit options cannot be age restricted

# Dependent Coverage and COBRA

- ▶ Mandate must be extended to qualified beneficiaries under COBRA
  - Former employee on COBRA would have the same right to add an adult child up to age 26 as would a similarly situated active employee
- ▶ Children who have aged out of a plan and now have COBRA continuation coverage must be given the opportunity to enroll as a dependent of an active employee
  - Child who later loses eligibility due to a qualifying event will then have *another* opportunity to elect COBRA

# Dependent Coverage and State Law

- ▶ For insured plans, state laws that provide more generous coverage requirements for adult children are not preempted by the Act
- ▶ These plans will need to look at each condition of both the federal mandate and relevant state law to determine which provisions can be applied to dependents at various ages.
  - *Example.* An insured health plan is subject to (i) the new federal mandate and (ii) a state law requiring coverage to be offered to *unmarried* children up to age 28. Once the federal mandate applies to this plan, children must be offered coverage to age 26 regardless of marital status, but children aged 26 and 27 must only be offered plan coverage if *unmarried*.

# Dependent Coverage- Special Enrollment Opportunity

- ▶ Only relevant for non-calendar year plans beginning between now and September 22, 2011.
- ▶ Encompasses all children under age 26 who have lost coverage due to aging out of a plan's pre-ACA eligibility provisions, and those originally denied coverage or ineligible due to age
- ▶ If a child is eligible under these new rules, a parent not currently enrolled must be given an opportunity to enroll as well

# Dependent Coverage- Special Enrollment Period

- ▶ Mandatory 30-day opportunity to enroll no later than the first day of the first plan year beginning on or after September 23, 2010
  - Coverage must start no later than that date, even if the request for coverage is made after that date
- ▶ Can use open enrollment period provided special notice is furnished and children are given at least 30 days to enroll

# Dependent Coverage- Notice of Enrollment Period

- ▶ Plans must provide written notice about the opportunity to enroll
- ▶ A “prominent” notice must be given (by the plan or an insurer) to an employee on behalf of the child, and may be included with other enrollment materials
  - The enrollment right must offer all benefit packages available to similarly situated children under 26
  - Parents may switch to a benefit package option for which a child is eligible

# Dependent Coverage- Who *May* be Covered

- ▶ Beyond mandate, plan sponsors are free to cover other “dependents” as a matter of plan design
- ▶ Common examples:
  - Children age 26 and older
  - Children of domestic partners
  - Grandchildren

# Dependent Coverage – Tax Treatment

- ▶ Taxation of Dependent Coverage prior to Health Care Reform
  - Code Section 105 – generally excludes from income benefits paid/reimbursed under employer-sponsored accident and health plans
  - Code Section 106 – generally excludes from income the value of health plan coverage paid by employer (or paid with pre-tax employee contributions)

# Exclusion from Income (before Reform)

- ▶ Prior to Health Care Reform, Sections 105 and 106 excluded from income benefits and coverage (for “medical care,” as defined in Code Section 213) provided to:
  - Employees (including retirees);
  - Spouses (as defined under DOMA); and
  - Dependents (as defined in Code Section 152, determined without regard to subsections (b)(1), (b)(2) and (d)(1)(B)).

# Tax Code “Dependent”

- ▶ Under Code Section 152, “dependent” includes a “qualifying child” or “qualifying relative”
- ▶ A “qualifying child” must:
  - Be a “child,” as defined in Sec. 152(f)(1);
  - Live with taxpayer for over ½ the year;
  - Not provide over ½ of own support; and
  - Be under 19 for entire year, or a full time student who is under 24 for entire year

# Tax Code “Dependent”

- ▶ Under Section 152(f)(1), a “child” is:
  - A son or daughter;
  - A stepson or stepdaughter (no definition in Tax Code);
  - A legally adopted child;
  - A child lawfully placed for adoption; or
  - An eligible foster child (broad Tax Code definition).

# Tax Code “Dependent”

- ▶ “Qualifying Relative”
  - Unlike “qualifying child”, no age restrictions
  - Must be either “relative” (broader definition than “child”) or reside with taxpayer
  - Taxpayer provides over  $\frac{1}{2}$  support
  - Must not be the “qualifying child” of any other person

# “Imputed” Income

- ▶ If coverage is provided to non-tax dependent, value of coverage must be reported as taxable income on employee’s W-2
- ▶ Common examples
  - Grandchildren
  - Domestic partners
  - Non-dependent children

# “Imputed” Income

- ▶ Amount reported is FMV of coverage (less any after-tax employee contributions)
- ▶ Usually COBRA rates

# Changes Made by Reform Act

- ▶ Health Care Reform amends Section 105 (and 106) by *extending* the exclusion from income to:
  - Any “child” (not just “qualifying child”) of the taxpayer who, as of the end of the taxable year, has not attained age 27 (slightly longer than coverage mandate)
- ▶ Note: Health Care Reform does not amend or change Section 152
  - So no change in who can be claimed as a “dependent” on employee’s tax return

# Impact of Tax Code Change

- ▶ Coverage and payments for a child under 27 are excludible from income, even if the child does not qualify as a Tax Code “dependent” because:
  - Child is too old (>18, or student > 23)
  - Child does not live with parent;
  - Child pays for > ½ of own support;
  - Child is married; or
  - Child is no longer a full-time student.

# Impact of Tax Code Change

- ▶ Amounts paid or reimbursed for “medical care” of adult child (under 27) are not taxable to employee
- ▶ Employer-paid health care coverage for adult child (under 27) is not taxable to employee
- ▶ Applies to coverage provided or payments/reimbursements made on or after March 30, 2010
- ▶ Applies to group health plans (including premiums paid via 125 cafeteria plans), HRAs, and health FSAs
- ▶ Does not apply to HSAs

# State Tax Issues

- ▶ Approx.  $\frac{1}{2}$  states automatically follow federal tax law
- ▶ Other  $\frac{1}{2}$  states do not automatically follow and have not yet changed state law to conform to the new federal law
  - In such states, may still need to “impute” income for older children who do not meet state’s definition of “dependent”

# IRS Guidance: Notice 2010-38

- ▶ Confirms applicability to Section 106
- ▶ ER may rely on employee's representation of child's age or DOB
- ▶ Excludes coverage/reimbursements from "wages" for purposes of FICA, FUTA, RRTA and FIT withholding

# Cafeteria Plans

- ▶ Exclusion from income applies to:
  - Premiums for coverage of children < 27 paid with pre-tax employee contributions
  - Reimbursement of medical care expense of children < 27 through a health FSA
- ▶ Mid-year “change in status” events may include a child who is <27:
  - Becoming newly eligible for coverage; or
  - Becoming eligible for coverage beyond the date child would have otherwise lost coverage

# Health FSAs

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- ▶ Not subject to coverage mandate (“excepted benefits”) but *may* provide tax-free reimbursements for child under age 27

# Health Reimbursement Arrangements

- ▶ May reimburse expenses of child under age 27 or a tax dependent
- ▶ Most HRAs subject to coverage mandate