

# IRS Issues Guidance on Tax Exclusion for Health Care Coverage of Adult Children

*This is the third in a series of Reinhart E-Alerts concerning the recently enacted Patient Protection and Affordable Care Act (PPACA) and the Health Care and Education Reconciliation Act (HCERA) (referred to collectively as the Act).*

On April 27, 2010, the IRS issued Notice 2010-38, the first round of health care reform guidance. Notice 2010-38 provides guidance on the tax treatment of health care benefits provided to children under age 27. Notice 2010-38 does not offer any guidance regarding the mandatory coverage of adult children as a result of the Act. On May 10, 2010, however, the IRS, Department of Labor and Department of Health and Human Services jointly issued interim final regulations regarding the Act's mandatory coverage provisions. A future Reinhart E-Alert will address the provisions of these regulations.

## Background

Effective as of the first plan year beginning on or after September 23, 2010, the Act requires group health plans and health insurance issuers that provide dependent coverage to children to make such coverage available for a child, whether married or unmarried, until age 26. Effective March 30, 2010, the Act also amends the Internal Revenue Code (the Code) to exclude from an employee's gross income the value of coverage provided to the employee's children who have not attained age 27 as of the end of the taxable year.

## Federal Tax Exclusion

The income tax exclusion applies to health coverage for a child who has not attained age 27 as of the end of the taxable year. For example, if a child will turn 27 on November 14, 2012, the exclusion applies only to coverage provided for that child through December 31, 2011. The taxable year is the employee's taxable year, and employers may rely on an employee's representation as to the birth date of a child. Thus, effective March 30, 2010, the value of coverage and reimbursements for such child are excluded from the employee's gross income, and are not considered wages for FICA or FUTA purposes (i.e., no income need be imputed to the employee).

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A "child" for purposes of this exclusion includes an employee's child, stepchild, adopted child, and eligible foster child, married or unmarried. The exclusion is available for a child meeting the age limit regardless of whether the residency, support and other tests under Code section 152 are satisfied.

The income exclusion extends to cafeteria plans, health flexible spending accounts (health FSAs), health reimbursement accounts (HRAs), voluntary employee benefit associations (VEBAs), health care accounts in pension plans, and the self-employed medical tax deduction. The exclusion does not apply to health savings accounts (HSAs).

## Cafeteria Plans

Although cafeteria plan amendments generally must be prospective, the notice allows employers to amend their cafeteria plans retroactively to permit pretax salary reductions for children under age 27. The amendment must be executed by December 31, 2010 and must be retroactive to the first date on which employees may make pretax contributions (no sooner than March 30, 2010).

Generally, a cafeteria plan may permit an employee to revoke an election and make a new election only in limited circumstances, such as a "change-in-status" event. The IRS intends to amend the cafeteria plan regulations, retroactive to March 30, 2010, to include as "change-in-status" events those events affecting adult children under age 27, including becoming newly eligible for coverage or eligible for coverage beyond the date on which the child otherwise would have lost coverage.

## Mandatory Coverage

The Code's exclusion from federal income tax for coverage and reimbursements for an "adult child" are effective March 30, 2010. However, as noted above, the Act's requirement that group health plans and health insurers provide dependent coverage to adult children until age 26 is not effective until the first plan year beginning on or after September 23, 2010. Thus, group health plans and insurers may, but are not required to, provide coverage to adult children under age 27 before the mandatory effective date. If plans or insurers provide this coverage before required to do so, the coverage or reimbursements are excluded from federal income tax, FICA and FUTA. A number of insurers (including UnitedHealthCare, Humana, WellPoint and Kaiser Permanente) announced that they will begin extending coverage to older children sooner than the mandatory



effective date.

## State Tax Issues

In many states, insured plans are already required to provide coverage to older dependents of covered employees. These state laws include a wide variety of eligibility requirements and age limits. According to a survey published by National Conference of State Legislatures, as of August 20, 2009, at least 30 states had enacted insurance legislation to extend dependent coverage regardless of student status.

Effective March 30, 2010, employers are no longer required to impute income to employees for the value of employer-paid health coverage for children under age 27 for federal tax purposes. However, employers may still be required to impute income for state tax purposes, depending on whether the state is using the same definition of "dependent" for tax purposes as the federal law. We anticipate that where disparities exist, states will pass laws to revise their income tax provisions to parallel the exclusion under federal law for adult children. Until this happens, however, employers may have to impute income based on one set of rules for federal tax purposes and another for state tax purposes.

For more information on the tax implications of health coverage for adult children, please contact your Reinhart Employee Benefits attorney.

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