

MP&S TAX ALERT: HEALTH COVERAGE FOR ADULT CHILDREN MAY 2010

IRS ISSUES GUIDANCE ON TAX TREATMENT OF HEALTH COVERAGE FOR ADULT CHILDREN

The Internal Revenue Service (IRS) has released guidance on provisions of the Patient Protection and Affordable Care Act (PPACA) related to the tax treatment of employer-provided health coverage for adult children. Under the PPACA, coverage requirements have expanded and such coverage is generally tax free for employees. IRS Notice 2010-38 explains the implications for workplace and retiree health plans, including cafeteria plans and flexible spending accounts (FSAs).

THE EXPANDED GENERAL EXCLUSION

The PPACA *requires* plans that provide coverage to employees' dependent children to now continue making that coverage available until the child turns age 26. (This coverage must be provided no later than plan years beginning on or after Sept. 23, 2010.) Employers may provide coverage for children beyond that age but aren't required to do so.

What about the tax treatment? As Notice 2010-38 observes, Sections 105 and 106 of the Internal Revenue Code (IRC) already excluded coverage under an employer-provided accident or health plan — as well as employer-provided reimbursements for the medical care of the employee, employee's spouse or dependents — from an employee's taxable gross income.

PPACA amended those sections to extend the tax benefit to coverage for an employee's child who hasn't reached age 27 as of the end of the employee's taxable year. Children under the age of 27 will also be considered dependents of a taxpayer for purposes of the deduction of self-employed persons of amounts paid during the year for health insurance for themselves, their spouses and their dependents. However, denial of the deduction for the health care costs of a self-employed person who can participate in a health plan maintained by an employer (i.e., the self-employed person has another job) or an employer of the spouse is extended to situations where the self-employed person is eligible to participate in any subsidized health plan maintained by any employer of a taxpayer's dependent or a child of the taxpayer who is under age 27 at the end of the tax year.

A "child" is defined as the son, daughter, stepson or stepdaughter of an employee, including those both legally adopted and lawfully placed with the employee for adoption. The term also includes foster children placed by an authorized placement agency or by court order. Significantly, the previous exclusion applied only to children who qualified as "dependent," but PPACA's exclusion doesn't require that a child be a dependent.

Let's review an example from Notice 2010-38: An employer provides health care coverage for its employees and their spouses and dependents. Effective May 1, 2010, to comply early with PPACA, the employer amends the health plan to provide coverage for any employee's child under age 26. An employee's son graduates from college on May 15, 2010, and will turn 22 later in the year. Prior to graduation the son is a dependent, but not after.

For the 2010 taxable year, the health care coverage and reimbursements provided to the son are excludible from the employee's gross income. They're excludible for the period from Jan. 1 through May 15 because the son was a dependent. For the period on and after March 30, they're excludible because the son is an employee's child who will not reach age 27 during the 2010 taxable year. So, for the period from March 30 through May 15, the coverage and reimbursements are excludible on two bases. It makes

no difference if the son becomes employed during the year — unless he participates in his employer's plan.

THE EFFECT ON CAFETERIA PLANS

The IRC provides that the gross income exclusion applies to certain qualified benefits that are offered as part of a cafeteria plan. Cafeteria plans allow employees to elect between cash and certain qualified benefits that aren't includible in an employee's gross income.

Notice 2010-38 makes clear that the exclusion for an employee's child who hasn't reached age 27 at the end of the employee's tax year also applies to qualified benefits in cafeteria plans, such as accident or health plans and health FSAs.

Cafeteria plans may allow an employee to revoke an election between cash and benefits during a coverage period to make a new election only in limited circumstances, including a "change in status" event. A change in the number of an employee's dependents qualifies as a change in status event.

According to Notice 2010-38, the IRS and the Treasury Department intend to amend regulations, effective retroactively to March 30, 2010, to include change-in-status events that affect nondependent children under age 27. Such events will include becoming newly eligible for coverage or eligible for coverage beyond the date on which a child would otherwise have lost coverage.

Notice 2010-38 also explains the transition rule for cafeteria plan amendments. As of March 30, 2010, employers could allow employees to immediately make pretax salary-reducing contributions for accident or health benefits for children under age 27 under a cafeteria plan — even if the plan hasn't yet been amended to provide coverage for those children.

However, a retroactive amendment to cover children under age 27 must be made no later than Dec. 31, 2010, and the amendment must be effective retroactively to the first date in 2010 when employees could make the contributions — but not before March 30, 2010.

TAX WITHHOLDING RULES

Coverage and reimbursements for employees and their dependents under employer-provided accident and health plans generally are excluded from wages for purposes of Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) tax withholding.

Notice 2010-38 states that such coverage and reimbursements for an employee's child under age 27 also don't constitute wages for FICA and FUTA purposes. The coverage and reimbursements are exempt from income tax withholding, too.

NEXT STEPS

The IRS has stressed that it intends to make it as easy as possible for employers to extend tax-free health coverage to the adult children of their employees. We recommend that employers consult with their MP&S advisor before implementing these changes to confirm they properly comply with all of the relevant rules and regulations.

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FOR MORE INFORMATION

For more information about the Patient Protection and Affordable Care Act, please contact your MP&S tax advisor or Steven Eliach, JD, LL.M., the Principal-in-Charge of the MP&S Tax Practice, by phone at 212.503.6388 or by email at seliach@markspaneth.com.

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