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Volume 33 | Issue 22 | May 4, 2010

IRS Provides Guidance on Taxation of Adult Children's Health Benefits under Health Reform Law

The IRS has issued the first guidance on a provision of the new health reform law that treats employer-provided health coverage for adult children as nontaxable to the employee. Notice 2010-38 also addresses cafeteria plan amendments allowing coverage of adult children to be paid for on a pre-tax basis. The White House has also issued a Fact Sheet on the coverage of adult children under health reform.

Background

The Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010, requires group health plans and insurance issuers that cover dependents to cover adult children until they reach age 26. The law also changes the Internal Revenue Code to provide that this coverage is not taxable to the employee for the entire taxable year if the adult child does not reach age 27 during that year. The IRS has issued [Notice 2010-38](#) to provide guidance on the tax changes. Concurrently, the White House issued a [release](#) that discusses the requirements of the health reform law and the administration's efforts to encourage insurers to voluntarily offer adult child coverage prior to the dates required under the health reform law.

Notice 2010-38

The IRS first notes that the two provisions referred to above are not consistent in certain respects – i.e., the first provision requires coverage of children up to age 26 and is effective for the first plan year beginning after September 23, 2010 (January 1, 2011 for calendar year plans), while the provision on the revised tax treatment applies to children who have not attained age 27 in a taxable year and went into effect on March 30, 2010.

Although the guidance does not provide any real surprises regarding the revised tax treatment, the IRS provides several confirmations and clarifications –

- Even though the law did not specifically amend Section 106 (which provides favorable tax treatment for employer contributions to a health plan), the IRS says that it will amend the regulations under Section 106 to be consistent with the changes made to Section 105 (which provides favorable tax treatment to amounts received under an employer-sponsored plan).
- Reimbursements made on and after March 30, 2010 are eligible for the new tax treatment. Any reimbursements made prior to that date are subject to the tax treatment in effect prior to the change.

BUCK COMMENT. *Employers who are currently imputing income to employees for coverage provided to adult children due to state mandates should immediately cease doing so for adult children who satisfy the new federal tax requirements, and consult with their payroll advisors on how to address coverage provided since March 30, 2010.*

- For purposes of this tax treatment, a “child” includes an employee’s son, daughter, stepson, or stepdaughter. “Child” also includes a legally adopted child, a child placed for adoption, and a foster child placed with the employee.
- The child does not have to be a tax dependent and the employer may rely on the employee’s representation as to the child’s date of birth.
- For purposes of IRC Section 125, this new tax treatment will be considered a change-in-status event, and the IRS intends to amend its regulations to so provide retroactive to March 30, 2010.
- Coverage and reimbursements for adult children are not considered wages for FICA or FUTA purposes.
- The new treatment applies to reimbursements from health flexible spending accounts (FSAs) and health reimbursement accounts (HRAs). As health savings accounts (HSAs) are not mentioned, the treatment presumably does not apply to these accounts.

BUCK COMMENT. *The favorable tax treatment also applies to dental and vision benefits, even when they do not have to be provided to age 26 because they qualify as HIPAA-excepted benefits. (Limited scope dental and vision benefits generally will be HIPAA-excepted if they are not bundled with medical coverage – i.e., employees have separate election rights and pay an additional premium for the coverage.) For administrative ease or because of benefit philosophy, employers may decide to also allow young adults to continue dental and vision coverage to age 26.*

High-deductible health plans that are offered in conjunction with HSAs will be required to cover adult children. However, since the health reform law did not amend IRC Section 223, which governs HSAs, it appears that HSAs cannot reimburse medical expenses for adult children on a tax-free basis unless the child otherwise qualifies as a tax dependent of the account holder. Any HSA reimbursements would be treated as nonqualified reimbursements subject to income inclusion and penalties, which increase to 20% in 2011. Employers will need to consider communicating this to employees.

Transition Rule and Cafeteria Plan Amendments. Amendments to cafeteria plans may generally apply only prospectively. The notice states that employers may allow employees to make salary reduction contributions for the coverage of adult children as of March 30, 2010, even though they do not amend their plans until a later date. However, the IRS says that a retroactive amendment to the first date employees are allowed to make these contributions (no earlier than March 30, 2010) must be made by December 31, 2010.

White House Fact Sheet

The White House also issued a Fact Sheet on the coverage of young adults under the health reform law. The Fact Sheet discusses the efforts the administration has made to encourage insurance carriers to begin covering young adults immediately, rather than waiting until the statutory effective date. Many insurance carriers have agreed to early adoption, generally allowing young adults who are currently covered under the plan to continue coverage, even if they would otherwise lose coverage due to age limitations or because they are no longer attending school.

BUCK COMMENT. *Employers should discuss with their insurance carriers whether they want to cover young adults immediately. Since no guidance has been issued yet on the young adult coverage requirements, there are open issues that an employer will need to consider. For example, guidance is needed in areas such as which young adults must be offered coverage and what an employer can charge for this coverage. If an employer wants to make coverage available immediately for all adult children, and not just those currently covered under the plan, the employer would also need to consider a special mid-year open enrollment period to allow adult children to enroll in the program.*

Conclusion

The IRS guidance is useful in resolving some issues regarding the new tax treatment for adult children's health coverage. Because of the many questions that employees have about this coverage, employers should consider specialized communications to employees. We will continue to provide you with updates as new guidance emerges.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.