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Extension of Health Coverage to Adult Children May Result in Tax Consequences in Some States

PPACA amended the federal Internal Revenue Code to exclude from an employee's income for federal tax purposes the value of health coverage provided to an "adult child" through the end of the year in which the adult child turns age 26. However, the value of this coverage may be includible in the employee's income for state tax purposes if the state's tax code does not coordinate with the change in federal tax treatment. State tax treatment currently is a "moving target" as many legislatures in non-conforming states are considering whether to change state tax laws to conform to federal tax treatment.

Background

The Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010, (collectively "PPACA") requires group health plans and insurance issuers that cover an employee's biological, adopted, step, or foster children to extend coverage to these children until they attain age 26 ("adult child" or "adult children"). (See our May 13, 2010 [For Your Information](#).) Plans and issuers must make coverage available regardless of the adult child's marital or student status or whether the child resides with, or is supported by, the employee. (Prior to 2014, a grandfathered group health plan does not have to offer coverage to an adult child who is eligible for health coverage from his or her own employer.) This provision was effective for plan and policy years beginning on or after September 23, 2010. However, some plans and issuers either voluntarily, or pursuant to existing state laws, adopted some version of adult child coverage earlier. (See our May 4, 2010 [For Your Information](#).)

To coordinate the federal tax laws with the mandatory coverage of adult children, PPACA amended the Internal Revenue Code ("federal Code") to exclude from federal income tax the value of health coverage and benefits provided to adult children. The federal tax exclusion which became effective on March 30, 2010, is available until the end of the calendar year in which the adult child attains age 26.

BUCK COMMENT. *PPACA deliberately extends the special federal tax treatment to the end of the calendar year in which the adult child turns age 26 (even though the mandatory coverage requirement only applies until the adult child attains age 26) in order to prevent an employee from facing a federal tax issue if the plan provides coverage beyond the birthdate. It is not unusual for plans to continue coverage until the end of the month in which the birthday occurs or, in some cases, until the end of the calendar year.*

Prior to PPACA, the federal Code limited the income exclusion for health coverage to dependents, defined either as a “qualifying child” or a “qualifying relative,” as set out below:

- An individual is a “qualifying child” if he or she satisfies all of the following five requirements:
 - The individual lives with the employee for more than one-half of the tax year;
 - The individual is the employee’s son, daughter, stepchild, sibling, stepsibling, or a descendent of any such individual;
 - As of the end of the calendar year, the individual is under the age of 19, under the age of 24 and a full-time student, or permanently disabled;
 - The individual does not provide over one-half of his or her own support; and
 - The individual has not filed a joint tax return for the year with his or her spouse.
- An individual is a “qualifying relative” if he or she satisfies all of the following three requirements:
 - The individual bears a specified relationship (including that of a child, a sibling, or a descendent of a child or sibling) to the employee;
 - The employee provides more than one-half of the individual’s support; and
 - The individual is not a qualifying child of the taxpayer or any other person for that calendar year.

Prior to PPACA, the value of health coverage provided to children who did not fall within these definitions (i.e., was a “nonqualifying dependent”), such as a 25-year-old individual who did not receive more than one-half of his or her support from the employee, would be includable in the employee’s income. PPACA removed the need for biological, adopted, step, or foster children to meet one of the dependent tests.

BUCK COMMENT. *PPACA did not eliminate the dependent tests as an alternative means of income exclusion, and these rules are still applicable, for example, in determining whether the employee can exclude the value of coverage for the child of a domestic partner.*

State Taxation Issues

In many states, the starting point for calculating an individual’s state income tax liability is the individual’s federal adjusted gross income as determined under the applicable provisions and definitions of the federal Code. In those states that have tax codes that automatically “conform” to the most current version of the federal Code, the individual’s adjusted gross income generally will be the same for both federal and state tax purposes.

However, in those states that refer to a version of the federal Code that was in effect on a date prior to March 30, 2010 (the effective date of the new federal tax exclusion), do not refer to the federal Code at all, and/or have their own rules, the adjusted gross income of an employee covering an adult child could be higher for state tax

purposes than for federal tax purposes. Income will not be higher under state tax law if either the adult child qualifies for the income tax exclusion under the federal Code referred to by the state as a dependent or the state has some special provision under its tax code.

BUCK COMMENT. *Many states have legislation pending that could affect 2010 (and thus 2010 W-2s) and/or 2011 (and thus 2011 withholding). In these states, the state tax treatment is a “moving target.” Employers should continue to check with their tax advisors or payroll administrators for the latest information.*

Non-Conforming States

States that have directly addressed the state tax treatment, in whole or in part, to date are California, Iowa, Kentucky, Minnesota, Oregon, Virginia, and Wisconsin. In many of these states, however, the information provided contains a caution that the state legislature may revise the treatment retroactively.

California. California follows the federal Code as in effect on January 1, 2010. California takes the position that the provision of health coverage to a child who is not a dependent (i.e., “qualifying child” or “qualifying relative”) as defined in the January 1, 2010 federal Code will result in taxable income to the employee for state tax purposes. This income must be reported as additional wages on the employee’s W-2. The state Franchise Tax Board has issued [guidance](#) stating that the amount of income to be included is equal to the amount by which the fair market value of the coverage provided to the nondependent child exceeds the amount that the employee paid for the coverage. This means that every employee who covers a nondependent child may have an amount included in income.

BUCK COMMENT. *California has legislation pending that will change its tax rules to conform with the new federal treatment retroactive to March 30, 2010. The legislation has made some progress in committee, but its fate is far from certain as California grapples with major initiatives to reduce its budget deficit.*

Iowa. Iowa follows the federal Code as in effect on January 1, 2008, but its tax code provides for an adjustment to an employee’s income to exclude the value of health coverage provided to a child who does not qualify as a taxpayer’s tax dependent under the federal Code. The Iowa Department of Revenue has issued [guidance](#) stating that as a result of Iowa’s adjustment, the tax treatment of coverage of “nonqualified dependents” will be the same for both federal and state income tax purposes.

Kentucky. The Kentucky Department of Revenue issued [guidance](#) informing employers that the state follows the federal Code in effect as of December 31, 2006 and that employers must treat the amounts paid to provide health coverage to children who are not dependents (i.e., not “qualifying children” or “qualifying relatives”) under that federal Code as being paid with post-tax dollars for state income tax purposes.

Minnesota. The Minnesota Department of Revenue issued [guidance](#) stating that although under current state law the fair market value of nondependent child health coverage would constitute wages to the employee, the

Department would not require employers to withhold taxes with respect to these benefits until the state legislature addresses the issue.

BUCK COMMENT. *In January 2011, a bill providing for retroactive amendment of the state law to conform to federal law was introduced.*

Oregon. Oregon follows the federal Code as in effect on January 1, 2009. The Oregon Department of Revenue (DOR) takes the [position](#) that the provision of health coverage to a child who is not a dependent (i.e., not a “qualifying child” or “qualifying relative”) under the January 1, 2009 federal Code will result in taxable “imputed” income to the employee for state tax purposes. The DOR states that the amount of imputed income is the fair market value of the coverage and suggests that one way to determine this is to use the plan’s COBRA rate minus the administrative fee. The DOR release includes a caution that only the legislature can change the treatment.

Virginia. On February 16, 2011, Virginia’s governor signed HB 1874, which amends the Virginia tax code to follow the federal Code and other federal tax laws as they existed on December 31, 2010. (The prior reference was to January 22, 2010.)

BUCK COMMENT. *Employers should check with their tax advisors as to whether this change affects 2010 state tax treatment. On its surface, it appears to affect only 2011 and later years.*

Wisconsin. Wisconsin follows the federal Code as in effect on December 31, 2008. The Wisconsin Department of Revenue (DOR) has issued [guidance](#) stating that if an adult child does not qualify for the exclusion as a dependent, the fair market value of the adult child’s health insurance coverage and the reimbursements from a medical flexible spending account are income and taxable wages to the employee. The DOR notice includes a caveat that any change in treatment requires legislation.

Nonconforming states that have not yet taken a formal position on the taxation issue include Arizona, Arkansas, Georgia, Hawaii, Idaho, Indiana, Maine, Massachusetts, Mississippi, New Jersey, South Carolina, and West Virginia.

BUCK COMMENT. *There are a number of states – both conforming and nonconforming – that require coverage of adult children to ages beyond the date the child attains age 26. For example, New York requires coverage until the “child” attains age 30 and New Jersey requires coverage until the “child” attains age 31. This mandatory health coverage is likely to generate federal and perhaps state tax on the employee (unless the “child” is otherwise a dependent). This For Your Information does not address those issues.*

Conclusion

Employers in nonconforming states face great uncertainty – even in those states that have provided preliminary guidance. With many legislatures considering whether to change their current law and the lack of clarity in many

cases as to what income to impute as the fair market value of coverage for “nonqualifying dependents,” employers face challenges in determining the amount to withhold and the amount to report as wages. While it is likely that in most states the fair market value of the provided coverage would have to be reported as additional wages to the employee, some states may only require that the incremental cost of covering the adult child be reported. Employers should consult with their payroll administrators and state tax advisors as to whether the state tax treatment has changed and whether there is additional state guidance on imputed income and withholding.

Employers should also keep in mind that some of the previously ineligible children who have been added to health coverage as a result of health care reform will satisfy the definition of “qualifying relative” if they are receiving more than one-half of their support from the employee. Employees that can provide evidence that their adult children are “qualifying relatives” will not have taxable income for federal and perhaps state purposes.

Buck’s consultants are available to assist you in addressing these tax issues and other issues related to the extension of dependent coverage and health care reform.

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.