

New Rules for Health Coverage of Children Under Age 27

The recent health care legislation (the “Affordable Care Act”) provides for an extension of dependent coverage effective March 30, 2010. The legislation requires group health plans that provide dependent coverage to continue coverage until the child turns 26. Congress amended the Internal Revenue Code (IRC) to exclude the coverage as a taxable fringe benefit as part of the legislation. Health care coverage for adult children over the age of 19 (or over the age of 24 in the case of a student) previously was a taxable fringe benefit. The IRS recently issued guidance on the tax treatment of health coverage for children under age 27 under the new law. The new under-age-27 rule applies broadly to:

- > Employer-provided coverage or reimbursements
- > Cafeteria plans
- > Flexible spending arrangements (FSAs)
- > Health reimbursement arrangements (HRAs)
- > Voluntary employees’ beneficiary associations (VEBAs)
- > The Section 162(l) above-the-line deduction for a self-employed individual’s medical care insurance costs

This alert addresses the changes to the taxable fringe benefit rules for health coverage, answers some common questions pertaining to the new coverage requirement, and provides a brief discussion of the other benefit plans impacted by the under-age-27 rule.

Background

The Affordable Care Act made three important changes:

1. Section 105(b) excludes from taxable income the reimbursements for medical care (including dental and vision care) under an employer-provided accident or health plan. This exclusion is extended to any employee’s child who has not attained age 27 by the end of the tax year.
2. The new law applies the under-age-27 rule to retiree health accounts in pension plans, VEBAs, and self-employed individuals’ deductions for medical care insurance.
3. The new law requires group health plans and health insurance issuers that provide dependent coverage of children to continue to make such coverage available for an adult child until age 26.

Note that the health insurance coverage rules do not parallel the tax rules. The health insurance rules apply to children **under age 26** and are effective for the first plan year beginning on or after September 23, 2010. The tax rules apply to children who have **not attained age 27** by the end of the tax year and are effective March 30, 2010.

The following is a summary of the IRS’s guidance (Notice 2010-38) on the expanded rules for medical coverage of children.

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Exclusion for employer-provided medical care reimbursements

The exclusion from taxable income for employer-provided reimbursements for expenses incurred by the employee for medical care is extended to such reimbursements for medical care of the employee's child who has not attained age 27 as of the end of the tax year.

"Child" includes the employee's child, stepchild, legally adopted individual, an individual lawfully placed with the employee for legal adoption, and an eligible foster child.

The exclusion applies to an employee's child who has not attained age 27 by the end of the tax year, including a child who is not the employee's dependent. Therefore, the age limit, residency, support, and other tests that otherwise apply to determining whether a child qualifies as a dependent for the dependency exemption do not apply to such a child for health care coverage purposes. The exclusion applies only for reimbursements for medical care of individuals who have not attained age 27 at any time during the employee's tax year. Employers may rely on the employee's representation of a child's date of birth.

Caution: Please note that the law is not retroactive to the start of 2010. If your plan provided health care benefits to adult children from January 1, 2010, through March 29, 2010, those benefits will remain taxable.

Questions and Answers Regarding Dependent Eligibility for Coverage

Q1: Does the adult child have to be a student to be eligible for coverage? Or must any child up to age 26 be covered?

A1: Any adult child of the taxpayer between the ages of 19 and 26 can be covered if the taxpayer desires. Grandfathered plans will be able to exclude adult dependents that are eligible for other employer coverage until plan years beginning on or after January 1, 2014. Further guidance regarding adult child dependent coverage is expected.

Q2: With regard to dependent coverage, if the dependent is married do you also have to cover his or her spouse or children until the dependent turns 26?

A2: As written, the extension of dependent coverage to age 26 only applies to the adult child, not to his or her spouse or children.

Q3: If you have employees in more than one state does your health plan have to follow the laws of the state in which the employee provides services or the laws of the state in which the policy is written?

A3: The federal requirement for coverage up to age 26 will apply to all plans in all states. Fully-insured plans and certain self-funded plans that are subject to state mandates will need to look at the mandates of the state in which they are located. If you have employees in other states, you must determine whether or not those states have "extra-territorial" laws that apply to policies written in other states. If there is an extra-territorial law, then a fully-insured plan may be required to follow the other state's requirements to the extent that it exceeds the federal requirements.

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Q4: When do you have to impute income?

A4: If a child on the benefit plan does not meet the new expanded exclusion under the new law, then the value of the coverage cannot be excluded from the employee's gross income. In addition, any plan that provided coverage to adult children that were not qualifying students prior to March 30, 2010, would need to impute income for the period January 1, 2010, through March 29, 2010. **In addition, many states have mandates** for providing health coverage beyond the age of 26, which would require income to be imputed. Such states include:

- > Illinois: Age 30
- > New Jersey: Age 3
- > Wisconsin: Age 27

Health care coverage mandates are rapidly changing in many states. You should review your state's requirements annually as part of your benefit review procedures.

Note: Many states do not conform to the IRC as of the enactment date of the health care legislation. Therefore, the exclusion will not apply for those states' tax purposes. The District of Columbia automatically adopts changes to the IRC, so the exclusion applies in the District. However, Maryland, Virginia, Wisconsin, Minnesota, and Michigan all have conformity dates preceding the enactment date. Therefore, amounts will not be excludible in those states.

Impact on Cafeteria plans, FSAs, and HRAs

The exclusion for coverage of an employee's child who has not attained age 27 also applies to the definition of qualified benefits for cafeteria plans, including health flexible spending accounts (FSAs).

A cafeteria plan may permit an employee to revoke an election during a period of coverage and to make a new election only in limited circumstances, such as a change-in-status event (e.g., changes in the number of an employee's dependents). However, the IRS rules do not currently permit election changes for children under age 27 who are not the employee's dependents. The IRS has indicated that it will amend its rules retroactively to March 30, 2010, to include change in status events affecting non-dependent children under age 27.

Transition rule for cafeteria plan amendments

Cafeteria plans may need to be amended to include employees' children who have not attained age 27 as of the end of the tax year. Despite the general rule that cafeteria plan amendments may be effective only prospectively, as of March 30, 2010, employers may permit employees to immediately make pre-tax salary reduction contributions for accident or health benefits under a cafeteria plan (including a health FSA) for children under age 27, even if the plan has not yet been amended to cover these individuals. However, a retroactive amendment to a cafeteria plan to cover children under age 27 must be made no later than December 31, 2010, and must be effective retroactively to the first date in 2010 when employees are permitted to make pre-tax salary reduction contributions to cover children under age 27 (but not before March 30, 2010).

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Payroll- and income-tax withholding

Coverage and reimbursements under a plan for employees and their dependents that are provided for an employee's child under age 27 are not wages for Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), or Railroad Retirement Act (RRTA) purposes, and such coverage and reimbursements also are exempt from income tax withholding.

VEBAs, Section 401(h) accounts, and Section 162(l) deductions

A VEBA is a tax-exempt entity that provides for the payment of life, sick, accident, or other benefits to members of the VEBA or their dependents or designated beneficiaries. The IRS intends to amend the VEBA rules to include children who are under age 27 with respect to sick and accident benefits. Similarly, any individual who is a retired employee's child, and who has not attained age 27 by the end of the calendar year, may be covered under Section 401(h), which provides that a pension or annuity plan can establish and maintain a separate account to provide for the payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees, along with their spouses and dependents, if certain enumerated conditions are met.

We expect additional guidance and regulations to be issued pertaining to these and other aspects of the health care legislation as the various provisions become effective in the coming weeks, months, and years.

Recommended Action

Until additional guidance is issued, you should be aware of the following:

- > Your health care plans must be available to employees' children through age 26 if they are currently available.
- > Any reimbursements to employees for medical costs of such children should be treated in the same manner as reimbursements for younger children. Such reimbursements should not be included in W-2 wages, and you should not withhold income taxes on account of these reimbursements. You should consider reminding employees that the reimbursements may be taxable for state purposes, and that you are not withholding taxes.
- > You may need to amend their cafeteria plans to cover this legal change.

If you have questions or require further information, please contact your Baker Tilly tax advisor or send an e-mail to tax@bakertilly.com. We will keep you up to date with health care reform as guidance is issued.