



BENEFIT *Advisor*

In This Issue

In this fourth issue of the McGrawWentworth Benefit Advisor for 2008, we will discuss domestic partner benefits. Many organizations extend coverage under their health plan to same-sex and sometimes even opposite sex domestic partners. When organizations begin to consider offering domestic partner benefits, the primary concern is the cost of adding the benefit.

However, cost is a relatively easy consideration. Extending coverage to domestic partners does raise additional administrative concerns. Tax implications are complicated and need to be considered at a federal and a state level. This Advisor will overview the complexity of extending domestic partner benefits and key considerations for organizations extending these benefits.

We welcome your comments and suggestions regarding this issue of our technical bulletin. For more information on this Benefit Advisor, please contact your Account Manager or visit the McGrawWentworth web site at www.mcgrawwentworth.com.

“Domestic Partner Benefits”

Many organizations offer coverage to domestic partners under their health plan. According to the McGrawWentworth 2008 Mid-Market Employee Benefit Survey, 13% of organizations in Southeast Michigan offer domestic partners benefit coverage. Of those that extend coverage to domestic partners:

- 62% offer to same-sex domestic partners.
- 38% offer to both same-sex and opposite sex domestic partners.
- 79% extend coverage to the children of a domestic partner.



Cost is actually the easiest consideration when adding domestic partner coverage. If your organization is considering adding domestic partner benefits or currently offer domestic partner benefits, you should consider the following key issues:

- Definition of Domestic Partners
- Benefits Extended
- Federal Tax Consequences of Domestic Partner Benefits
- State Tax Considerations with Domestic Partner Benefits
- Federal and State Law Protections

Domestic partner benefits are not as easy as amending plan eligibility. Federal law does not limit the classes of persons that can be covered by a group health plan. Employers have tremendous flexibility in whom they choose to extend coverage. But there are laws at State and also the Federal level that address who is eligible to receive health benefits on a tax-favored basis. Therefore, an organization may extend coverage for domestic partners and that may have tax consequences for the employee.

Your organization should address numerous issues before launching domestic partner benefits. This Advisor will address these key issues.

Definition of Domestic Partner

One of the first steps in adding coverage for domestic partners is defining a domestic partner relationship. There are a number of issues that need to be considered:

- **Same-sex and/or opposite sex partners:** Some employers offer domestic partner benefits only to same-sex couples. The idea is that opposite sex partners have the ability to marry. Marriage between opposite sex partners is recognized in all 50 states and by the Federal Government. Same-sex couples only have the ability to marry in Massachusetts. Massachusetts is the only state that recognizes "same-sex" marriages and the Federal government does not.

It is important to determine up front if your organization wants to limit coverage to same-sex partners or extend coverage to opposite sex domestic partners as well.

- **Vendor considerations:** If your organization self-funds your benefit plan, your vendor should have no problem administering a domestic partner benefit. Your organization should make sure your stop loss vendor accepts the partner coverage.

If your organization fully insures your benefit plan, you will need to verify the insurance carrier can extend coverage. Some insurance carriers limit extending coverage to same-sex domestic partners. State law may also have impact. Some states, for example, California, require insurance carriers to extend domestic partner coverage when an employer requests it.

- **Requirements to prove domestic partnerships:** Most employers that extend domestic partner coverage require the employee to provide some proof a domestic partnership exists. The proof of domestic partnership ties to how the organization defines a domestic partner.



Typically, there are several requirements an employee in a domestic partnership must attest to:

- **Relationship:** unmarried adult of the same or opposite sex, must not be related.
- **Exclusivity:** the relationship is a committed one which is intended to be permanent.
- **Cohabitation:** the adults live together.
- **Interdependence:** the individuals shoulder mutual responsibility for each other's welfare.

Most employers require the employee and the domestic partner to sign an affidavit attesting to the committed and exclusive relationship. The employer may also require some proof of cohabitation.

Several states and even some cities offer domestic partner registries. If your employees live in areas that allow domestic partners to register, your organization may want to cover only domestic partners that complete the registration process.

If your organization is self-funded with employees throughout the country, you could create your own criteria for defining a domestic partner relationship to be consistent across your multi-state locations. This definition would need to be met regardless of any state or city registration opportunity. The registration process will typically have impact on the tax-favored status of the benefits provided to the domestic partner. We will address this issue in more detail in the tax consequences section.

If your plan is fully insured, you may be limited in how your organization defines a domestic partnership to the language approved by your insurance carrier. Prior to launching domestic partner benefits, you should ask your carrier any requirements they may have in defining covered domestic partners.

Your organization will also need to determine if coverage will be extended to the children of domestic partners. It is fairly common to extend coverage to the children of domestic partners.

Benefits Extended

When organizations choose to extend benefits to domestic partners, it is recognizing the role of a domestic partner in an employee's life. As such, most employers that choose to extend health plan coverage to domestic partners also typically discuss what other type of benefits should be extended.

Other benefits to consider extending to domestic partners include:

- In addition to health plan coverage, dental, vision and EAP coverage are typically extended to domestic partners.
- Dependent life coverage (check if your carrier will be willing to offer).
- Adoption assistance benefits.
- COBRA like continuation benefits.

If your organization offers a consumer driven health plan, offering domestic partners coverage under these types of plans can have added complexities. The high deductible health plan benefits should not be an issue. However, the complexities come from tax-favored accounts you offer to help offset the additional employee liability:

- **Medical Flexible Spending Account:** Medical flexible spending accounts are simply vehicles that allow tax-free dollars to be used for qualified medical expenses. Section 125 of the Internal Revenue Code creates rules for these plans. In order to be an eligible dependent under a flexible spending account, an individual must meet the definition of dependent in

Section 152 of the Internal Revenue Code. More information on Section 152's definition of dependent can be found in our Special Alert at http://www.mcgrawworth.com/Special_Alert/2006/Special_Alert_Issue_3.pdf. For the most part, most domestic partners will not meet the definition of dependent so they will not be eligible to benefit from any of the funds set aside in a flexible spending account.

- **Health Reimbursement Arrangement:** These plans are treated just like self-funded plans by the IRS. The IRS has confirmed that domestic partners can be named eligible dependents under HRA plans; it is the employer's decision to determine who is eligible under the plans. That being said, the domestic partner may not be eligible for tax-favored benefits under the HRA account. This will be addressed in the next section.



- **Health Savings Account (HSA):** The HSA guidance relating to domestic partners can be complicated when it comes to contributions and tax-favored distributions.

First, the annual contribution limit for an HSA is driven by coverage status. Separate limits apply for self-only coverage and family coverage. If an employee covers a domestic partner under a high deductible health plan, this is viewed as family coverage and

the family contribution limit applies.

However, in order for a distribution from an HSA to be tax-free, the expenses must be for an eligible Section 152 dependent. In many cases a domestic partner will not meet the Section 152 dependent requirement and therefore any of the partner's expenses **will not be eligible** for a tax-free, penalty-free distribution from an HSA.

It appears a domestic partner could set up an HSA and make contributions to that HSA and receive tax-free distributions for eligible medical expenses from that HSA. Contributions for married couples are limited to the family coverage limit in total if separate HSAs are

established. It appears that this limit would not apply to domestic partners. If the domestic partners are both

covered under a qualifying high deductible health plan, each would be able to contribute the family limit to their separate HSAs. The IRS has not commented on this situation directly, but it is believed, based on current guidance, this is how the situation would be handled.

When organizations add domestic partner benefits to various benefit plans, they frequently evaluate specific human resource policies to determine if domestic partners should be included in those as well.

Policies sometimes amended to include domestic partners include:

- Bereavement leave
- Relocation
- FMLA-equivalent leave

When deciding to add domestic partner benefits to the health plan, it often makes sense to review other benefit plans and employment policies to determine if you should expand those to address your recognition of domestic partners as part of the family.

Federal Tax Consequences of Domestic Partner Benefits

While employers have great flexibility to determine who to cover under a group health plan, that does not always guarantee the benefit will be considered tax-favored. The Internal Revenue Code allows health benefits to be considered tax-free for employees and any dependents under the plan that meet the definition of dependent under Section 152.



Under Federal law, an employee's legal spouse must be an opposite sex spouse considered legally married under state law. The Defense of Marriage Act, which was passed in 1996, specifically excludes a same-sex domestic partner from ever being considered a spouse under Federal Law. So unless a domestic partner meets the dependent definition under Section 152, the health plan benefits provided to a domestic partner are considered taxable income to the employee.

This means two very specific things:

1. The fair market value of coverage provided to a domestic partner is considered taxable income to the employee and the value must be included on the employee's W-2.
2. Contributions required to pay for the domestic partner

benefits cannot be deducted on a pre-tax basis under a Section 125 plan. Any contribution required to pay for domestic

partner benefits must be paid on a post-tax basis.

Therefore, adding domestic partner coverage will result in a bit more administrative work for your organization.

The first challenge involves determining the "fair market value". Unfortunately, the IRS does not specifically define what is meant by fair market value, nor have they set forth an accepted methodology for calculating fair market value. It is generally believed that fair market value is the premium rates charged by the carrier if your plan is fully insured. If your plan is self-funded, the fair market value can be your organization's COBRA rates minus the 2% administration fee.

Determining the fair market value is only the first step. Only the portion of the rate for couple or even family coverage is applicable to the domestic partner. The employee and any dependents that qualify under Section 152 are entitled to tax-favored benefits. As such, the IRS has informally approved two approaches employers can use to determine the imputed income relating to the domestic partner benefits:

1. The single coverage category rate can be used as the fair market value rate. The single rate should reflect the cost of covering a single risk under the plan.
- or**
2. The employer can calculate the difference between the single rate and the employee +1 coverage rate and use that result to show the fair market value.

Whichever approach your organization chooses to use to calculate fair market value, you should use that method consistently for all domestic partners covered under your plan.

NOTABLE THOUGHTS

**OBSTACLES ARE THOSE FRIGHTFUL THINGS YOU SEE
WHEN YOU TAKE YOUR EYES OFF THE GOAL.**

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Once the monthly fair market value is determined, your organization must account for any contributions the employee makes for coverage. Since those contributions are made on a post-tax basis, they needed to be accounted for, prior to imputing income.

An example will help understand the calculation. An organization offers domestic partner benefits and determines the fair market value of the domestic partner coverage is \$450 a month. The employee pays \$50 in contributions pre-tax for the employee coverage and an additional \$60 post-tax to cover the domestic partner. The imputed income per month for the domestic partner coverage would be as follows:

Fair Market Value
(determined by
using single rate
or difference in
rate between single
and employee +1
coverage tier).....\$450

Subtract any
portion of this
premium paid with
post-tax dollars.....\$ 60

**Imputed income
amount.....\$390**

The imputed income amount can be added per pay, per month or annually. Imputed income is also subject to FICA and FUTA.

**State Tax Considerations
with Domestic Partner
Benefits**

Federal law is just one piece of the puzzle and state tax law is a completely different animal. State law

can actually be much more confusing than Federal law, so it makes sense to consult with your legal and tax specialist to determine how domestic partner coverage should be handled in the states you have employees.

Certain states do allow tax-favored health benefits to be provided to domestic partners. In these situations, your employee may have tax consequences on a Federal level but not have to pay state taxes on the imputed income from the value of domestic partner benefits.



The following will give you an idea of the different approaches various states take in regard to the taxation of domestic partner benefits:

- **Same-sex marriage:** Massachusetts is the only state that currently licenses same-sex marriages. In Massachusetts, same-sex couples that marry are given tax-favored status for their benefits. If same-sex domestic partners in Massachusetts choose not to marry, the partner benefits are considered taxable.
- **Civil Unions:** Four states permit same-sex couples to enter civil unions (Vermont, Connecticut, New Jersey and New Hampshire). A civil union is similar to marriage and provides same-sex domestic partners the rights and responsibilities granted by law to spouses in a marriage. In these states if a domestic

partner enters a civil union, domestic partner benefits are tax-favored under state law. Again, if a domestic partner chooses not to enter into a civil union, domestic partner benefits are taxable.

- **Registered partnerships:** Five states and the District of Columbia (California, New Jersey, Maine, Washington and Oregon) allow domestic partners to register to receive many of the spousal rights granted by the state. State tax-favored status is only given to partnerships that register with the state.

State laws addressing domestic partnerships are complicated and change frequently. You should consult your tax specialist to understand how to handle domestic partner benefits in the states where you have employees.

As for opposite sex domestic partners, some states still have common law spouse statutes on their books. Your organization should also consult your tax specialist on how common law statutes may impact the tax status of opposite sex domestic partner coverage.

Federal and State Law Protections

Domestic partners will typically not be granted the same rights under certain Federal laws that spouses are granted. That being said, your organization can always be more generous to employees than Federal law requires, however, you need to make sure any vendors you work with agree with extending additional benefits to domestic partners.

Your organization’s approach to the following Federal laws should be addressed in your policies and procedures for covering domestic partners:

- **COBRA:** COBRA allows any qualified beneficiary who loses coverage as a result of a qualifying event the opportunity to continue coverage under the group health plan. The qualified beneficiary is responsible for paying the full cost of coverage. A domestic partner is not considered a qualified beneficiary under COBRA. If your plan covers the children of domestic partners, the children may be considered a qualified beneficiary under COBRA if they qualify as a dependent child of the employee.



Many organizations choose to offer COBRA-like coverage to domestic partners. If your organization chooses to extend these continuation rights, your first step should be to verify with your vendors that they

will allow this continuation. The next step is to determine what your organization will define as a termination of the domestic partnership. Your organization also needs to define any other qualifying events that will trigger the extension of COBRA-like coverage. Finally, your organization should outline the employees’ obligation and timing for notification of any qualifying event.

- **HIPAA:** HIPAA has two sections that may impact domestic partners: special enrollment rights and the portability requirements. The special enrollment rights require health plans to allow immediate health plan enrollment for dependents acquired through birth or marriage. These immediate enrollment rights do not apply to

domestic partner relationships. An employer’s plan may allow this enrollment, but it is not required.

The other special enrollment right applies when a dependent loses coverage under another health plan. HIPAA requires a group health plan to enroll a dependent mid-year if the dependent experiences a loss of the other coverage. This special enrollment right does apply to domestic partners if they are defined as a covered dependent under your plan.

HIPAA portability requirements require an employer to issue certificates of creditable coverage for participants that lose coverage under the plan. Your organization should make sure a certificate of creditable coverage is issued for any dependent that loses coverage under the plan.

- **FMLA:** Domestic partners are not considered immediate family members for the purposes of Family and Medical Leave Act protections. Therefore, employers are not required by Federal law to extend FMLA job protections to an individual who requests a leave to care for a domestic partner with a serious health condition.

Many organizations do extend FMLA-like protections to employees that need to care for a seriously ill domestic partner. However, it does not appear that this job protection can actually run concurrently with the FMLA. It is a potential area of abuse when an individual needs 6 weeks off to care for a seriously ill domestic partner, those 6 weeks cannot count as FMLA leave time. If that employee also had a parent fall ill and needed 12 weeks to care for that parent, those 12 weeks would theoretically be available under the FMLA. So employers should carefully evaluate the potential impact of offering expanded FMLA-like protections to domestic partners.

State laws are no less complex dealing with domestic partners. Some areas to understand include:

- **State COBRA Continuation**

Laws: Many states have continuation laws that apply to organizations not subject to COBRA and also some organizations that are subject to COBRA. Make sure you understand if a state law may compel your organization to extend continuation coverage to a domestic partner losing benefits under your group health plan.

- **City Contractor Laws:**

Some cities have passed ordinances that require any organization that does business on behalf of the city to extend domestic partner benefits under their health plan. In short, in order to secure a contract to do business for a city, your organization needs to provide proof that health benefits are extended to domestic partners. San Francisco was the first city to require these benefits be provided, but several more are requiring these benefits as well, including Los Angeles and Seattle.

It is important to understand how your organization is impacted by state laws addressing domestic partners. It is equally important to understand how domestic partners will be handled in terms of Fed-

eral laws that do not necessary apply to them, but employers may want to extend protections in the interest of providing complete benefits to domestic partners.

Concluding Thoughts

As you can see, adding domestic partner coverage is not as simple as changing the eligibility provisions of your plan. Many aspects of providing coverage must be addressed. It is a good practice to create poli-

cies and procedures addressing domestic partner coverage so it is clear how your organization will handle the benefits. It is equally important to draft clear communications for employees to understand the benefits available and also the potential tax consequences of electing the benefits.

If you have any questions regarding providing domestic partner benefits, please contact your McGraw Wentworth Account Director. **MW**



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