

# REFORM *Update*

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Health Care Reform includes a requirement that all health plans extend coverage to dependents up to age 26 (effective first day of the first plan year following September 23, 2010). Though Department of Health and Human Services (HHS) was tasked to issue compliance guidance, the first information release has been issued by the IRS in the form of Notice 2010-38. This *Reform Update* reviews the dependent age 26 rules and the recently released IRS Notice.

Our review of the two legislative acts that comprise Health Care Reform found very broad definitions surrounding the dependent to age 26 rules, including:

- Must extend coverage to dependent children up to age 26 with most experts agreeing this means up to the day of the 26<sup>th</sup> birthday.
- Dependent child can be married or unmarried.
- Dependent child coverage will be exempt from income taxes through age 26.
- Does not require dependent meets current IRC Section 152 criteria (e.g., child may not have to live with you).
- Grandfathered groups can exclude dependents that have another source of employer-sponsored health coverage until 2014.

Health Care Reform indicated that HHS would issue compliance guidance. Though HHS has not yet issued guidance, HHS Secretary Kathleen Sebelius has been loudly “encouraging” major insurance carriers to immediately extend health plan coverage to dependent children up to age 26 – and many carriers have acquiesced. With no clarifying guidance, it is unclear to us (and we suspect many carriers) what exactly they have agreed to do.

The just released IRS Notice 2010-38 discusses the tax-treatment of the health coverage extended to these adult children. The Notice amends several aspects of the Internal Revenue Code to ensure benefits provided and the cost of coverage for adult children remains tax-favored. However, the Notice does not provide any compliance guidance with regard to the new dependent age 26 rules.

We noted four headline issues in IRS Notice 2010-38:

- Tax-favored status is extended for employer-provided coverage and for reimbursement of medical care expenses for an employee’s child who has not attained age 27 by the end of the tax year.

- Child is defined as an employee's son, daughter, stepchild, adopted child or eligible foster child, and the child does not need to meet requirements of IRC Section 152 (age limits, residency requirements, support requirements, income limitations, and student status **are not applicable**).
- Confirms coverage and reimbursements for adult non-dependent children are excluded from FICA and FUTA.
- Expanded definition of dependent also applies to VEBAs, Section 401(h) pension or annuity plans and Section 162(l) that applies to deductions allowed for self-employed individuals.

We also noted that IRS Notice 2010-38 only explains what will receive tax-favored status. It does not provide clarifying guidance on how plans will comply with the new dependent to age 26 rules. This could be confusing. As an example, Health Care Reform only requires dependent coverage extended up to age 26 while IRS Notice 2010-38 indicates tax-favored status will be extended, provided the child has not attained age 27 by the end of the tax year (as child's 26<sup>th</sup> birthday could be in the middle of a tax year).

The Notice also amends Section 125 and permits employees to pay for qualified benefits on pre-tax basis for these dependent children. The Notice makes the following changes:

- Permits reimbursements under a Health Care Flexible Spending Account for a dependent child that has not attained age 27 by the end of the tax year.
- Section 125 amended retroactively as of March 30, 2010 to recognize changes in status that apply to adult non-dependent children that have not attained age 27 by the end of the tax year.
  - ▶ Will specifically include becoming newly eligible for coverage because of the broader definition of dependent children.

**Important Note:** These changes only apply to Section 125, but HIPAA special enrollment rights have not yet been amended - if you will allow adult non-dependent children to enroll mid-year make sure your insurance carrier or stop loss carrier approves the mid-year coverage election.

- ▶ Includes a transition rule to reflect these changes - employers may permit immediate pre-tax deductions to pay for benefits for adult non-dependent children. Since most plan documents do not include the necessary adult dependent children requirements, the plan can allow changes but must retroactively amend the plan no later than December 31, 2010. The amendment should be effective as of the first date employers allowed adult non-dependent children on the plan (but no earlier than March 30, 2010).

Finally, IRS Notice 2010-38 includes a number of examples to help employers understand the tax rules at <http://www.irs.gov/newsroom/article/0,,id=220809,00.html?portlet=6>.

Please remember, employers are compelled to extend coverage to dependents to age 26 - the new IRS Notice 2010-38 only speaks to the tax-favored status of the extended coverage. The IRS Notice offers a broad definition and this may be, in part, because HHS compelled health insurers to extend coverage before providing compliance details and taxpayers needed immediate answers regarding the tax treatment of that coverage. Additional guidance will still be needed from HHS to clarify many details about how employers will comply with the new dependent to age 26 rules.

Finally, nothing in the IRS Notice requires an employer group health plan to extend coverage to dependent children any sooner than the first day of the first plan year following September 23, 2010.

In our next Health Reform Update, we will cover the employer “pay or play” option that will affect employers in 2014.

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