

REFORM *Update*

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The health care reform legislation has changed many aspects of health plan coverage and administration. One provision of the ACA (Affordable Care Act) requires health plans to extend medical coverage to children up to age 26, without any dependency requirements. Additional guidance was later issued on these adult child coverage requirements and, at the same time, the IRS amended the tax code to allow:

- Employee contributions for the health plan associated with these adult children to be taken on a pre-tax basis.
- Eligible adult children to receive health plan benefits on a tax-free basis.
- Expenses for adult children to be eligible for tax-favored reimbursement under a Section 125 medical reimbursement account.

These changes address the federal tax code only. Most states have tax rules as well. Some states mirror the federal tax code, and in these states adult children can be provided with health benefits on a tax-favored basis. But in states that don't mirror the federal tax code, the definition of an eligible dependent is likely to differ from the federal definition. This can create a situation where health benefits for certain "dependents" are tax-favored on the federal level, but considered taxable on the state level.

We have identified the following states as those where the state tax law currently does not conform to federal law:

Arizona	Iowa	South Carolina
Arkansas	Kentucky	Vermont
California	Maine	Virginia
Georgia	Massachusetts	West Virginia
Hawaii	Minnesota	Wisconsin
Idaho	Ohio	
Indiana	Oregon	

In addition, we have not been able to determine if the following states' current definition of an eligible dependent conforms to federal law:

Alaska	New Hampshire	Texas
Florida	New Jersey	Washington
Mississippi	South Dakota	Wyoming
Nevada	Tennessee	

Although a state may not conform to the federal definition of dependent today, the state may later modify their tax code once they realize this is an issue. However, if you have employees in any of these 30 states, this is an important issue to discuss with your tax advisor, or you can contact the state's Department of Revenue for more information. (Contact information for these states' Departments of Revenue can be found at the end of this *Update*.)

If the state definition of a dependent is more restrictive than the federal definition, then there is a state tax consequence for any **covered** dependent who:

1. Meets the definition of a dependent under the federal tax code **and**
2. Does not meet the state's definition of an eligible dependent for the purpose of tax-favored health benefits.

If a dependent meets both of the above requirements, the value of the dependent's health coverage becomes taxable income to the employee. How do you determine "value?" This is a pertinent question, but it has not been addressed by the ACA. However, this situation is similar to providing coverage to same-sex spouses or domestic partners. Until additional guidance is issued, it should be sufficient to determine the fair market value of coverage for these adult children by applying the same logic used for domestic partners. Fair market value can be calculated in several acceptable ways; an example of one of those ways is found at the end of this *Update*.

Once the fair market value is determined, it may be added as imputed income to each paycheck, or to the final paycheck of the year. This income is only taxable at the state level, so it is critical to consult with a tax expert to determine how to handle this appropriately.

Please note that if the employer expanded the definition of eligibility to adult children for the dental and/or vision plans, then, in most cases, the value of this coverage will likely need to be included as imputed income, too. Again, it depends on state tax law.

Action Steps

If your organization has adult children enrolled as dependents in any of the states noted in this *Update*, you should:

1. Consult a tax advisor to determine the definition of an eligible dependent for tax-favored health coverage in those states. Ask if it is expected that the definition of a dependent will be modified during the year.
2. Notify your employees that this may be an issue if they cover an adult child who does not meet the state's definition of a dependent. The financial impact is not likely to be substantial. For example, if the value of providing coverage to this dependent is calculated at roughly \$200 per month, then that would result in \$2,400 being imputed to income at year-end. **Only state tax applies here.** Assuming a state tax rate of 4%, the employee in this example would pay an additional \$96 annually in state taxes for covering that dependent.

3. Set a follow-up to address the issue again in October, 2011. At that point, you should revisit with your tax advisors to determine which states have not modified state law to mirror federal tax law. Next, identify the employees in those states who cover adult children. You should create an affidavit to determine if these adult dependents meet the requirements under state tax law. State laws will likely have age limits or financial dependency requirements that differ from federal law. Ask employees to complete the affidavit on any adult child they cover in impacted states. If any dependents fail to meet state law requirements, then these are the dependents for which an imputed income calculation will be required.

It is likely that many states will amend their tax codes in order for dependents to be eligible for tax-favored health coverage at both the federal and state levels. However, if this does not occur, you will need to calculate and tax imputed income for the state only at year-end.

Example of Determining Fair Market Value

One way to determine fair market value is to calculate the additional cost of adding an adult child. Assume your plan has a three-tier rate structure and your current rates are as follows:

Single	\$ 432
Two Person	\$ 963
Family	\$1,199

You could calculate the difference between the Two Person and Family rates ($\$1,199 - \$963 = \$236$) to determine the fair market value of the child's coverage:

	Fair Market Value
Monthly Premium Cost	\$ 236

If any part of the employee's contribution is paid with post-tax dollars, that amount can be deducted from the \$236 to determine the amount that should be used for imputed income.

States Department of Revenue Information

States Where the Definition of Eligible Dependent Does Not Conform with the Federal Definition	
Arizona Department of Taxation and Revenue 800-352-4090 www.azdor.gov	Massachusetts Department of Revenue 617-887-6367 www.mass.gov
Arkansas Department of Taxation and Revenue 501-682-2242 www.dfa.arkansas.gov	Minnesota Department of Revenue 800-652-9094 www.taxes.state.mn.us
California State Board of Equalization 800-400-7115 www.boe.ca.gov	Ohio Department of Taxation 888-405-4039 http://tax.ohio.gov/
Georgia Department of Revenue 877-602-8477 www.dor.ga.gov	Oregon Department of Revenue 800-356-4222 www.oregon.gov/dor
Hawaii Department of Taxation 800-222-3229 www.state.hi.us/tax	South Carolina Department of Revenue 803-898-5709 www.sctax.org
Idaho State Tax Commission 800-972-7660 www.tax.idaho.gov	Vermont Department of Taxes 802-828-2551 www.state.vt.us/tax
Indiana Department of Revenue 317-232-2240 www.ai.org/dor	Virginia Department of Taxation 804-367-8031 www.tax.virginia.gov
Iowa Department of Revenue 515-281-3114 www.iowa.gov/tax	West Virginia State Tax Department 800-982-8297 www.wvtax.gov
Kentucky Department of Revenue 502-564-4581 www.revenue.ky.gov	Wisconsin Department of Revenue 608-266-2486 www.revenue.wi.gov
Maine Revenue Services 207-624-9595 www.state.me.us	

States Where It Is Unknown if the Definition of Eligible Dependent Conforms with the Federal Definition	
Alaska State Department of Revenue 907-465-2300 www.revenue.state.ak.us	South Dakota Department of Revenue and Regulation 605-773-3311 www.state.sd.us/drr2/revenue.html
Florida Department of Revenue 800-352-3671 http://dor.myflorida.com/dor/	Tennessee Department of Revenue 615-253-0600 www.tn.gov/revenue/
Mississippi Department of Revenue 601- 923-7000 www.dor.ms.gov/	Texas Texas Taxes www.window.state.tx.us/taxes/
Nevada Department of Taxation 866-962-3707 http://tax.state.nv.us/	Washington Department of Revenue 800-647-7706 http://dor.wa.gov/Content/Home/Default.aspx
New Hampshire Department of Revenue Taxation 603-271-2191 www.nh.gov/revenue/	Wyoming Department of Revenue 307-777-7961 http://revenue.state.wy.us/
New Jersey Division of Taxation 609-826-4400 www.state.nj.us/treasury/taxation/	

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