

May 4, 2010

MEMORANDUM TO CLIENTS

RE: Tax-Free Treatment for Adult Child's Health Care Coverage

The Internal Revenue Service (IRS) recently issued Notice 2010-38, which provides important tax guidance on the proper treatment of health care benefits for children up to age 26. Effective March 30, 2010, the Health Care and Education Reconciliation Act of 2010 (HCERA) extends tax-free health care reimbursements under Code section 105(b) to cover a "child" through the age of 26, regardless of whether or not he or she is a dependent under Code section 152(a). The Notice extends this same tax-free treatment to health care coverage under Code section 106, effective March 30, 2010, and this Notice can be relied upon pending issuance of updated regulations.

Background

This tax relief pre-dates the corresponding mandatory health care changes for coverage of adult children under the Patient Protection and Affordable Care Act (PPACA). Specifically, effective for plan years beginning on or after September 23, 2010 (January 1, 2014 for grandfathered plans with respect to any dependent who is otherwise eligible to enroll in another employer-sponsored plan), group health plans and health insurance issuers that provide dependent coverage for children will be required to continue coverage for children up to age 26. Therefore, the coverage change will become effective for most plans in 2011, and this corresponding tax relief will be a critical component.

For this purpose, a "child" is defined as a son, daughter, stepson, stepdaughter, legally adopted child, or eligible foster child under Code section 152(f)(1). The child's age is determined as of the end of the employee's taxable year, which an employer can assume is the calendar year. For example, the child health care benefits are tax-free through the end of the calendar year in which the child attains age 26. An employee's representation as of the child's date of birth is sufficient. Although the definition of child under this PPACA provision references Code section 152(f)(1), this extended coverage must be provided by a group health plan whether or not the child satisfies the other requirements under Code section 152. Therefore, absent further relief, it may have been necessary to impute the value of coverage provided to adult children who were not dependents under Code section 152.

HCERA

The HCERA amended Code sec. 105(b) to provide tax-free health care *reimbursements* under Code section 105(b) to cover a "child" through the age of 26, regardless of whether or not he or she is a dependent under Code section 152(a). However, this was not sufficient to address all tax consequences associated with providing health care coverage to adult dependents of employees because Code section 106(a), which allows the *value* of health care coverage to be excluded from the income of employee (i.e., the premium), was not similarly amended.

Notice 2010-38

The Notice makes clear that the IRS will extend the same tax-free treatment to health care coverage under Code section 106, effective March 30, 2010, and this Notice can be relied upon pending issuance of updated regulations.

Accordingly, effective March 30, 2010, for reporting purposes, no imputed income is reported on Form W-2 for the coverage or benefits for these children. These health care amounts are not treated as wages for FICA, FUTA, RRTA (Railroad taxes) or federal income tax purposes. Therefore, for coverage on or after March 30, 2010, no wage reporting should be required. However, the new W-2 reporting provision for informational reporting of the cost of health insurance coverage beginning in 2011 will likely include the value of this coverage.

The Notice explains that coverage for children under age 27 extends to the following types of health plans, effective March 30, 2010:

- Cafeteria Plan (Section 125);
- Health Flexible Spending Account (Health FSA);
- Health Reimbursement Arrangement (HRA);
- Section 401(h) Retiree Medical Account;
- Voluntary Employees' Beneficiary Association (VEBA); and
- Self-employed Health Care Deduction (§ 162(l)).

The Notice also provides that the cafeteria plan regulations will be amended to provide that a change in status event occurs (which permits an employee to make a mid-year election change for a cafeteria plan and a Health FSA) when the child becomes eligible for coverage due to PPACA beyond the date on which the child otherwise would have lost coverage. Importantly, the Notice provides an exception to the general rule that a cafeteria plan may not be retroactively amended. Under this exception, the cafeteria plan must be amended by December 31, 2010 to provide for a retroactive plan amendment to cover these adult children. This relief is helpful for employers who intend to implement the extended coverage rule under PPACA in advance of the statutory deadline (i.e., during the plan year when elections are irrevocable in the absence of a mid-year change in election event).

Notably, Health Savings Account (HSA) and Code section 105(c) (accidental coverage) are not included in the tax relief provided under HCERA or Notice 2010-38. Therefore, if adult children who do not otherwise satisfy the definition of dependents under Code section 152(a) receive coverage through these arrangements, the benefit will generally be taxable.

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If you have any questions, please contact your regular Groom contact or any of the attorneys listed below:

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