

Federal Legislative Brief

Over age Dependents: Taxation – An Expansion Discussion– 2008-23



On October 1, 2008 we published our Legislative Update (2008-19) *Plan Year End Compliance: Highlights for Welfare Plans*. One of the tax compliance items involved the tax treatment for coverage provided to over age (24) dependents receiving health care benefits. The purpose of this memorandum is to provide you with a more in depth analysis of this topic.

In Brief

The imputed income taxation of health care benefits for purposes of over age dependents applies to those dependents over age 24 who do not meet the definition of dependents under IRC Section 152. Although over age dependents do not meet the definition of qualifying child, it is important to note that a small number of dependents may meet the definition of a Qualifying Relative under IRC Section 152 as modified by IRS Notices, for purposes of health care benefits. For example, a dependent child of the employee, over age 24 (who meets the carrier definition of student, if required by the insurance contract), who receives more than half of his/her support from the employee, would qualify under an exception allowed by IRS Notice 2004-79 or 2008-5. To determine the tax status of dependents over age 24, I recommend that employers require employees to complete a survey on dependent status (sample attached to this Memorandum.) The following is a more detailed discussion of the issues.

The Basic Rule

IRC Section 152, as amended by the Working Families Tax Relief Act, effective January 1, 2005 defines a child to include children up to age 24. Children beyond age 24 may continue to be treated as a qualifying dependent for income tax purposes if he/she meets the definition of a Qualifying Relative. Handicapped children continue to qualify as dependents, for income tax purposes, under IRC Section 152, regardless of age. The following is a brief summary of the relevant provisions of the current IRC Section 152 definition of dependents:

1. A “Qualifying Child” has to meet all the following criteria:

- Is the employee’s daughter, son, stepchild, sibling, step-sibling or a descendent of any of these individuals
- Has the same principal residence as the employee for over half the tax year
- Is under age 19 at the end of the tax year, or if a full-time student, is under age 24 at the end of the tax year, or is disabled
- Does not provide more than half of his or her own support

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1. A “Qualifying Relative” has to meet all the following criteria:

- Is not a “qualifying child”
- Has the same principal residence as the employee and is a member of the employee’s household
- Receives more than half of his or her support from the employee
- Whose gross annual income amount is less than the exemption amount (2005: \$3,200) (This provision has been modified for purposes of IRS Regulation 1.106-1, for purposes of health care plans under IRC Section 105).

Discussion

1. **Legislative Intent.** At the time of the original legislation modifying the IRC Section 152 Definition of Dependents, Congress indicated a general intention not to impact health care plans. However, many group health plans and now certain state laws (New Jersey, Massachusetts, Illinois) define eligible dependents to be not more than age 24. For federal tax purposes, almost anyone over age 24 would be eligible for health care coverage only on a taxable basis. The legislation appears to have not met its stated legislative intent. To resolve this conflict to the extent that it can, the IRS issued Notice 2004-79, discussed below.
2. **Qualifying Relative.** With the introduction of this concept and without IRS or Congressional relief, the over age 24 dependent may meet the definition of a Qualifying Relative so long as he/she does not exceed the annual gross income limitation of \$3,200 (2005 indexed going forward). Otherwise the value of the employer provided health insurance coverage would be taxable income to the employee.
3. **IRC Section 105.** This same legislation modified IRC Section 105(b) to exclude from gross income the cost of employer provided health care coverage for dependents WITHOUT REGARD to the definition of dependents contained in IRC Section 152, which conflicts with regulations under IRC Section 106 (IRS Regulation 1.106-1) which defines dependents to be those who MEET the definition under Section 152. To achieve the intent of the legislation, regulators had to address this issue.
4. **IRS Notice 2004-79.** To alleviate the unintended impact of the new definition on group health plans, the IRS issued a notice declaring its intent to revise IRS Regulation 1.106-1 to allow dependent children to be treated as Qualifying Relatives under IRC Section 152 without regard to the income limitation. The notice may be relied upon pending issuance of the revised regulations. It has fixed the problem for some but not for all.
5. **Principal Residence.** The Qualifying Relative definition under IRC Section 152 also contains a Principal Residence requirement, but only for those other individuals who are not family (son, daughter, etc.) members. As a result, a child over age 24, away at school, is not required to live with the employee, but must receive more than half of his/her support for the year from the employee.

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6. **IRS Notice 2008-5.** In November 2007, the IRS did provide guidance on the treatment of over age dependents supported by a non-parent taxpayer. The dependent supported by a non-parent taxpayer will qualify as a Qualifying Relative so long as the dependent is not the qualifying child of any other taxpayer. The health care coverage for that dependent will not be taxable to the (non-parent) employee under these circumstances.

Action Plan

Employers will need to determine which plan participants are to be taxed for 2008. As we recommended in our original Legislative Update, employers should conduct an over age dependent survey to determine which dependents are subject to the imputed income requirements. I have attached a sample survey for employer to use to be completed by employees who have elected coverage for dependent children.

If you wish to review the terms of the law or IRS Notices 2004-79 and 2008-5, please visit my website at www.abferisa.com.

If you have further questions, please let me know.

Note

It has also been brought to our attention that the Mothers and Newborn Health Protection Act Noticed appeared in the annual notice checklist attached to our October 1 Compliance Update. In fact, it is an event driven notice and is also required to be included in the Summary Plan Description. We have revised and attached this checklist.

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Sample Survey

Survey of Employees Who Cover Dependents Over Age 24 Under the Company-sponsored Health Plan

The Working Families Tax Relief Act of 2004 (WFTRA) changed the rules under Internal Revenue Code Section 152 for determining who you can cover tax free under certain employee benefit plans. The new rules took effect January 1, 2005. There has been a lack of clarity with regard to the applicability of the new rules to health plans. However, there are circumstances where the cost of employer provided health care coverage for children over age 24 will be treated as income to the employee. The purpose of this survey is to determine whether health coverage provided to your over age dependents may be taxable.

Please answer the following questions and return this form to _____ (name) by _____ (date).

No Yes

I have children covered under the company-sponsored health plan who have or will turn age 24 in 2008.

No Yes

I will provide more than half of their annual support for each of them for 2008.

No Yes

I have one or more dependents on the group health plan for whom I provide less than half of their annual support. If so, please list their names and dates of birth:

1. _____
2. _____
3. _____
4. _____

Print Name: _____

Signature: _____

Date: _____

Federal Benefit Law Notice Requirements as of September 30, 2008

Annual Notices:

- Women's Health and Cancer Rights Act
- Medicare Part-D Notice
- Notice of HIPAA Special Open Enrollment Rights
- Summary Annual Reports (if applicable)

Event Driven Notices:

- COBRA General Notice (upon enrollment in a health plan)
- HIPAA Notice of Pre-existing Condition Limitations (each open enrollment)
- COBRA Election Notice (at time of a qualifying event)
- Notice of Unavailability of COBRA
- COBRA Premium Change Notice
- Notice of Insufficient COBRA Notice
- Notice of Early Termination of COBRA
- Certificate of Creditable Coverage (upon cessation of health coverage)
- Notice of Privacy Practices (upon enrollment in a health plan)
- Notice of Creditable or Non-creditable coverage for purposes of Medicare Part-D (upon change in plan effecting drug coverage)
- Summary of Material Modification (in the event of a change in plan design, carrier, etc.).
- Mothers and Newborns Protection Act

Other Notices:

- FMLA DOL Notice (posting and mail)
- FMLA Military Rights Notice (posting and mail)
- Exemption from Mental Health Parity Law (posting)
- Availability of Written Qualified Medical Child Support Order Procedures (applicable to National Medical Support Notices) (in SPD)
- Uniformed Services Employment and Reemployment Rights (posting)