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Client Alert

A report for clients and friends of the firm

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New Definition of "Dependent" Under the Working Families Tax Relief Act of 2004 and Its Impact on Employee Benefit Plans

Congress recently passed the Working Families Tax Relief Act of 2004 ("WFTRA"), which, among other things, amended the definition of "dependent" under Section 152 of the Internal Revenue Code (the "Code") for taxable years beginning after December 31, 2004. Congress intended to provide a uniform definition of "dependent" for purposes of (1) the dependency exemption; (2) the child credit; (3) the earned income credit; (4) the dependent care credit; and (5) head of household filing status. *However, the changes also impact employee benefit plans that provide benefits to dependents (i.e. health plans) or for dependent-related expenses (i.e., health savings accounts, dependent care assistance programs, and 401(k) plans).* Accordingly, employers and other plan sponsors should be aware of the new definition and its potential impact on their employee benefit plans.

WFTRA's Definition of "Dependent"

Under the new definition of "dependent," an individual qualifies as a dependent if he or she is either a "qualifying child" or a "qualifying relative."

A "qualifying child," with respect to a taxpayer for any taxable year, is generally an individual:

(A) who bears a familial relationship to the taxpayer (*e.g.*, is a child or stepchild of the taxpayer or a descendant of such a child, or a brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of any such relative);

(B) who has the same principal place of abode as the taxpayer for more than one-half of such taxable year;

(C) who has not attained the age of 19 as of the close of the taxable year in which the taxable year of the taxpayer begins, or is a full-time student who has not attained the age of 24 as of the close of such taxable year; and

(D) who has not provided over one-half of such individual's own support for the calendar year in which the taxable year of the taxpayer begins.

In the case of an individual who is permanently and totally disabled (as defined in Code Section 22(e)(3)) at any time during such calendar year, the age requirement for a "qualifying child" does not apply.

A child who does not meet the requirements of a "qualifying child" may nevertheless qualify as a "dependent" if the child satisfies the "qualifying relative" test. A "qualifying relative," with respect to a taxpayer for any taxable year, is generally an individual:

(A) who bears a familial relationship to the taxpayer (as detailed in the law) or an individual (other than the taxpayer's spouse) who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household;

(B) whose gross income for the calendar year in which such taxable year begins is less than the exemption amount (as defined in Code Section 151(d))(*i.e.*, $3,200 for 2005);

(C) with respect to whom the taxpayer provides over one-half of the individual's support for the calendar year in which such taxable year begins; and

(D) who is not a qualifying child of such taxpayer or of any other taxpayer for any taxable year beginning in the calendar year in which such taxable year begins.

WFTRA's Impact on Employee Benefit Plans

Pursuant to WFTRA and a recent Internal Revenue Service ("IRS") Notice, the "qualifying relative" gross income limit (discussed in paragraph (B), above) will not apply to health plans. WFTRA explicitly provides that this gross income limit will not apply for determining dependent status for purposes of receiving benefits pursuant to Code Section 105, which is the provision of the Code that generally excludes from an employee's gross income employer-provided medical care reimbursements for the care of an employee, his spouse and dependents. In addition, in IRS Notice 2004-79, the IRS announced that the "qualifying relative" gross income limit also will not apply for purposes of benefits provided pursuant to Code Section 106 (and the regulations thereunder), which generally excludes from an employee's gross income any employer contributions made to accident and health plans on behalf of the employee.

However, as noted above, WFTRA's definition of "qualifying child" contains two other new requirements that may affect health (and perhaps other) benefit plans. First, there is an age limitation for a "qualifying child," which means that a child who attains age 19 during a taxable year or who is a student who attains age 24 during a taxable year cannot be a dependent under the definition of a "qualifying child." Second, in order to be a "qualifying child," the child must have the same primary residence as the taxpayer for more than half of the year. However, it appears that a child who reaches the age limits or does not meet the residency requirement (*i.e.*, is not a "qualifying child") could *still* qualify as a dependent if the child satisfies the definition of a "qualifying relative," as outlined above.

It also should be noted that WFTRA's definition of dependent will apply to employee benefit plans that provide benefits for dependent-related expenses, such as Code Section 129 dependent care assistance programs, health savings accounts and 401(k) plan hardship provisions. The imposition of the gross income limit in particular has potentially far-reaching implications. For example, if an employee's disabled parent has income (such as a pension) that exceeds the limit, the employee will not be able to use monies accumulated in a dependent care spending account to cover expenses related to the care of the disabled parent. However, subsequent to WFTRA's passage, members of Congress indicated that they did not intend to impose the gross income limit on benefits provided through dependent care assistance programs. While a technical corrections bill was introduced in both the House and Senate to exempt Code Section 129 dependents from the gross income limit, the bill was not passed before Congress adjourned for the year. Thus, unless further guidance is released or legislation is enacted, employers that sponsor dependent care assistance programs will need to consider the new definition of dependent.

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In summary, sponsors of benefit plans, such as health plans, dependent care assistance programs, health savings accounts and 401(k) plans that permit hardship withdrawals for dependents' education or medical expenses, should verify that the definition of "dependent" in their benefit plans conforms to WFTRA's new definition, *which is effective as of the new year,* and that they are administering their plans in accordance with WFTRA. If a plan provides benefits to (or on behalf of) an individual who does not qualify as a dependent under the new definition, there will be tax consequences to the employee. For example, if a health plan provides benefits to an individual who is not a "qualifying child" or "qualifying relative" (as defined in Code Section 152, without the gross income limit), the value of the benefits will constitute taxable income to the employee. Moreover, since the gross income limit exception for health plans is not found directly in Code Section 152, some plans may require technical amendments so that they do not inadvertently incorporate the new gross income limit in their definition of dependent (*e.g.*, if the plan defines eligible dependents by specifically referencing Code Section 152).

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