Proskauer

Important IRS Guidance on Tax Treatment of Health Coverage for Children Under Age 27

April 28, 2010

On April 27, 2010, the Internal Revenue Service (the "IRS") issued Notice 2010-38 (the "Notice"), which provides important guidance regarding the tax treatment of employer-provided health coverage to employees' adult children.

Background

The Affordable Care Act (the "Act")[1] requires group health plans and health insurance issuers that provide dependent coverage to provide coverage to an employee's child up to age 26, and amends Section 105(b) of the Internal Revenue Code ("Code") to extend the Code's income exclusion for reimbursements for medical expenses incurred by an employee to include reimbursements with respect to an employee's children through the end of the taxable year in which they attain age 26.[2] Prior to this change, an employee's child generally had to be no older than age 19 (or age 24 if a full-time student) in order to qualify as a dependent for purposes of the income exclusion.

The Notice

The Notice confirms that the Act's change to Section 105(b) of the Code with regard to reimbursements paid to employees for medical expenses of such adult children, as described above, is effective March 30, 2010. In addition, in order to address the fact that the Act failed to provide a parallel income exclusion under Code Section 106 with respect to the employer-provided coverage itself (*i.e.*, amounts paid by the employer for the coverage of the child), the Notice states that the IRS and Treasury Department intend to amend the applicable regulations under Code Section 106 retroactively to provide for such exclusion. Accordingly, effective March 30, 2010, both the amounts paid by an employer for coverage for an employee's adult children and the amounts paid (or reimbursed) to the employee for such coverage are excluded from the employee's gross income, in the same manner as coverage that is provided to an employee's spouse or dependent defined under Section 152 of the Code. The Notice includes examples that illustrate this concept.

Importantly, although the Act does not require that a plan's dependent coverage be extended to cover adult children until the first plan year beginning on or after September 23, 2010, the Notice states that the new income exclusions are effective as of March 30, 2010 (the date of the Act's enactment). (See our Client Alert of April 1, 2010 for more information about the effective date of this requirement and the impact on grandfathered plans.)

Impact on Cafeteria Plans

The Notice confirms that these changes apply to cafeteria plans (including flexible spending accounts), such that coverage and reimbursement provided with respect to adult children are "qualified benefits" under a cafeteria plan and employers may permit employees to make pre-tax salary reductions to pay for the benefits. However, since the Section 125 cafeteria plan rules only permit employees to make mid-year election changes due to specific change in status events (which do not currently include an event that would apply in this situation), the IRS states in the Notice that the applicable Treasury Regulations will be amended retroactive to March 30, 2010 to include change in status events covering children under age 27 who do not otherwise qualify as dependent children, including becoming newly eligible for coverage or eligible for coverage beyond the date on which the child otherwise would have lost coverage.

In addition, the IRS recognizes that cafeteria plans may need to be amended to include coverage for these adult children, but that current law only permits *prospective* amendments to such plans. Accordingly, the Notice provides relief from that rule, allowing employers to permit employees to immediately make election changes and pay for the coverage of such adult children on a pre-tax basis, *provided that* the plan is amended to cover these children no later than December 31, 2010 and the amendment is effective retroactive to the first date in 2010 when the employees are permitted to make such salary reductions (but no earlier than March 30).

Other Clarifications Included in the Notice

The Notice clarifies that:

- The guidance also applies to reimbursements made under a health reimbursement arrangement (HRA).
- Coverage and reimbursements provided under an employer-provided accident or health plan for these adult children are not considered wages for purposes of FICA and FUTA, and are exempt from income tax withholding.
- For purposes of the following, the term “dependent” includes adult children under the age of 27:
    - the VEBA rules (which allow for the payment of sick and accident benefits to the “dependents” of VEBA members);
    - accounts established under a pension or annuity plan pursuant to Code Section 401(h) (which allows for the payment of hospitalization and medical expenses of “dependents” of retired employees); and
    - the Code Section 162(l) deduction for amounts paid by a self-employed individual for insurance that constitutes medical care for such individual’s “dependents.”

Conclusion

In light of the changes made by the Act, the Code's income exclusions for employer-provided health coverage and reimbursements now apply with respect to children who have not attained age 27 as of the end of the employee's taxable year (which employers may assume is the calendar year), and the Notice provides important guidance and further clarifications with regard to these issues. Importantly, with regard to deadlines for employers, the Notice clarifies that, although an employer may immediately begin allowing employees to pay for medical coverage for these adult children on a pre-tax basis under a cafeteria plan*, an appropriate amendment must be made to the cafeteria plan document by the end of the year* (and it must be retroactive to the first day in 2010 for which the plan allowed the pre-tax salary reductions, but no earlier than March 30).

[1] "Affordable Care Act" means The Patient Protection and Affordable Care Act (PPACA) and the Health Care and Education Reconciliation Act of 2010 (HCERA).

[2] For purposes of the new income exclusions under Code Sections 105(b) and 106, as described in this Alert, the term "child" includes the employee's son, daughter, stepson, stepdaughter, legally adopted individual (or an individual placed with the employee for adoption), and eligible foster child. In addition, as the Notice confirms, such a child does not have to satisfy the age limits, residency, support and other tests described in Section 152 of the Code in order to be considered an employee's child for purposes of these new income exclusions.

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