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State Tax Issues under the Affordable Care Act

February 14, 2011

In general, coverage under a group health plan for an employee, spouse, and other "eligible tax dependents" is excludable from the employee's gross income for federal tax purposes. Federal law contains a number of specific rules regarding who can be an eligible dependent for purposes of this tax exclusion, including financial support and residency requirements. For example, prior to the Affordable Care Act, an employee's child generally had to be no older than age 19 (or age 24 if a full-time student), or rely on the employee for more than half of his or her financial support in order for the value of the child's health coverage to be excludable from the employee's gross income.

Under the Affordable Care Act, group health plans are generally required to extend coverage to employees' children who are under age 26, without regard to any dependency requirements (e.g., residency, support, employment or marital status). To facilitate this coverage, an employee can exclude the value of a child's health coverage from gross income for federal tax purposes even if the child does not otherwise meet the federal definition of an eligible dependent (i.e., the child is neither under age 19 nor a full-time student, and does not rely on the employee for financial support). In addition, the Affordable Care Act permits (but does not require) a plan to extend coverage through the end of the year in which the child turns age 26 with no adverse tax consequences to the employee from a federal perspective.

However, state tax law is different. Some states conform to the federal tax code, in which case a child's coverage is excludable for state tax purposes to the same extent as federal. Other states have created their own definition of eligible dependent (through laws regulating insurance). Of those states, some have amended their laws to conform to the new federal rules, others have not.

If a group health plan covers employees in a non-conforming state with children who meet the federal, but not state, definition of an eligible dependent, the coverage is potentially taxable to the employees for state income tax purposes. As of February 11, 2011, the following states appear to be non-conforming: Arizona, Arkansas, California, Georgia, Hawaii, Idaho, Indiana, Kentucky, Maine, Massachusetts, Minnesota, Oregon, South Carolina, Virginia, West Virginia, and Wisconsin.

This list will change over time as more states review the issue and consider amendments to their state tax codes. Employers and plans should review their coverage and consider the state tax implications (including income tax and withholding obligations) and monitor this situation closely to determine how best to address the state tax issues.

Please contact your Proskauer lawyer or any member of our Health Care Reform Task Force should you have questions regarding any aspect of health care reform.