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IRS Issues Guidance to Facilitate Employers' Offering Health Plan Coverage to Adult Children

The recent health care reform legislation, including the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 (collectively, the "Act"), requires, among many other things, generally that insurers who offer group and individual coverage and employers who maintain group health plans that provide dependent coverage for children continue to make that coverage available for adult children under age 27. (Plans in effect on March 23, 2010 are only required to make this coverage available before the 2014 plan year if the adult child is not eligible to enroll in any other employer-sponsored plan.)

This requirement is effective for plan years beginning on or after September 23, 2010. Despite this effective date, a number of insurance companies and employers have indicated that they will make this coverage available before that date. In addition, the White House is encouraging insurers and employers to implement this coverage as soon as possible to avoid the loss of coverage that generally would occur imminently, as many children are about to graduate from school.

As written, the Act created some questions and potential tax concerns for employers offering group health coverage to adult children, regardless of whether they did so before they are required to under the Act. Because of the tremendous desire on the part of the current administration to have this coverage extended earlier, the IRS and Treasury issued guidance this week that eliminates the adverse tax consequences created and eases the administrative burdens on employers created by the legislative language and other existing tax rules. In fact, the guidance actually extends favorable tax treatment for coverage of adult children under circumstances beyond those required by the Act. IRS Notice 2010-38 (the "Notice") was released on April 27.

This *GT Alert* explains the issues presented by the Act and the resolutions provided by the Notice.

Background

The Internal Revenue Code of 1986, as amended (the "Code") contains a number of provisions that exclude amounts provided as benefits under group health plans or contributed by employers for coverage under these plans from employees' taxable income. Code section 105 generally provides an exclusion for amounts paid from employer-provided health plans to cover or reimburse most medical expenses. This exclusion, however, is generally only available for amounts paid with respect to employees, their spouses and their "dependents" as defined elsewhere in the Code.

Code section 152 defines "dependents" to include an individual's children, provided that the child (1) has not attained age 19 by the end of the taxable year or (2) is a

student and has not attained age 24 by the end of the taxable year. The Act did not amend Code section 152 to encompass adult children; instead, it amended section 105 to extend this exclusion to encompass any child of the individual who has not attained age 27 as of the end of the taxable year. Thus, the Act ensured that amounts provided as payment or reimbursement of qualifying medical expenses on behalf of an adult child would not give rise to taxable income.

On the other hand, Code section 106 provides an exclusion from income for the cost of health plan coverage (generally, the premiums) provided by an employer. The statutory language refers only to the employee, but regulations under this section indicate that the exclusion applies to the cost of coverage for "dependents." As noted above, non-student children over the age of 19 and student children over age 24 are not dependents. Thus, if the employer incurred additional costs to extend coverage to adult children and did not require the employee to pay the full amount of the additional cost, the employee could, under the legislative language, have taxable income equal to the incremental cost covered by the employer.

In addition, if the employer chose to pass that cost on to the employee, under relevant law in place before the issuance of the Notice, the employee would only be able to pay that cost on an after-tax basis. Most employers enable employees to pay their share of the cost of health plan coverage on a pre-tax basis under a "cafeteria plan" maintained pursuant to the rules of Code section 125. But these costs can be paid under a cafeteria plan only to the extent that the amounts would be excludable from income under Code section 106. And because, as noted above, the Act by itself did nothing to cause the cost of adult child coverage to be excludable under Code section 106, the payment of these costs under a cafeteria plan would be prohibited.

Even if the costs were excludable from income under Code section 106, questions arose as to whether they could be paid on a pre-tax basis through a cafeteria plan if coverage for adult children was made available before the beginning of the next plan year. The rules governing cafeteria plans require that coverage elections be made before the beginning of a plan year. Mid-year changes are permitted only under very limited exceptions. The principal exception is for a "change in status event." Generally, a change in status event occurs when a dependent of an employee becomes, or ceases to be, eligible for coverage under a plan. As noted above, adult children are not dependents, so this rule would not allow a change in a cafeteria plan election mid-year. (There is another exception to the prohibition against mid-year election for changes in coverage options that might have allowed a mid-year change if adult child coverage were made available before the Act requires it to be provided, but that rule would not allow mid-year changes in future years when the coverage of an adult child is a coverage option available throughout the plan year.)

The Notice

The Notice resolves these issues in a manner that is favorable to employees and to employers. Specifically:

- The Notice provides that the IRS and Treasury intend to amend the regulations under Code section 106, retroactively to March 30, 2010, to provide that coverage of an employee's adult child under age 27 is excluded from income; and
- The Notice provides that the IRS and Treasury intend to amend the regulations under Code section 125, retroactively to March 30, 2010, (1) to provide that coverage for nondependent adult children may be paid for on a pre-tax basis, (2) to clarify that expenses for these adult children can be reimbursed from a health FSA maintained under a cafeteria plan, and (3) to allow events affecting these adult children (*e.g.*, becoming

newly eligible for coverage or being eligible for coverage beyond the date it originally would have been lost) to be considered change in status events allowing mid-year changes to cafeteria plan elections (including those with respect to contributions to health FSAs).

It is important to note that, while the Act only requires extension of coverage to adult children, the Notice recognizes that employers may wish to extend coverage to spouses of married children. In such a case, it is clear, under both the statutory language and the Notice, that coverage of the child's spouse will **not** be excluded from income.

The guidance provided in the Notice also facilitates the ability of employers to allow employees to pay for adult child coverage under a cafeteria plan. Under existing regulations, a benefit cannot be offered under a cafeteria plan before the date the cafeteria plan is amended to allow for that benefit. Under the Notice, a cafeteria plan can permit payment of premiums for adult child coverage before the plan is amended, provided that the plan is amended retroactively before the end of 2010.

The Notice also explicitly restates other tax results related to the provision of adult child coverage that were addressed in the legislative language or were unaffected by the Act. For example, it notes that adult child coverage can be provided through a plan that is funded through a VEBA or through a health benefits account within a qualified retirement plan, and that the deduction for premium payments made by self-employed individuals includes amounts expended for adult child coverage. In addition, coverage and reimbursements under a plan for adult children are not wages subject to FICA, FUTA or Railroad Retirement Tax Act purposes.

Conclusion

As a result of the issuance of the Notice, employers who choose to extend coverage to nondependent adult children of employees until the child attains age 27 can do so without creating adverse consequences for employees. In addition, the employer can do so promptly without having to address the administrative issues attendant to amending its cafeteria plan in advance. Of course, no employer is required to extend this coverage before the beginning of the plan year beginning on or after September 23, 2010. But for those employers who wish to be more generous than the law requires, the Notice offers them very helpful relief.

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