

To: Our Clients and Friends

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IRS Releases Guidance on Tax Treatment of Employer-Provided Health Care Coverage for Children under Age 27

On Tuesday, the IRS issued Notice 2010-38 discussing the tax treatment of employer-provided medical care coverage for employees' adult children up to age 27.

Background

The Patient Protection and Affordable Care Act (PPACA), enacted in late March and subsequently amended, requires that group health plans providing coverage for employees' dependent children extend such coverage to adult children (even if married) up to 26 years of age. Coverage must be provided for plan years beginning on or after September 23, 2010 (January 1, 2011 for calendar year plans). However, in response to a government plea, many insurance companies are implementing this rule before this mandatory effective date. PPACA also amended the Internal Revenue Code (Code) to provide that this coverage is generally tax-free to the employee, effective March 30, 2010.

Before this law change, Section 105(b) of the Code provided that an employee's gross income excluded employer-provided reimbursements made directly or indirectly to the employee for the medical care of the employee, employee's spouse or employee's "dependents" (which, for this purpose, was generally limited an unmarried child up to age 19 (or up to age 24 if a full-time student) or an unmarried child living with the employee and receiving more than half of his support from the employee). Under PPACA, the tax-free treatment is extended to employer-provided coverage of an employee's child who has not attained age 27 as of the end of the taxable year, whether or not the child is treated as the employee's dependent for federal income tax purposes.

The Notice

Notice 2010-38 provides guidance in four areas: (1) the exclusion from income of employer-provided reimbursements and coverage; (2) the rules affecting cafeteria plans, flexible spending arrangements (FSAs) and health reimbursement arrangements (HRAs); (3) Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA), Railroad Retirement Tax Act (RRTA) and income tax

withholding treatment; and (4) the impact on voluntary employee beneficiary associations (VEBAs), Section 401(h) accounts and Section 162(l) deductions.

1. Gross Income Exclusion

The exclusion from gross income for employer-provided reimbursements under Code Section 105(b), as amended by PPACA, applies to an employee's child who has not attained age 27 as of the end of the taxable year, even if such child is not the employee's dependent within the meaning set forth in Code Section 152(a). The Notice makes clear that the exclusion is limited to medical care of persons who are not 27 or older at any time during the taxable year.

The new law does not contain a parallel exclusion from income for employer-provided medical coverage under Code Section 106. The Notice states that the IRS intends to amend regulations issued under Section 106 to provide that employer-provided medical coverage for an employee's child under age 27 is excludable from gross income, effective retroactive to March 30, 2010.

Accordingly, employers are no longer required to impute income on group health coverage for any dependent child who is under age 27.

2. Cafeteria Plans, FSAs and HRAs

A Code Section 125 cafeteria plan may allow an employee to revoke an election and make a new election during a period of coverage only under specific circumstances, such as a "change in status." Current rules do not allow for election changes for children under age 27 who are not dependents of the employee. The Notice states that the IRS intends to modify the applicable regulations to include changes in status affecting nondependent children under age 27, such as becoming newly eligible for coverage or becoming eligible for coverage beyond the date on which the child otherwise would have lost coverage, effective March 30, 2010.

The Notice also recognizes that cafeteria plans may require amendment to permit coverage of employees' children who have not attained age 27 as of the end of the taxable year. The Notice states that employers may permit employees to immediately make pre-tax contributions under a cafeteria plan (including a health FSA) for children under age 27, effective March 30, 2010, even if the cafeteria plan has not yet been amended to cover these individuals. Any retroactive amendment to a cafeteria plan to cover such children must be adopted no later than December 31, 2010, and must be effective retroactive to the first date in 2010 when employees are allowed to make pre-tax contributions to cover children under age 27. This is an exception to the general rule that cafeteria plan amendments cannot be amended retroactively.

The same rules apply to an HRA, which is an arrangement that is paid for solely by an employer by means other than a Section 125 cafeteria plan and that reimburses an employee for medical care expenses up to a maximum dollar amount for a coverage period.

3. FICA, FUTA, RRTA and Income Tax Withholding Treatment

The Notice makes it clear that employer provided health care coverage of an employee's child under age 27 does not constitute wages for purposes of FICA, FUTA, RRTA or income tax withholding purposes.

4. VEBA's, Section 401(h) Accounts and Section 162(l) Deductions

The Notice makes it clear that the same general rules for providing a tax exclusion to an employee's children under age 27 applies to these provisions:

- VEBA's providing for the payment of sick and accident benefits to members;
- Code Section 401(h) accounts that provide for the payment of benefits for sickness, accident, hospitalization, and medical expenses; and
- Code Section 162(l), which allows self-employed individuals to deduct, amounts paid during the taxable year for insurance that constitutes medical care.

Please feel free to contact any member of the Bryan Cave LLP Employee Benefits and Executive Compensation Group listed below if you require assistance or have any questions regarding the information contained in this Bulletin.

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