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EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION UPDATE

Health Care Reform: Adult Child Coverage and Related Tax Treatment

This bulletin discusses certain provisions of the Patient Protection and Affordable Care Act ("PPACA") and the Health Care and Education Reconciliation Act of 2010 ("HCERA")...

The Reform Legislation contains two provisions relating to adult children and employer-provided group health plans: one provision imposes a coverage requirement and the other affects how coverage will be taxed.

This bulletin will briefly address the coverage requirement, explain the tax provision and compare the two provisions to highlight taxation and plan changes that employers may be able to immediately implement.

COVERAGE OF ADULT CHILDREN UNDER THE REFORM LEGISLATION

Under the Reform Legislation, employer-sponsored group health plans that provide dependent coverage to children must provide dependent coverage to an employee's adult child until age 26...

Plans that are considered "HIPAA excepted benefits," such as limited-scope dental and vision plans, are not subject to this continuation requirement.

Until 2014, grandfathered plans may refuse to provide coverage to an adult child if the child is eligible to enroll in another employer-sponsored health plan other than the plan of a parent.

As addressed in our first bulletin in this series, "grandfathered plans" are group health plans or health insurance coverage in which an individual was enrolled on March 23, 2010.



The required coverage must be provided to eligible adult children no later than the first day of the first plan year beginning on or after September 23, 2010 (January 1, 2011 for calendar year plans). Prior to that effective date, plans must provide an enrollment notice and a 30-day enrollment period for children who are not currently eligible for the plan due to age, but who must be provided coverage as a result of this requirement.

Unless a plan decides to adopt the coverage provision before the required effective date, the plan may satisfy the enrollment opportunity requirement through the use of its general open enrollment process. In that event, the newly required notice should be added to employees' open enrollment materials and the enrollment period may need to be extended if currently less than 30 days.

This coverage requirement applies to “children,” not “tax dependents.” This distinction becomes significant when the coverage requirement is compared to the Reform Legislation’s tax provision and to the cafeteria plan mid-year election change rules, as discussed more fully below.

TAXATION OF ADULT CHILD COVERAGE

Prior to passage of the Reform Legislation, employer-sponsored group health plan coverage and benefits were exempt from federal income tax only to the extent they applied to the employee, the employee’s spouse and the employee’s tax dependents (as defined by Section 152 of the Internal Revenue Code (the “Code”), without regard to subsections (b)(1), (b)(2) and (d)(1)(B)). However, the Reform Legislation amended Code Section 105, effective March 30, 2010, to exempt from federal income tax any medical care benefits provided to certain adult children under an employer-provided accident or health plan. Specifically, the exclusion applies to any adult natural child, stepchild, legally adopted child (or child legally placed for adoption) or eligible foster child, whether married or unmarried, for any year before the year in which the individual reaches age 27. Children need not meet dependency or student status requirements in order for the benefits to be exempt from federal income tax.

Although the Reform Legislation did not address the taxation of coverage under Code Section 106, the Treasury Department has indicated that it will amend its regulations under Code Section 106, retroactively to March 30, 2010, to be consistent with amended Code Section 105.

As a result of the amendment to Code Section 105 and the anticipated amendment to the Code Section 106 regulations, coverage and benefits provided to an adult child under age 26 (as required by the coverage provision of the Reform Legislation) will not be considered taxable to the employee for federal income tax purposes.

The Reform Legislation did not amend Code Section 105(c), applicable to accident plans, or Code Section 223, applicable to distributions from health savings accounts (“HSAs”). Employers sponsoring high-deductible health plans should communicate to participants



that expenses incurred by non-dependent adult children may not be reimbursed from an HSA, especially in light of the increased penalties for ineligible distributions.

The tax provision's effect is not limited to the new coverage required by the Reform Legislation. By amending Code Section 105 with an immediate effective date, the Reform Legislation provides favorable tax treatment for coverage voluntarily extended to certain adult children and for certain coverage that may otherwise be required by state insurance laws.

Early Adoption of Adult Child Coverage Requirement

Of all the requirements imposed by the Reform Legislation, the adult child coverage requirement has garnered the most attention—from both employers and employees. Although the requirement is not immediately effective, many employers have received requests from employees to immediately add an adult child to coverage or to refrain from terminating the coverage of a child who has become ineligible under the plan's current definition of dependent.

Because the Reform Legislation's amendment to Code Section 105 became effective upon enactment of the HCERA, employers who wish to become early adopters of the coverage requirement can do so on a tax-favored basis. Of course, any such change will require coordination with the plan's insurer or third-party administrator.

The preamble to the Interim Final Regulations indicates that a plan will not lose its grandfathered status if it is amended to comply with the coverage requirement or for voluntary compliance before the required effective date.

Taxation of Coverage Required by State Insurance Laws

Many state insurance laws require insurance policies issued in that state to cover children until a certain limiting age. For example, any group health insurance policy issued or renewed in Ohio on or after July 1, 2010 must provide for coverage of certain adult children until age 28.

The requirements for extended coverage under state insurance laws often do not correspond with the federal definition of tax dependent (as modified for group health plan purposes), nor do they correspond with the coverage requirement imposed by the Reform Legislation. As a result, many employers have questioned whether and how the Reform Legislation impacts their insured plans.

Coverage

The Reform Legislation does not override or preempt state insurance law coverage requirements. Employers maintaining insured health plans are subject to both laws.

For example, an Ohio insured plan will generally be required by the Reform Legislation to cover adult children until age 26. A child who is not required to be covered by an insured plan under the Reform Legislation (whether because the child has attained age 26 or because the child is eligible



for another employer-sponsored health plan), must be covered by an insured plan under Ohio law if the child is (i) unmarried; (ii) under age 28; (iii) the natural child, stepchild or adopted child of the employee; (iv) a resident of Ohio or a full-time student at an accredited public or private institution of higher education; (v) not employed by an employer that offers any health benefit plan under which the child is eligible for coverage; and (vi) not eligible for coverage under Medicaid or Medicare.

Taxation

Prior to the Reform Legislation, employers had to treat state-required coverage as taxable to the employee if the adult child was not considered a tax dependent under Code Section 152 (as modified for group health plan purposes). The lack of coordination between the state insurance coverage requirements and the Code's definition of tax dependent created an administrative burden on employers to confirm whether a child over age 18 (or over age 23 if a full-time student) was considered a tax dependent. While the Reform Legislation did not completely remove this administrative burden, it eliminated the need for employers to perform this analysis for children up to age 26.

Therefore, employers can immediately stop imputing the value of adult child coverage as income for federal income tax purposes with respect to employees whose adult children will be age 26 or younger by the end of 2010. The taxation of adult child coverage under state and local laws will vary. Employers should confirm whether and how the Reform Legislation's change to the Code impacts taxation of adult child coverage for each applicable state or locality.

APPLICATION TO CAFETERIA PLANS

Prior to the Reform Legislation, cafeteria plans could permit employees to make mid-year election changes only in response to certain events that affected the employee, the employee's spouse or the employee's tax dependents (as determined for group health plan purposes). The Treasury Department has indicated that it will amend its regulations under Code Section 125, retroactively to March 30, 2010, to provide that cafeteria plan elections may be changed in response to changes in status affecting non-dependent children who qualify for tax-favored treatment. Therefore, if an employer wishes to offer immediate coverage of adult children, or if it is necessary to change the tax treatment of premiums paid for such children, a cafeteria plan can be amended to permit employees to immediately change their pre-tax plan elections to pay for the adult child coverage on a pre-tax basis.

Although limited scope dental and vision plans are not required to comply with the coverage requirement, they are eligible for the favorable tax treatment described above. Therefore, cafeteria plans may permit employees to pay for eligible adult child coverage under dental and vision plans on a pre-tax basis.



While the cafeteria plan may need to be amended to permit these mid-year election changes, the changes affecting pre-tax premium payment elections can be implemented before the amendment is actually adopted. In Notice 2010-38, the Treasury Department granted an exception to the general rule requiring cafeteria plan amendments to be made prospectively. As a result, employers may implement the changes now so long as the plan amendment is adopted by December 31, 2010.

The narrow exception does not extend to medical flexible spending accounts (“FSAs”). Therefore, an employer will be required to actually amend its cafeteria plan before an FSA can reimburse expenses incurred by non-dependent children or before an employee can increase his or her FSA election to accommodate the newly reimbursable expenses.

FOR MORE INFORMATION

For more information about the Reform Legislation, please contact Laura A. Ryan, 513.352.6727 or Laura.Ryan@ThompsonHine.com, or any member of our **Employee Benefits & Executive Compensation** group.

To view our prior Reform Legislation bulletin, go to www.ThompsonHine.com/publications/publication2083.html or www.ThompsonHine.com/publications/pdf/2010/04/employeebenefits2083.pdf.

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