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Health care reform at-a-glance

Tax Treatment of Dependent to Age 26

The health care reform law requires health insurers and self-funded group health plans to provide dependent coverage to the age of 26 if the plan provides dependent coverage. This provision is effective for plan years beginning on or after September 23, 2010.

As part of this provision, the health care reform law amended some, but not all, of the Internal Revenue Code sections dealing with tax treatment of health insurance coverage. To further align the code with the health care reform law, the IRS issued Notice 2010-38 on April 27, 2010. Changes announced in the notice were retroactively effective March 30, 2010.

The notice clarified that:

- Employer-paid coverage (directly or via cafeteria plan) for an adult child is excludable from income for any tax year ending before the year in which the child attains age 27.
- This tax exclusion for adult children is also available under flexible spending accounts and health reimbursement arrangements.

However, the health care reform law did not amend the definition of dependent for health savings account (HSA) expenses. Therefore, for employees who have a high-deductible health plan (HDHP) and an HSA:

- Employees do not have to pay taxes on their adult dependent's HDHP coverage.
- However, HSA disbursements for a dependent are tax-free only if the dependent meets the definition of a "tax dependent" (which is narrower than the definition of dependent set forth in the health care reform law).

Disbursements for a dependent who doesn't meet the definition of "tax dependent" may be considered nonqualified expenses, which are subject to taxes and penalties. In 2011, the penalty on nonqualified expenses is increasing from 10% to 20% of the disbursed amount. (The rules are different for distributions after the age of 65 and distributions made after the participant's death or disability.)

For more details about eligible expenses and dependents for HSAs, refer to IRS Publication 969, Keep in mind that this document changes regularly and you should check with your tax adviser if you have questions.

The health care reform law expanded the definition of eligible dependent for medical plan coverage, flexible spending accounts and health reimbursement accounts. The law did not expand the definition of eligible dependent for health savings account (HSA) expenses. Therefore, employees can use HSA funds tax-free only for eligible expenses of family members who meet the definition of a "tax dependent" in the Internal Revenue Code.

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Questions and Answers

The regulations amended the tax code so there are no federal tax implications for children to age 26 (even if they're not traditional IRS dependents). However, some states (such as Wisconsin) are still using the traditional IRS definition of dependent, so coverage for a child who does not meet the traditional IRS definition but who is under 26 and added per the HCR mandate is subject to state tax. How is an employer to know which states apply the imputed income tax?

We believe that the Treasury guidance issued in April combined with the language that appears in the reconciliation bill will resolve the issue around imputed income in favor of the employer/employee with respect to the up to age 27 changes in the health care reform law. While there can be no assurance that a specific state will follow suit, generally most states tend to piggyback onto the federal tax treatment of an item. The law of a specific state will need to be reviewed with your tax adviser to determine what, if any, impact the rule will have on an individual employee.

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