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Employee Health Benefits for Adult Children: Managing the Variations in State Income Tax

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Pursuant to the Patient Protection and Affordable Care Act ("PPACA"), group health plans that cover dependent children must now make such coverage available until the child reaches age 26, and the value of health benefits provided to adult children is excluded from the employee's gross income for federal income tax purposes. In states that have not conformed to the Internal Revenue Code changes made by PPACA, coverage of adult children may be considered income for state income tax purposes unless the child also meets the applicable state definition of a tax dependent.

Prior to the passage of PPACA, the value of employer-provided health coverage to an employee's child was treated as taxable income for federal income tax purposes if the child did not qualify as the employee's "tax dependent" under the Internal Revenue Code. Pursuant to PPACA, which mandated extending dependent coverage to adult children up to age 26, and guidance provided in IRS Notice 2010-38, the value of employer-provided health benefits provided to any child who is under the age of 27 at the end of the taxable year is excluded from gross income, regardless of whether the child is the employee's tax dependent. (For information on PPACA, see our client alerts dated March 30 and May 13 and September 8 and September 9 and our white paper dated July 12, 2010.)

States that have an income tax often follow the federal income tax laws and use federal taxable income as the starting point for determining taxable income for state personal income tax purposes. As relevant to the taxation of employer-provided health coverage, states generally conform to changes in the Internal Revenue Code in three ways.

- "Rolling" conformity states automatically conform to the latest version of the Internal Revenue Code, and thus automatically adopt any changes to the Internal Revenue Code. New York, Maryland and the District of Columbia are examples of rolling conformity states.

- "Fixed date" conformity states follow the Internal Revenue Code as in effect on a specific date. Legislative action is required in such states to incorporate changes to the Internal Revenue Code that

occur after the specified date. Virginia is an example of a state with fixed date conformity. As of the date of this Client Alert, Virginia conforms to the Internal Revenue Code as in effect on January 22, 2010. An amendment to the Virginia Code is required to exempt the value of employer-provided health coverage for a child who is not the employee's tax dependent from taxable income. We expect that Virginia, like many other "fixed date" states, will probably conform to PPACA's tax exemption in the future. However, until such conforming language is enacted, employers should take the steps outlined below.

- "Selective" conformity states adopt only certain Internal Revenue Code provisions, adopt certain provisions as of a specific date, or make material changes to key Internal Revenue Code provisions. California is an example of a selective conformity state. As of the date of this Client Alert, with regard to Internal Revenue Code Sections 105(b) and 106, which generally provide the exclusion from gross income of the value of employer-provided coverage under a health care plan and the benefits received from the plan, California law conforms to those sections as in effect on January 1, 2009. California would need to enact legislation adopting the PPACA changes to Internal Revenue Code Sections 105(b) and 106 in order for the income exclusion to apply for state income tax purposes when health care benefits are provided to a child who is not an employee's tax dependent. California considered, but failed to pass legislation during the 2010 legislative session that would have conformed California to several tax provisions of PPACA.

In states that do not conform to the Internal Revenue Code as in effect on March 30, 2010 (when PPACA amendments to the Internal Revenue Code became effective), the following issues must be addressed:

- Employee contributions to pay for coverage provided to such children must be made on an after-tax basis for state income tax purposes.

- Employers must impute income for state income tax purposes for the value of coverage provided to any adult child who is not the tax dependent of an employee (for example, a 22-year-old child who is not a full-time student would be eligible for favorable tax treatment under the Internal Revenue Code, but may not be a dependent for state income tax purposes).

- The amount of imputed income must be determined. In general, the amount includable in gross income would be the fair market value of the health coverage. One method of determining the value is to use the plan's COBRA premium for individual coverage. Another method would be to determine the value based on the incremental cost of adding coverage for an individual (for example, the difference between employee-plus-one and family coverage). Employers using the incremental method should note that in some instances, the incremental cost may be minimal or zero (for example, if the employee already has family coverage), and that the fair market value of such coverage must still be determined even when adding the individual does not change the overall cost of coverage. Some employers may have the fair market value of coverage determined by an actuary.

Employers who offered health coverage to adult children of employees during 2010, as permitted by PPACA, should determine whether the state in which the employee is taxable conforms to the Internal Revenue Code as in effect on or after March 30, 2010. If the state does not conform and the state tax authority has not otherwise issued guidance relieving employers from reporting taxable income by reason of the coverage of non-dependent children, employers should consider the need to take action to (i) identify the individuals enrolled for dependent coverage under the plan during the open enrollment period who were adult children; (ii) determine whether such adult children would qualify as tax dependents of an employee; (iii) determine an appropriate amount of imputed income with respect to benefits provided to any child who was not an employee's tax dependent; and (iv) include the imputed income amount

reported for such employees for state income tax purposes on a Form W-2 or, if permitted by the state, a supplemental state W-2. If an amount of imputed income is reported and the state involved adopts a conforming amendment retroactive to 2010, an amended W-2 should then be issued to the employee.

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