



JONES DAY
COMMENTARY

TIME FOR IMMEDIATE DECISIONS: INCOME TAX EXCLUSION FOR COVERAGE OF ADULT CHILDREN

ADULT CHILDREN COVERAGE MANDATE

The Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010 (collectively, “PPACA”), will require group health plans and insurance issuers that provide health coverage for dependent children to continue making such coverage available to adult children until they reach age 26. This extended coverage will be required for plan years beginning on or after September 23, 2010 (*i.e.*, as of January 1, 2011, for calendar year plans). For a more detailed overview of this health coverage mandate (including its application to “grandfathered plans”), see the Jones Day White Paper, “Impact of Health Care Reform Legislation on Employer-Sponsored Group Health Plans” (April 2010), available at http://www.jonesday.com/impact_of_health_care_reform/.

On April 27, 2010, the Internal Revenue Service (“IRS”) issued Notice 2010-38, which provides interim guidance on certain aspects of the income tax exclusion

for employer-provided health coverage of adult children under age 27. Until additional regulations are issued, employers and insurance issuers may rely on the guidance provided in Notice 2010-38. An important purpose of Notice 2010-38 is to encourage employers to start covering nondependent adult children prior to the mandatory effective date under PPACA. This *Commentary* discusses extended coverage of nondependent adult children and the impact of Notice 2010-38.

INCOME EXCLUSION FOR REIMBURSEMENT OF ADULT CHILDREN’S MEDICAL EXPENSES

In addition to mandating extended coverage for adult children, PPACA provides an exclusion from an employee’s gross income for any medical expense reimbursement the employee receives under an employer-sponsored accident or health plan with respect to a child who has not attained age 27 by the end of the employee’s taxable year. The income

exclusion under Section 105(b) of the Internal Revenue Code (“Code”) (as amended by PPACA) with respect to adult children under age 27 is effective as of March 30, 2010.

INCOME EXCLUSION FOR EMPLOYER-PROVIDED COVERAGE OF ADULT CHILDREN

While PPACA expands the gross income exclusion under Code Section 105(b) to cover medical expense reimbursement with respect to adult children under age 27, the Act contains no corresponding exclusion under Code Section 106 for employer-provided coverage under an accident or health plan (i.e., for employer contributions to or payment of premiums under a group health plan). In Notice 2010-38, the IRS notes that, prior to PPACA, the exclusion for employer-provided accident and health plan coverage under Code Section 106 has paralleled the exclusion for reimbursement under Code Section 105. Because “there is no indication that Congress intended to provide a broader exclusion in § 105 than in § 106,” the IRS announced its intention to amend the regulations under Code Section 106 to provide that employer-provided coverage with respect to an employee’s adult child under age 27 is also excluded from the gross income of the employee, effective retroactively to March 23, 2010.

“CHILD” FOR PURPOSES OF INCOME EXCLUSION

PPACA does not change the definition of “child” under Section 152(f) of the Code. Under that provision, a child is an individual who is the son, daughter, stepson, or stepdaughter of the employee, including any legally adopted child, a child placed with the employee for adoption, and an eligible foster child placed with the employee by an authorized agency or by a court order. PPACA also does not change the rules under Code Section 152 for purposes of determining whether a child may be considered as a parent’s dependent for federal income tax purposes (e.g., age limits, residency requirements, and a support test). PPACA does, however, extend the exclusion from gross income under Code Section 105(b) (and under the IRS interpretation under Code Section 106) to children of a taxpayer who have not attained age 27 by the end of the employee’s taxable year.

Notice 2010-38 specifically states that for purposes of the income tax exclusions under Code Sections 105(b) and 106 for adult children under age 27, other requirements that generally apply to determine the dependent status of a child, such as the age limit, the residency requirement, and the support test contained in Code Section 152, do not apply.

Notice 2010-38 also sets forth certain rules and assumptions for employers in determining whether a child has attained age 27 at any time during the employee’s taxable year. The Notice states that a child attains age 27 on the child’s 27th birthday. In determining the child’s age, an employer may assume that the taxable year of the employee is the calendar year, and the employer may rely on the employee’s representation as to the child’s date of birth.

COVERAGE OF ADULT CHILDREN UNDER CAFETERIA PLANS, FSAs, AND HRAs

Income Exclusion. Notice 2010-38 makes it clear that the income tax exclusions for coverage and reimbursement of adult children who have not attained age 27 also apply to coverage and reimbursement provided under a cafeteria plan, a health care flexible spending arrangement (“FSA”), or a Health Reimbursement Account (“HRA”).

Immediate Coverage of Adult Children. Consistent with its purpose of encouraging the extension of immediate coverage for nondependent adult children, the Notice also permits a mid-year election change when the employee’s adult child becomes newly eligible for health coverage or becomes eligible for extended coverage beyond the date on which the child would lose eligibility for dependent coverage under the plan. The IRS announced its intention to amend the change in status regulations under Code Section 125 to include change in status events affecting adult children under age 27, including becoming newly eligible for coverage or becoming eligible for coverage beyond the date on which the child otherwise would have lost coverage.

Similarly, Notice 2010-38 permits immediate pre-tax salary reduction elections with respect to adult children under age 27 under a cafeteria plan (including a health care FSA). Although the regulations under Code Section 125 require cafeteria plan amendments to apply only prospectively, a transition rule contained in Notice 2010-38 will permit retroactive salary reduction elections for dependent children under age 27. The transition relief applies only if the employer amends its plan by December 31, 2010, effective retroactively to the first date in 2010 when employees were permitted to make pre-tax salary reduction contributions to cover children under age 27 (but in no event before March 30, 2010).

EXCLUSION FROM FICA, FUTA, RRTA, AND TAX WITHHOLDING

Notice 2010-38 clarifies that coverage and reimbursement under a health plan that is provided with respect to an employee's child under age 27 are not wages for purposes of the Federal Insurance Contributions Act ("FICA"), Federal Unemployment Tax Act ("FUTA"), and Railroad Retirement Tax Act ("RRTA"). In addition, such reimbursement and coverage are exempt from income tax withholding.

WHAT THIS MEANS FOR EMPLOYERS

In view of the approaching compliance deadline for extending dependent coverage to children under age 26 and the income exclusion for employer-provided coverage and reimbursement (which is already effective), employers at a minimum should consider:

- Reviewing current definitions of the term "dependent" and/or "child" in all health plans (including health care FSAs and HRAs).
- Assessing their needs and objectives in providing benefits for the adult children of their employees.

- Deciding whether to offer extended coverage to adult children before the first plan year that begins on or after September 23, 2010, and the scope of such early coverage.
- Amending their health plans (including health care FSAs and HRAs) to reflect any change in coverage for adult children and the effective date of such change.
- Providing employees with appropriate forms to enroll (or re-enroll) adult children under age 27 and to make new salary reduction elections to pay for such coverage, if the intent is to provide immediate coverage for dependent adult children.
- Working with payroll vendors to reflect the tax exclusion and exemption from tax withholding with respect to medical reimbursement and coverage of adult children.

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