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States Address Tax Consequences of Health Coverage for Adult Children

PPACA amended the Internal Revenue Code to exclude from an employee's income for federal tax purposes the value of health coverage provided to an adult child through the end of the year in which the adult child turns age 26. Many state income tax laws did not provide automatic conformity with this tax treatment. All states have now addressed this issue. There are special considerations for Hawaii, Kentucky, and Wisconsin.

Background

The Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010, (collectively "PPACA") requires group health plans and insurance issuers that cover an employee's biological, adopted, step, or foster children to extend coverage to these children until they attain age 26 ("adult child" or "adult children"). (See our May 13, 2010 *For Your Information*.) This provision was effective for plan and policy years beginning on or after September 23, 2010. However, some plans and issuers either voluntarily, or pursuant to existing state laws, adopted some version of adult child coverage earlier.

To coordinate federal tax laws with the mandatory coverage of adult children, PPACA amended the Internal Revenue Code ("federal Code") to exclude from income the value of health coverage and benefits provided to adult children. The federal income tax exclusion, which became effective on March 30, 2010, applies through the end of the calendar year in which the adult child attains age 26. (See our May 4, 2010 *For Your Information*.)

> ***BUCK COMMENT.*** *The extension of the special federal tax treatment through the end of the calendar year in which the adult child turns age 26 (even though the mandatory coverage requirement only applies until the adult child attains age 26) was made to prevent an employee from facing a federal tax issue if the plan provides coverage beyond the birthdate.*

Applicable State Tax Provisions

Of those states which impose state income taxes, only 22 states and the District of Columbia have tax law provisions that automatically conform to changes in federal rules related to the definition of income. This meant that in 19 states there was the potential for state taxation of the value of coverage for some adult children newly covered as a result of PPACA. (See our February 25, 2011 *For Your Information*.)

Fortunately for plan sponsors, all states but Wisconsin have taken steps to bring their state income tax laws into conformity with federal law on this point. Most states also have made their rules effective on the same date as the federal Code (March 30, 2010). The exceptions are as follows:

- **Hawaii** follows federal law effective beginning with the employee's 2011 tax year. This means that benefits provided to adult children may have been subject to taxation in some circumstances if provided in 2010.
- **Kentucky** also is effective only beginning with the employee's 2011 tax year.
- **Wisconsin** passed legislation specifically declining to follow federal tax law.

This means that any health coverage provided to adult children in Wisconsin, as well as any coverage provided in 2010 to adult children in Hawaii and Kentucky, is potentially subject to state income taxation. All three states will impose taxes only if the adult child fails to satisfy the federal rules in effect prior to PPACA. Under those rules, the value of health care coverage may be excluded for any dependent who can qualify as either a "qualifying child" or "qualifying relative" of the participant, as set out below:

- A "qualifying child" is an individual who satisfies all of the following four requirements:
  - The individual lives with the participant for more than one-half of the tax year;
  - The individual is the participant's son, daughter, stepchild, sibling, stepsibling, or a descendent of any such individual;
  - As of the end of the calendar year, the individual is under the age of 19, under the age of 24 and a fulltime student, or permanently disabled; and
  - The individual does not provide over one-half of his or her own support.
- A "qualifying relative" is an individual who satisfies all of the following three requirements:
  - The individual bears a specified relationship (including that of a child, a sibling, or a descendent of a child or sibling) to the participant;
  - The participant provides more than one-half of the individual's support; and
  - The individual is not a qualifying child of the taxpayer or any other person for that calendar year.

Note that these "qualifying child" and "qualifying relative" tests are also generally still used for both federal and state income tax purposes when determining whether coverage provided for other dependents, such as grandchildren, is taxable.

Federal Tax Consequences for Coverage Beyond Age 26

It should also be noted that prior to PPACA, a number of states enacted laws requiring coverage of dependents under fully insured plans. In 10 states, these rules may require that coverage be extended beyond the adult child's 26^{th} birthday. These states are:

- Connecticut
- Florida
- Illinois
- Nebraska
- New Jersey
- New York
- Ohio
- Pennsylvania
- South Dakota
- Wisconsin

If an employer provides coverage beyond the year in which the adult child turns 26, whether voluntarily or due to a state mandate, the coverage could result in federal taxation of the value of coverage unless the child meets the "qualifying child" or "qualifying relative" definitions set out above.

Conclusion

The fact that the states have acted on this important issue is welcome news for plan sponsors. Although most states have conformed to the federal Code, employers with employees in Hawaii and Kentucky may have had special issues with state taxes for the 2010 tax year. In addition, employers with employees in Wisconsin may need to follow separate withholding rules for state and federal law with respect to adult children. Finally, for employers with insured plans in states where the required age of coverage is beyond the year in which an adult child turns 26, there may be additional withholding under the federal Code if the adult child is not a qualifying child or qualifying relative.

Buck's consultants are prepared to assist you in determining how these changes may impact your payroll systems.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.