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IRS Clarifies Tax Treatment of Coverage for Adult Children under the Health Care Reform Act

In late April, the Internal Revenue Service issued Notice 2010-38 ("Notice") addressing the federal income tax treatment of health care coverage provided to adult children under the Patient Protection and Affordable Care Act of 2010, as amended by the Health Care and Education Reconciliation Act of 2010 (collectively, "Health Care Reform Act"). This alert is a summary of the significant provisions in the Notice.

As explained in our recent client alert ("Health Care Reform — What Employers Need to Know Now"), the Health Care Reform Act requires employer-sponsored group health plans that already provide dependent coverage to make health coverage available for employees' adult children under age 26, regardless of marital status. Along the same lines, the new law excludes from gross income, beginning March 30, 2010, the value of any employer-provided coverage for adult children under age 27, and not just under age 26. There have been lingering questions about this inconsistency and the breadth of the income exclusion as it relates to the required coverage, as well as some practical concerns about implementation. Notice 2010-38 answers many of them.

Does the Health Care Reform Act require coverage for adult children under age 26 or age 27?

There is nothing in the Health Care Reform Act requiring employers to extend coverage to adult children over age 26 but under age 27. The Notice, however, says that the income tax exclusion for coverage provided to children under age 27 applies to any such coverage provided by an employer beginning March 30, 2010. The Notice also says that employers may offer coverage for children under age 27 on a pre-tax basis under a cafeteria plan, even though they are not required to provide coverage for those who have turned 26.

Does the income tax exclusion apply to coverage provided to adult children who are not "dependents" for federal income tax purposes?

The short answer is "yes." As previously mentioned, the Health Care Reform Act requires group health plans that already provide dependent coverage to extend that coverage to employees' adult children under age 26. The Notice reiterates that the gross income exclusion applies to that coverage provided to the employee's child, within the meaning of Code Section 152(f)(1). For this purpose, a "child" includes a son, daughter, stepson, stepdaughter, an

eligible foster child, an adopted child and a child placed for adoption by the employee. Examples in the Notice explain that although a child may not qualify as a dependent for federal income tax purposes (because, for example, an adult child graduated from college), the child nevertheless may be eligible for coverage until age 26 without regard to whether (i) the child's employer offers coverage, (ii) the child is a full-time student or (iii) the child is married. (Note, however, that the Health Care Reform Act does not require grandfathered plans [i.e., group health plans in existence on March 30, 2010] to offer coverage to adult children who are eligible for coverage under another employer-sponsored plan before 2014.) The Health Care Reform Act, moreover, excludes such coverage from the employee's gross income, but if an employer extends coverage to a married child's spouse or dependents, the spousal/dependent coverage would be taxable.

When does the income tax exclusion end for adult child coverage?

The exclusion from gross income ends on the last day of the calendar year in which the child turns age 26. In other words, the exclusion will not apply during the calendar year in which the child turns age 27. For example, the exclusion for coverage provided to a child

born on July 1, 1984, who turns age 27 on July 1, 2011, will end on December 31, 2010, because the child will reach age 27 during the 2011 calendar year.

What about health care flexible spending accounts and other health reimbursement arrangements?

The Notice explains that the same rules apply to health care flexible spending accounts and health reimbursement accounts. Therefore, beginning March 30, 2010, the covered expenses of adult children under age 27 generally can be paid under these accounts (to the extent the operative plan documents otherwise allow payment of such expenses).

Is the value of coverage and medical care reimbursements provided for children under age 27 subject to employment taxes?

Any coverage provided to, and any reimbursement of the medical expenses of, adult children under age 27 is not only exempt from income tax withholding but also is exempt from FICA and other employment taxes as well.

When must employers amend their cafeteria plans?

To provide adult child coverage under a cafeteria plan (if the plan document does not already allow for such

coverage), an employer probably will need a plan amendment. Cafeteria plan amendments, generally, must apply only prospectively so that adopted amendments are in place before changes become effective. The Notice, however, contains a special rule that allows a cafeteria plan that currently offers adult child coverage (or will begin offering such coverage before the end of 2010) to be amended retroactively, as long as the required amendment is adopted by December 31, 2010. In addition, employers may permit employees to make pre-tax elections in this context anytime beginning March 30, 2010, even though the needed language is not in place, as long as the timely adopted amendment is retroactively effective. Lastly, the IRS will allow the extension of adult child coverage to be treated as a change in status (or "life") event under which a corresponding midyear election change may be made.

Please let us know if you have any questions regarding the federal income tax treatment of health care coverage provided to adult children and the impact of Notice 2010-38 on your benefit plans.

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