



UPDATE:
Employee Benefits
and Compensation

APRIL 2010

Internal Revenue Service Issues Guidance on Tax Treatment of Health Coverage for Adult Children

On April 27, 2010, the Internal Revenue Service (IRS) issued Notice 2010-38, providing guidance regarding the new tax treatment of health care coverage for an employee's adult children. This guidance was issued concurrently with a news release outlining the immediate application of such favorable tax treatment to pretax contributions made by employees under a cafeteria plan. Effective March 30, 2010, the much-anticipated Notice implements provisions of the recently enacted [health care reform law](#), mandating group health plans to extend for covered employees dependent coverage to adult children up to age 26.

Background

The Patient Protection and Affordable Care Act (Affordable Care Act), as amended by the Health Care and Education Reconciliation Act, was signed into law on March 23, 2010. The Affordable Care Act mandates, effective for plan years commencing on or after September 23, 2010, that group health plans providing dependent coverage must allow children of covered employees to continue to be covered as dependents up to age 26. Dependent coverage provided pursuant to this provision is not taxable to the employee or the dependent.

For employers with calendar-year plans, this extension of coverage requirement begins on January 1, 2011; however, some insurers have already indicated that they will expand coverage to adult children before such date, and employers are considering amending their plans now. This has raised some concern over whether expanding coverage ahead of the effective date would result in employees being taxed on the cost of the coverage.

Exclusion from Income

Effective March 30, 2010, employer-provided coverage or reimbursements for medical care of adult dependents are not taxable to the employee. These provisions apply to both premiums and payments so that adult children subject to this provision are treated the same as the employee and the employee's dependents. This exclusion from gross income applies to an employee's child who has not reached age 27 as of the end of the taxable year, including a child of the employee who is not the employee's dependent for other provisions of the Internal Revenue Code. The IRS indicated that the age 27 rule was put into place to avoid having to include a partial year of income in the year the child attains age 26. The age limit, residency, support, and other tests applicable to dependents do not apply.

Additionally, the Affordable Care Act also requires plans that provide dependent coverage for

children to continue to make the coverage available for an adult child until the child turns age 26. In its news release, the IRS indicated that the extended coverage must be provided not later than plan years beginning on or after September 23, 2010, and the favorable tax treatment described in the Notice applies to that extended coverage.

Cafeteria Plans

Because many employers are considering adding coverage for adult dependents during 2010, it is a concern that the addition of such coverage would not qualify as a change in status. The Notice provides that employers with cafeteria plans under Section 125 of the Code may also permit employees to immediately make pretax salary reduction contributions to provide coverage for children under age 27, even if such cafeteria plans have not yet been amended to cover these individuals. Plan sponsors have until the end of 2010 to amend their plans to incorporate this change retroactively to March 30, 2010, or, if later, to the date on which employees were first permitted to make contributions on behalf of their adult dependents.

The IRS also indicated that it would amend the regulations governing cafeteria plans to include change in status events affecting nondependent children under age 27, including becoming newly eligible for coverage or eligible for coverage beyond the date on which the child otherwise would have lost coverage.

To receive more information on the changes under the health care reform law and the tax treatment of dependent coverage, please contact one of the following attorneys:

Bruce Barth (860) 275-8267 bbarth@rc.com	Cynthia Christie (860) 275-8259 cchristie@rc.com
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Virginia Spiess (860) 275-8291 vspiess@rc.com	Jean Tomasco (860) 275-8323 jtomasco@rc.com
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