Client Advisory

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Employee Benefits and Executive Compensation

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Many States Begin Falling in Line Regarding Tax Exclusion for Providing Health Benefits to Older Children

Last year as part of its health care reform bill, Congress mandated that group health plans and insurance issuers make coverage available to adult children until age 26. The Internal Revenue Code was amended at the same time to provide that there is no *federal* income tax due with regard to such coverage through December 31 of the year in which the child reaches age 26. However, many *state* tax codes did not provide the same tax exclusion for health benefit coverage for older children. While some states have since taken subsequent action to relieve the burden (and potential penalties on the employers and employees), at least for 2010, many others have yet to enact such exclusions.

Background

Until Congress enacted the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010 (collectively PPACA), employer medical benefit plans tended to extend coverage to employees' children only until their 19th birthday (or 24th birthday if a full-time student). Under PPACA and effective for plan years and insurance policy years beginning after September 22, 2010, coverage must be extended to an employee's biological, adopted, step or foster children until they reach age 26. Such coverage must be made available irrespective of the child's marital status or student status, or whether the child resides with or is supported by the employee. (Grandfathered plans do not have to provide such coverage until 2014 if the child is eligible for health benefit coverage from his or her own employer.)

Congress simultaneously amended the Internal Revenue Code to extend the exclusion from gross income to cover the benefit. As a result, employees are not taxed at the federal level on the value of health benefit coverage provided to their adult children. The tax exclusion actually extends longer than the period of time for which health benefit coverage must be available, in the event employers do not cut off coverage when an employee's adult child reaches age 26. Even if the employer extends coverage until the end of that month, or to the end of that calendar year, the federal income tax exclusion continues to apply.

The Problem

Many state income tax codes have provided an exclusion from state income tax only to the same extent that such an exclusion was provided under federal tax law as it was previously written. Thus, unless state legislatures take action, employees would be subject to state

If you would like assistance determining the current status of reporting requirements in your state and what obligations and potential penalties could apply, please contact your CPA or any member of Katten's **Employee Benefits and Executive Compensation Practice**.

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income tax on the value of the coverage provided to adult children. Many state legislatures were unaware of the issue, too busy to address the subject or welcomed the additional tax revenue. Employers either were similarly unaware of the issue or else held their collective breath hoping for a legislative fix. Many were in a quandary and unable to compute in a timely fashion the appropriate amount of state income tax and report it for 2010.

Legislative Fix at the State Level

Several state legislatures are enacting a fix this year, including:

California. California's senate approved A.B. 36, which would amend the state code to conform with the Internal Revenue Code. Governor Jerry Brown is expected to sign it.

Minnesota. Governor Mark Drayton signed into law H.F. 79, which provides the same exclusion as that contained in the Internal Revenue Code, however the Minnesota fix only applies with respect to coverage provided in 2010. It has not yet been determined what will be done with respect to 2011 coverage.

Kentucky. Governor Steven Beshear signed into law H.B. 255 providing the exclusion from state income tax.

Virginia. Virginia's governor signed into law H.B. 1874 providing the exclusion from state income tax.

Similar measures have been passed in Vermont (H. 436 passed by the Vermont House), South Carolina (S. 522 passed by the South Carolina Senate), Arizona, Maine and Oregon.

Several states (including Iowa, Oregon and Wisconsin) have issued guidance from their Departments of Revenue suggesting that income tax is owed and that only the legislature (which had not yet acted) can provide an exclusion.

States that have not yet passed legislation nor provided formal guidance/relief include Arkansas, Georgia, Hawaii, Idaho, Indiana, Massachusetts, Mississippi and New Jersey.

Conclusion

While some states either have taken legislative action to provide an exclusion from state income tax or may enact such exclusions retroactively, others may never take any action. Employers with employees located in nonconforming states are left to wonder whether they should impute and report taxable income, and if so, at what rate.

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