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TAX UPDATE

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Imputed Income and Health Insurance in Divorce Settlements

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Divorcing spouses have many issues to consider in negotiating the terms of a divorce agreement. One of the seemingly "easier" issues for divorcing spouses and their counsel is health insurance. While the issue of health insurance coverage is typically included within the divorce agreement, the federal tax implications are often overlooked. Recent interpretations of federal tax law underscore the need for divorcing spouses to use skilled divorce counsel and tax practitioners in negotiating the terms of their divorce agreements.

It is commonplace for a divorce agreement to contemplate one spouse continuing to provide health care coverage through his/her employment for an ex-spouse. Under the Affordable Care Act (ACA or "Obamacare"), the IRS will require reporting by the employer of the cost of such coverage of employer-sponsored insurance. In some instances, the reporting requirement may facilitate the apportionment of the cost of health coverage for divorced spouses. However, the insuring spouse must be forewarned of the *possibility* of being subject to tax on imputed income based on the fair market value of the insurance benefits being provided to his/her ex-spouse. The likelihood of this imputation varies greatly from employer to employer, such that divorce counsel often cannot state with certainty whether or not an employee who continues to carry the health care coverage of his/her former spouse will in fact be subject to tax on imputed income. Therefore, it is extremely important to be cognizant of this issue and plan for the possibility of imputed income for continuing health care coverage of a former spouse. Below is a brief discussion of how imputed income works in connection with continuing health care coverage of a former spouse.

Under the Internal Revenue Code, employer-provided health insurance is typically considered a nontaxable fringe benefit to the employee. However, this exclusion only applies to coverage of the employee and the employee's spouse, dependents, and children up to a certain age. It does not apply to the employee's former spouse. The IRS views the health care coverage of a former spouse as a taxable fringe benefit to the employee, notwithstanding the fact that the former spouse may in fact be the one who pays for any additional coverage costs. The IRS has taken the position that the "fair market value" of health insurance benefits provided to a person who is not an employee's spouse or dependent must be "imputed" to the employee and included in his/ her federal gross income.

> "Although divorcing spouses have enough issues to consider, imputed income for continuing health care coverage should be added to the list."

The crux of this situation lies in the determination of the "fair market value" of the employer-provided health insurance benefits. This amount could vary greatly from employer to employer, depending on how much the employer provides for coverage. The income imputed to the employee is the value of the benefit provided by the employer, excluding the benefit paid for that employee.

With most Massachusetts health insurance plans, provided he/she has not yet remarried, an employee with at least one dependent child can add a former spouse to the coverage for no additional cost, so there is no additional cost to the employer either. In these situations, one would presume that no income should be imputed to the employee because the employer is not required to pay the insurer any additional premium for the benefit of continuing coverage of a former spouse. Unfortunately, not all human resource departments share this view. Some human resource departments are deciding that the former spouse is receiving a benefit that is equal to the value of the employee's own individual

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coverage and, thus, are imputing the fair market value of that coverage to the employee on his/her Form W-2.

Other human resource departments are imputing the income to the employee by dividing the entire employer benefit amongst the family members in order to determine the fair market value of the benefit to the former spouse. For example, if a family plan costs the employer $100 per week and the former spouse is one of four people covered, some human resource departments would impute income of $25 per week ($100/4) to the employee as the fair market value of health care coverage of the former spouse. In neither scenario does the "fair market value" bear any relation to any real cost incurred by the employer.

Because of the discretionary nature of the imputation, many employees find themselves having to argue and plead their cases on an individual basis to human resource personnel or employers to not impute income to them (with varying degrees of success). Worse still, some employees do not even realize that income is being imputed to him/her until the following year when he/she sees it on his/her Form W-2.

Until federal tax laws set clearer guidelines as to how to apply the fair market value of the continued health insurance coverage of a former spouse, divorcing spouses should be mindful of this issue when providing for continuing health care coverage of a former spouse. Divorcing spouses and their counsel should include specific language in divorce agreements to plan for the possibility of imputed income after consultation with a tax professional, including a determination of who will have the burden of the economic and tax cost of continuing insurance coverage. Failure to take this issue into consideration at the outset could result in unexpected consequences to both divorcing spouses.

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