February 28, 2014

Novel IRS Guidance on HRAs, VEBAs and Domestic Partner Benefits

The Internal Revenue Service (IRS) recently provided guidance on several issues never before addressed. The guidance came in the form of a Private Letter Ruling (PLR), to be released later this year to the public under the Freedom of Information Act. The PLR addresses the technical tax and benefit issues that arise when a Health Reimbursement Arrangement (HRA) (funded through a Voluntary Employees' Beneficiary Association (VEBA)) provides coverage to a domestic partner who does not qualify as a dependent under the Internal Revenue Code.

Facts

The HRA, which was the subject of the PLR, is funded through a VEBA and is therefore qualified as tax-exempt under Internal Revenue Code §501(c)(9). It is proposed that the plan be amended to provide HRA coverage to the domestic partners of participants. Though the IRS had previously provided guidance regarding the tax implications of a medical plan providing coverage to domestic partners who do not qualify as dependents, the taxpayer requested guidance with respect to the unique questions that arise when the plan in question is an HRA or when it is funded through a VEBA.

Novel Issues/Guidance

Generally, health care benefits provided to an employee and his or her dependents from an employer-sponsored medical plan are tax-exempt to the employee and the dependents. This includes both the coverage and the benefit payment or reimbursement (Code §§105, 106). However, where coverage is provided to a domestic partner who does not qualify as a dependent under Internal Revenue Code §152, gross income is to be reported to the **employee** (IRS Private Letter Rulings 9109060; 200108010). Typically the amount includible in the employee's gross income is the equivalent of the COBRA applicable premium (IRS Notice 2002-45 Part VII).

Unique issues arise when the coverage is provided through an HRA, especially if the HRA is free-standing or is funded through a VEBA. In the new PLR, the IRS provided the following guidance with respect to these previously unaddressed issues:

1. The federal and state income and employment taxes reportable to the employee as a result of the coverage may be paid from the participant's individual HRA account.
2. The VEBA will not lose its qualified tax-exempt status by providing benefits to non-dependent domestic partners and paying the employees' income and employment taxes, if all of the domestic partner benefits and taxes paid out in any plan year, together with any other impermissible benefits payments, do not in the aggregate exceed three percent (3%) of the total payments from the VEBA.
3. The VEBA is considered the "employer" and is thereby obligated to conduct the tax withholding and reporting.

For more information, please contact your Katten Muchin Rosenman LLP attorney, or the following member of the **Employee Benefits and Executive Compensation practice**.

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4. The fair market value of the coverage provided to a non-dependent domestic partner is includible in the employee-participant's gross income, and is considered wages for FICA, FUTA and income tax withholding purposes. The amount of employee FICA and income tax withholding that is paid by the VEBA is also includible in the employee's income and is considered wages for employment tax purposes. The total amount to be reported, via Form W-2, is the gross-up amount computed under Revenue Procedure 81-48.
5. For purposes of determining the amount of income tax to withhold, the supplemental wages paid by the VEBA are considered separately from wages paid by the participant's common law employer.
6. The VEBA may treat the domestic partner coverage as provided on an annual basis for purposes of employment tax withholding, FICA and FUTA.

Summary

It has been relatively well-known that providing health care coverage to a non-dependent domestic partner results in gross income reportable to the employee-participant. However, until now there had been no guidance for HRAs regarding the specifics concerning: (1) the tax payments may be withdrawn from the participant's HRA account without disqualifying the HRA's status as a medical plan under IRC §105; (2) the VEBA could pay the employee's income and employment taxes without losing its status under IRC §501(c)(9); (3) the VEBA is obligated to conduct the withholding and reporting; and (4) the appropriate amount of federal income tax is computed under Revenue Procedure 81-48.