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Employee Benefits Advisory: DOR Issues Guidance Regarding Dependent Group Health Insurance Coverage

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In Technical Information Release 07-16 ("TIR 07-16"), the Massachusetts Department of Revenue (DOR) provided helpful guidance on "imputed income" resulting from group health insurance coverage of dependents under the expanded dependent coverage requirement of the Massachusetts health care reform act (the "Act").[1]
Among other things, the Act broadens the requirements imposed upon Massachusetts-licensed health insurance carriers where dependent coverage is concerned. Specifically, carriers issuing or renewing insured health benefit plans with coverage for dependents must make coverage available for persons "under 26 years of age or for 2 years after the end of the calendar year in which such persons last qualified as dependents" for federal tax purposes. The Act's dependent coverage extension addresses a legitimate and compelling policy goal of expanding coverage among young people who "age out" under their parents' plan but who may not be in a position to immediately obtain other coverage. Prior to the Act, a child generally "aged out" when he or she ceased to be a "dependent" for federal income tax purposes. By expanding dependent coverage, the Act creates a class of dependents who are "dependents" for Massachusetts purposes but not for federal purposes, resulting in the need to impute to the employee as income the fair market value of the coverage provided to the child who no longer qualifies as a dependent for federal purposes. (A similar issue arises in connection with group health coverage provided to nondependent domestic partners and same-gender spouses.)

This client advisory explains the key features of TIR 07-16 and the underlying federal and Massachusetts income tax rules to which it is addressed.

Federal Tax Issues—Code § 61

To understand the source and consequences of imputed income requires a brief digression into the Internal Revenue Code (the "Code"). Code § 61(a)(1) provides, in relevant part:

> Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) . . . compensation for services, including fees, commissions, fringe benefits, and similar items….

Treasury regulations expand upon and clarify this basic rule. According to Treas. Reg. § 1.61-21(a)(3), a fringe benefit provided in connection with the performance of services is considered "to have been provided as compensation for such services," and Treas. Reg. § 1.61-21(a)(2) directs us to other provisions of the Code to determine whether a particular fringe benefit is deductible, providing (again in relevant part):

> To the extent that a particular fringe benefit is specifically excluded from gross income pursuant to another section of subtitle A of the Internal Revenue Code of 1986, that section shall govern the treatment of that fringe benefit. Thus, if the requirements of the governing section are satisfied, the fringe benefits may be excludable from gross income.

Also, Treas. Reg. § 1.61-21(a)(4)(i) provides:

> A taxable fringe benefit is included in the income of the person performing the services in connection with which the fringe benefit is furnished. *Thus, a fringe benefit may be taxable to a person even though that person did not actually receive the fringe benefit*. If a fringe benefit is furnished to someone other than the service provider such benefit is considered in this section as furnished to the service provider, and use by the other person is considered use by the service provider… (Emphasis added).

Under Treas. Reg. § 1.61-21(b)(1), "an employee must include in gross income the amount by which the fair market value of the fringe benefit exceeds the sum of—(i) the amount, if any, paid for the benefit by or on behalf of the recipient, and (ii) the amount, if any, specifically excluded from gross income by some other section of subtitle A of the Internal Revenue Code of 1986."

Treas. Reg. § 1.61-21(b)(2) attempts to clarify the meaning of fair market value in this context. It says:

> In general, fair market value is determined on the basis of all the facts and circumstances. Specifically, the fair market value of a fringe benefit is the amount that an individual would have to pay for the particular fringe benefit in an arm's-length transaction. Thus, for example, the effect of any special relationship that may exist between the employer and the employee must be disregarded. Similarly, an employee's subjective perception of the value of a fringe benefit is not relevant to the determination of the fringe benefit's fair market value nor is the cost incurred by the employer determinative of its fair market value.

As a result of extended employer-provided health insurance coverage for children under the Act, there will be instances where the benefits provided to an employee, including health insurance for a nondependent child, will be taxed (or imputed) to the employee. The amount of the imputed income generally will be the fair market value of the coverage provided to the employee's child.

The Federal Tax Exclusion for Medical Coverage

Code § 106 provides that amounts an employer pays toward medical coverage of an employee are not taxable to the employee if the coverage is for the employee, his or her spouse, or dependents. Treas. Reg. § 1.106-1 describes the operation of § 106 as follows:

> The gross income of an employee does not include contributions which his employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by him, his spouse, or his dependents, as *defined in section 152*. (Emphasis added).

Code § 106 ensures that premiums paid by the employer on an employee's behalf are not included in the employee's income, but this income exclusion does not apply where coverage is provided to a dependent not defined in Code § 152. Instead, the general rules of Code § 61 apply to tax the employee at the fair market value of the coverage provided to the nondependent.

What Constitutes Fair Market Value?

The long recognized standard for establishing "fair market value" for tax purposes is set out in Rev. Rul. 59-60. 400,[2] under which "fair market value" is defined as:

> the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well informed about the asset and the market for such asset.

In this instance, the "asset" is health insurance. Perhaps the most logical starting point is the plan's individual rate (*i.e.*, the COBRA rate less the 2% allocated to overhead and administration). The Service did not object to the use of COBRA rates as a proxy for fair market in the context of a ruling on related matters of law.[3] There is, however, another plausible measure: the amount of income to be imputed to the employee could be equal to what the dependent would have to pay for similar Connector coverage (*i.e.*, Gold, Silver or Bronze) based on his or her age and geographic location. Because these dependents will be age 26 or less, this amount will usually be less than the plan's COBRA rate, which is a blended rate.

Definition of Dependent

Under Code § 152, a "dependent" is either a "qualifying child" dependent or a "qualifying relative" dependent. A "qualifying child" is a child who lives with an employee for more than half a year, who is either under age 19 or is a full-time student under age 24, and who does not provide over half of his or her own support for the calendar year. A "qualifying relative" is an individual who bears a relationship to the taxpayer (including any child of the taxpayer who is not a "qualifying child," regardless of the child's age), whose gross income is less than the exemption amount ($3,400 in 2007), and who receives over one half of his or her support from the taxpayer. But for purposes of the exclusion for employer-provided health coverage, the gross income limit does not apply to a qualifying relative. It is therefore possible for an individual to be a dependent for group health plan purposes, and not for purposes of claiming a dependency exemption.[4]

An employee may exclude from gross income the value of employer-provided health insurance coverage for a child who, while not a "qualifying child," meets the definition of a "qualifying relative" determined without regard to the child's gross income. (In effect, many children who do not meet the age requirements of a "qualifying child" will meet the requirements of a "qualifying relative" where the income limitation is not applied). Thus, a child of an employee who exceeds the age to be a "qualifying child" can nevertheless still be a "qualifying relative" if the employee provides over half of the child's support for the calendar year. Special rules apply in the case of divorced parents, under which a child who meets the expanded definition of dependent in connection with one parent is treated as a dependent of both parents.

Massachusetts Income Tax

According to G.L. c. 62, § 2(a), Massachusetts gross income is federal gross income, with certain modifications. Generally, with respect to the personal income tax, Massachusetts adopts the Code as amended and in effect on January 1, 2005. G.L. c. 62, § 1. Thus, Massachusetts would ordinarily follow the federal rules governing employer-provided health and accident premiums. Under the Act as most recently amended, however, for tax years beginning on or after January 1, 2007, amounts that would otherwise constitute imputed income by reason of dependent coverage provisions of the Act are *not* subject to tax for Massachusetts purposes.

Examples

The appendix to TIR 07-16 contains the following useful examples:

> ***Example 1***. A twenty-five year old child earning $10,000 receives over half of her support from her mother and is included in the mother's employer-provided health insurance coverage.
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> The child is considered a dependent for purposes of the income exclusion for employer-provided health insurance coverage. Under IRS Notice 2004-79, the child is a "qualifying relative" because (1) the child receives over half of her support from her mother, and (2) for purposes of the exclusion from gross income for employer-provided health insurance, the amount of the child's earnings is disregarded. As a result, there is no imputed income to the mother for Federal or Massachusetts purposes.
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> The mother is not allowed, however, to claim either a Federal or a Massachusetts dependency exemption for the child. The child is not a "qualifying child" because the child's age exceeds the maximum age. Also, the child is not a "qualifying relative" for purposes of the dependency exemption because the child's earnings exceed the exemption amount ($3,400 in 2007).
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> ***Example 2***. A child of divorced parents, age 25, is a full-time student living with his mother. The father is a Massachusetts resident. The child is included in the father's employer-provided health insurance coverage. The child is supported by both of his parents. Under the terms of the divorce agreement, the mother may claim the federal dependency exemption for him.
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> The child is considered a dependent for purposes of the income exclusion for employer-provided health insurance coverage. Under IRS Notice 2004-79, the child is a "qualifying relative" because the child is supported by his parents. For both Federal and Massachusetts purposes, there is no imputed income to the father as a result of the employer-provided health insurance coverage of the child.
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> Because of the terms of the divorce agreement, the father does not take a dependency exemption for the child. However, the mother is entitled to take the Federal dependency exemption for the child. The child is not a "qualifying child" because the child's age exceeds the maximum age. However, the child is a "qualifying relative" for purposes of the dependency exemption because the child has no earnings. If applicable, the mother is entitled to take the Massachusetts dependency exemption for the child.
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> ***Example 3***. A twenty-five year old child earning $30,000 does not live with the parent (and the parent does not otherwise provide over one-half of the child's support). As a result of the expanded coverage required by the Massachusetts health care reform law, the child is included in the parent's employer-provided health insurance coverage.
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> The employer's carrier is required to make coverage available for this child for two years after the end of the calendar year in which such person last qualified as a dependent under IRC § 106 or until the child reaches 26 years of age, whichever occurs first.
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> The child is not considered a dependent for purposes of the income exclusion for employer-provided health insurance coverage. The child does not come within the requirements of IRS Notice 2004-79 because the child does not receive over half of his or her support from the parent. Thus, for Federal purposes, the value of health insurance coverage for the 25 year old child will be imputed income to the employee. In contrast, under G.L. c. 62, § 2(a)(2)(Q), Massachusetts does not impose tax upon this imputed income because the coverage is required by state law.
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> The parent is not allowed to claim a Federal or Massachusetts dependency exemption for the child. The child is not a "qualifying child" because the child's age exceeds the maximum age; the child is not a "qualifying relative" because (1) the child does not receive over half of his or her support from the parent, and (2) the child's earnings exceed the exemption amount of $3,400 in 2007.

Conclusion

The complexity of the federal tax rules make the imputed income issues raised by the Act particularly challenging to employers and aggravating to employees. As a result, the DOR's guidance in this regard is useful and welcome. The DOR, however, can only go so far. Employers and employees must still endeavor to comply with both sets of rules, which now compel differing results for federal and state purposes.

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[1] 2006 Mass. Acts c. 58, An Act Providing Access to Affordable, Quality, Accountable Health Care, *as subsequently amended by* (i) 2006 Mass. Acts c. 324, An Act Relative to Health Care Access, (ii) 2006 Mass. Acts c. 450, An Act Further Regulating Health Care Access, *and* (iii) 2007 Mass. Acts c. 205, An Act Further Regulating Health Care Access.

[2] 1959-1 C.B. 237

[3] PLR 200108010 (Nov. 17, 2000)

[4] *See* IRS Notice 2004-79, 2004 C.B. 898 (clarifying that the annual income requirement does not apply).

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If you have any questions concerning the information discussed in this advisory or any other employee benefits topic, please contact one of the attorneys listed below or your primary contact with the firm who can direct you to the right person. We would be delighted to work with you.

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