
FOR YOUR INFORMATION

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Taxation of Health Insurance Benefits Provided Under Michelle's Law and to Domestic Partners

Under the Internal Revenue Code (IRC), the general rule is that all benefits provided to any person because of services provided by an employee are included in the employee's taxable compensation. However, the IRC provides an exception to the general rule for contributions made by an employer related to employee health insurance benefits. Under the IRC, the cost of health insurance paid by the employer for the employee, the employee's spouse, and the employee's dependents are excluded from the employee's taxable compensation.

However, under a new state law known as Michelle's Law, health benefits provided by an employer for an employee's adult children may be taxable compensation to the employee. Similarly, health insurance benefits provided by an employer to an employee's domestic partner may be taxable compensation to the employee. This FYI discusses the taxation of health insurance benefits provided by an employer under these two situations, as well as the employer's tax withholding and reporting obligations in each situation.

Michelle's Law. Effective January 1, 2010, Michelle's Law requires health insurers and

governmental self-insured health plans to offer all employees the opportunity to include health insurance coverage for an eligible adult child. An eligible adult child is a child between the ages of 17 and 27 who is unmarried and not eligible for coverage provided by his or her employer, or the premium for coverage provided by the child's employer is the same or more expensive than the premium charged for coverage under the parent's employer. Michelle's Law applies to health insurance policies issued or renewed on or after January 1, 2010, or the date the health plan is established, extended, modified or renewed, if the health plan is provided under a collective bargaining agreement.

Domestic Partnerships. Effective January 1, 2010, Wisconsin Statutes, Chapter 40, extends all benefit programs, including the state health insurance plan, administered by the Wisconsin Department of Employee Trust Funds, to qualifying domestic partners of both state employees and employees of participating local government employers. Wisconsin Statutes, Chapter 770, effective August 3, 2009, provides that same sex couples may apply for a declaration of domestic partnership in a

county in which at least one partner lives. Importantly, however, a declaration of domestic partnership under Chapter 770 does not, in and of itself, give the employee or his or her domestic partner rights to health insurance coverage.

Moreover, neither new law changes the rules governing the taxation of health insurance benefits when an eligible domestic partner receives health insurance coverage. This includes health insurance benefits extended to domestic partners through collective bargaining agreements or board policy.

Finally, a domestic partner does not qualify as a spouse for income tax purposes. However, some domestic partners may qualify as a dependent for income tax purposes.

Dependents Defined. The taxation of an employee's health insurance benefits provided under Michelle's Law and health insurance benefits provided to a domestic partner of an employee turns on whether the person to whom the health insurance is provided qualifies as a dependent of the employee for income tax purposes. A person can qualify as a dependent for income tax purposes if he or she satisfies the criteria as a qualifying child or as a qualifying relative.

Qualifying Child. A qualifying child is a child who is the employee's son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them, and meets any one of the following criteria:

1. Is under age 19 at the end of the tax year and younger than the employee; or
2. Is under age 24 at the end of the tax year, a student, and younger than the employee; or
3. Any age and permanently and totally disabled.

In addition, the qualifying child must not have provided over half of his or her own support during the tax year, and must not be filing a joint income tax return for the tax year. The qualifying child must have lived with the employee for more than half of the tax year (not including temporary absences such as school, vacation, military service, etc.). The qualifying child must be a U.S. citizen, U.S. national, U.S. resident alien, or a resident of Canada or Mexico, and must not be married. Finally, the employee and the employee's spouse, if filing a joint return, cannot be claimed as a dependent on someone else's tax return.

Qualifying Relative. A qualifying relative is the employee's son, daughter, stepchild, foster child, or descendant of any of them, who is not a qualifying child. Also, any other person who lived with the employee all year (except for absences for school, military service, vacation, etc.) may be a "qualifying relative," if that person meets the other following requirements:

1. The "qualifying relative" must have had a gross income less than the personal exemption amount for federal income tax purposes (i.e., \$3,650 for each of 2009 and 2010).
2. The employee must have provided over half of the qualifying relative's support during the tax year.
3. The qualifying relative must be a U.S. citizen, U.S. national, U.S. resident alien or a resident of Canada or Mexico.
4. The qualifying relative cannot be married.
5. The employee or employee's spouse, if filing a joint return, cannot be claimed as a dependent on someone else's tax return.

Taxation of Benefits Under Michelle's Law. Any additional years of insurance coverage under Michelle's Law that an employee elects for any child age 24, 25, or 26 are taxable to the employee for Social Security and Medicare tax (FICA tax) purposes and for federal and Wisconsin income tax purposes, unless the adult child is a qualifying child or a qualifying relative. If the adult child is a qualifying child or a qualifying relative, then the insurance coverage is not taxable to the employee. The requirements for a qualifying child age 24, 25, or 26 could only be met by a permanently and totally disabled child.

Further, any additional years of insurance coverage under Michelle's Law that an employee elects for any child who is not a student and is age 19 through 26 are taxable to the employee for FICA tax and for federal and Wisconsin income tax purposes, unless the adult child is a qualifying child or a qualifying relative. The requirements for a qualifying child who is not a student and age 19 through 26 could only be met by a permanently and totally disabled child.

Taxation of Benefits Provided to Domestic Partner and His/Her Children. If a domestic partner (and/or his or her children) does not qualify as a qualifying relative under the above requirements, health insurance benefits provided by an employer to an employee's domestic partner

(and his/her children) will be taxable to the employee for FICA tax and federal and Wisconsin income tax purposes.

Calculation of Value. The employer must value the insurance coverage provided to the nondependent of the employee. The value of the insurance will then be included as compensation for FICA tax purposes, for withholding of federal and Wisconsin income tax purposes, and will be reported to the IRS on Form W-2. The employer may rely on the information provided by the employee regarding a person's dependency status, unless the employer has reason to believe it may not be accurate.

The Internal Revenue Service has not approved any particular method for the calculation of the value of the insurance benefit provided to the nondependent. The premium amount could be divided by the number insured, but that may produce a low value for the insurance benefit. The most conservative (and recommended) valuation method for tax purposes is to value the insurance provided to the nondependent at the COBRA rate that would have been charged for the benefit provided to the nondependent. The COBRA rate is the amount that the adult child would have paid under COBRA for single health insurance under the employer's plan. The employer's health insurance carrier should be able to provide the COBRA rate.

If you have any questions regarding this topic, please call David P. Weller of Lathrop & Clark LLP at 608-257-7766. Attorney Weller provides counsel in the areas of taxation and employee benefits to our school and municipal clients.

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