

# Employee Benefits Briefing

## IRS Issues Guidance on Tax Treatment of Health Care Coverage for Adult Children Under Age 27

On April 27, the Internal Revenue Service issued Notice 2010-38, which addresses various questions relating to the tax treatment of health care coverage provided to nondependent adult children under the Patient Protection Act.<sup>1</sup> The Notice primarily focuses on the tax treatment of coverage and the application of cafeteria plan rules if an employer *voluntarily* extends coverage to nondependent adult children in 2010. The Notice also discusses how these tax law changes affect the tax treatment of coverage that is already being provided to nondependent adult children under existing plans.

The key provisions of this Notice are:

- Coverage for adult children who do not turn age 27 until after 2010 is tax-free beginning on March 30, 2010.
- If employers choose to cover adult children in 2010, they may amend their cafeteria plans in 2010 to permit employees:
  - to pay with pretax dollars for coverage relating to their adult children; and
  - to change (or make) health care flexible spending account (FSA) elections in 2010 as if their adult child(ren)'s becoming eligible were a change in family status under the cafeteria plan rules.

### *Background*

The Patient Protection Act addresses coverage of adult children in two ways. First, the Act requires that plans that provide for dependent coverage continue to cover children of covered employees until those children turn age 26. This requirement applies beginning with plan years that begin on or after September 23, 2010 (i.e., January 1, 2011 for calendar-year plans). Generally, plans in existence on March 23, 2010 are "grandfathered" and not required to offer coverage to adult children who are eligible for medical coverage at their current employer. Many insurance companies have announced that they will implement this expanded coverage earlier than required for these insurance plans.

Second, the Act provides that health care coverage of children is tax-free to the covered employee until the calendar year in which a nondependent adult child turns age 27. For example, if a nondependent adult child will turn 27 in 2012, a plan may continue to cover that child through the end of 2011 on a tax-free basis. If coverage continues into 2012, the fair market value of the coverage for all of 2012 will be taxable income to the covered employee in 2012.

<sup>1</sup> References to the "Patient Protection Act" or "Act" are references to both the Patient Protection and Affordable Care Act that was signed into law on March 23, 2010 and the Health Care and Education Reconciliation Act of 2010 that was signed into law on March 30, 2010.

## 2010 Coverage

The Notice confirms that the statutory change relating to the tax treatment of health care coverage for nondependent adult children was effective immediately, and thus coverage for such an adult child is tax-free on and after March 30, 2010, so long as the adult child will not turn age 27 until a future year.

If a plan was covering a nondependent adult child prior to March 30, 2010, and the employer was imputing the fair market value of the coverage to the covered employee, the employer may stop imputing income for coverage on and after March 30 (again, until the year the adult child will turn age 27).

The Notice makes it clear that the Patient Protection Act requirements about offering coverage to adult children do not affect the taxation of that coverage. As noted above, grandfathered plans are not required under the Patient Protection Act to offer coverage to nondependent adult children who are eligible for coverage under their employer's medical plan. Nevertheless, an example in the Notice makes it clear that if a plan were to offer coverage to an adult child who is eligible for (but declines) coverage at his/her employer, that coverage is still tax-free through the end of the year in which the child turns age 26.

## Cafeteria Plans

Cafeteria plan rules under Section 125 of the Internal Revenue Code provide that participants may change coverage paid for with pretax dollars only at the beginning of the plan year or, if permitted under the plan, upon the occurrence of an eligible change in status (e.g., marriage, divorce, birth, etc.) during the plan year.

Under the Notice, if an employer chooses to extend coverage to nondependent adult children for the balance of 2010, the IRS will permit the employer to amend its cafeteria plan in 2010 to treat the new eligibility of a nondependent adult child as an eligible change in status under the cafeteria plan rules. Thus, the covered employee will be able to elect to cover the adult child and pay with pretax dollars for any additional employee premiums relating to covering that adult child. *The Notice requires any employer that extends coverage in 2010 to amend its cafeteria plan by December 31, 2010 to permit this change in coverage.* The amendment must specify the date on which adult children were permitted to be covered under the plan (which can be retroactive to as early as March 30).

Similarly, a cafeteria plan that contains a health care FSA may be amended to permit the employee to make (or change) health care FSA elections for the remainder of 2010 on account of, and consistent with, an adult child's becoming eligible for coverage under the plan. Again, such an amendment must be adopted by December 31, 2010 and can be retroactive to the specified date on which the change became effective.

If you have any questions regarding this IRS Notice, please contact **Philip L. Mowery** (312-609-7642), **Paul F. Russell** (312-609-7740) or any other employee benefits attorney with whom you have worked.

**FEDERAL TAX NOTICE: Treasury Regulations require us to inform you that any federal tax advice contained herein is not intended or written to be used, and cannot be used, by any person or entity for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code.**

**VEDDERPRICE®**

222 NORTH LASALLE STREET  
CHICAGO, ILLINOIS 60601  
312-609-7500 FAX: 312-609-5005

1633 BROADWAY, 47th FLOOR  
NEW YORK, NEW YORK 10019  
212-407-7700 FAX: 212-407-7799

875 15th STREET NW, SUITE 725  
WASHINGTON, D.C. 20005  
202-312-3320 FAX: 202-312-3322

[www.vedderprice.com](http://www.vedderprice.com)

**The Employee Benefits Group**

Vedder Price has one of the nation's largest employee benefits practices, with ongoing responsibility for the design, administration and legal compliance of pension, profit sharing and welfare benefit plans with aggregate assets of several billion dollars. Our employee benefits lawyers also have been involved in major litigation on behalf of benefit plans and their sponsors. Our clients include large national corporations, smaller professional and business corporations, multiemployer trust funds, investment managers and other plan fiduciaries.

**Employee Benefits Group Members**

Mark I. Bogart	312-609-7878
Sara Stewart Champion	212-407-7785
Michael G. Cleveland	312-609-7860
Christopher T. Collins	312-609-7706
Megan J. Crowhurst	312-609-7622
Thomas P. Desmond	312-609-7647
John H. Eickemeyer	212-407-7760
Thomas G. Hancuch	312-609-7824
Benjamin A. Hartsock	312-609-7922
Jonathan E. Hyun	312-609-7791
John J. Jacobsen, Jr.	312-609-7680
Michael C. Joyce	312-609-7627
Neal I. Korval	212-407-7780
Philip L. Mowery (Practice Leader)	312-609-7642

Stewart Reifler	212-407-7742
Paul F. Russell	312-609-7740
Robert F. Simon	312-609-7550
Patrick W. Spangler	312-609-7797
Kelly A. Starr	312-609-7768
Lawrence L. Summers	312-609-7750
Jessica L. Winski	312-609-7678
Charles B. Wolf	312-609-7888

**About Vedder Price**

Vedder Price P.C. is a national, business-oriented law firm with more than 250 attorneys in Chicago, New York and Washington, D.C. The firm combines broad, diversified legal experience with particular strengths in labor and employment law, employee benefits, executive compensation, corporate finance and transactions and commercial litigation.

EMPLOYEE BENEFITS BRIEFING is published by the law firm of Vedder Price P.C. It is intended to keep our clients and other interested parties generally informed of legal developments in employee benefits. It is not a substitute for professional advice. For purposes of the New York State Bar Rules, this bulletin may be considered ATTORNEY ADVERTISING. Prior results do not guarantee a similar outcome.

© 2010 Vedder Price P.C. Reproduction is permissible with credit to Vedder Price P.C.