

VI. Health Benefits: Federal and State Tax Rules and Related Issues

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A. Overview

Many benefits provided to the spouses of employees—in particular, health coverage—may be provided on a tax-free basis, just as benefits are provided on that basis to employees themselves. However, because the definition of “spouse” applicable for federal tax purposes requires a married, opposite-sex couple,¹ domestic partners do not qualify as spouses, even if they are married in one of the states that now recognize same-sex marriage.² As a result, domestic partner benefits do not qualify for the tax treatment accorded to spousal benefits under federal law; rather, to receive health coverage on a tax-free basis, a domestic partner must qualify as the employee’s tax dependent under Code § 105(b). This is not only difficult to explain to employees (especially when domestic partner benefits are viewed as a comparable benefit to spousal benefits), it also creates obvious tax compliance issues for an employer providing domestic partner benefits because (1) the conditions for Code § 105(b) tax dependent status are relatively complicated and many domestic partners will not qualify; and (2) certain states allow for tax-free coverage for same-sex spouses and domestic partners for state income tax purposes (see subsection N), thus requiring separate tracking for federal and state purposes.

This Section concentrates generally on how health benefits provided to the domestic partners and their children are taxed under federal law. (Subsection N addresses the different tax treatment in certain states for purposes of state taxation of health benefits.) It explains how

¹ The Defense of Marriage Act (DOMA), discussed in more detail in Section II.C.2, limits the term “spouse” for federal tax and other purposes to a member of the opposite-sex. The DOMA definition controls for all federal laws, leading to different rules for domestic partners under COBRA, HIPAA’s portability rules, and others. Although, in general, an individual is considered to be a husband or wife if recognized as a legal spouse under applicable state law, see Priv. Ltr. Rul. 9717018 (Jan. 22, 1997), reproduced in Appendix 1, in private letter rulings before and after DOMA, the IRS had ruled that a domestic partner cannot qualify under Code § 152 as an employee’s spouse unless the domestic partner is of the opposite sex and recognized under applicable state law as the spouse. See Priv. Ltr. Rul. 9603011 (Oct. 18, 1995) (before DOMA) and Priv. Ltr. Rul. 9717018 (Jan. 22, 1997), both reproduced in Appendix 1.

² Unmarried, opposite-sex partners do not satisfy the definition either (unless recognized under applicable state law as common-law spouses).

domestic partners and their children may qualify as Code § 105(b) tax dependents (and thus receive employer-provided health coverage on a tax-free basis) and addresses the documentation issues created by the need to determine whether particular domestic partners (and children) qualify as Code § 105(b) tax dependents. It also addresses the tax consequences when domestic partners (or their children) do not qualify as Code § 105(b) tax dependents, including the requirements for imputing income to the employee equal to the value of benefits provided to such domestic partners and children (less any after-tax payments made by the employee for the coverage). It then discusses whether, in order to lessen tax compliance burdens, all coverage provided to domestic partners and their children could be treated as taxable income. It also addresses the practice of “grossing up” employee pay to offset the tax consequences of imputed income, as well as the withholding and employment tax issues created by domestic partner health coverage. Last, it discusses special issues for cafeteria plans, health FSAs, health reimbursement arrangements (HRAs), and health savings accounts (HSAs).

B. Federal Income Exclusions for Health Coverage: How They Work

1. Reimbursements From Health Plans Are Excluded From Income Under Code §§ 105 and 104

Reimbursements from an accident or health plan are taxable unless they qualify for an exception under the Code. As discussed in the following paragraphs, Code § 105 enables tax-free treatment of reimbursements if the plan is funded by employer contributions (including employee pre-tax salary reductions); Code § 104 enables tax-free treatment of reimbursements if the plan is funded by an employee’s after-tax contributions.

a. Health Plan Funded by Employer Contributions: Reimbursements Are Excluded From Income Under Code § 105(b)

To the extent that the health plan is funded by employer contributions (including employee pre-tax salary reductions),³ reimbursements for medical care expenses for the employee, spouse, and Code § 105(b) tax dependents are excluded from the employee’s income under Code § 105. The general rule under Code § 105(a) is that reimbursements are taxable to the extent that employer contributions were not included in gross income or were paid by the employer. Reimbursements only qualify for the exclusion if they are for medical care under Code § 213(d) for the employee, spouse, and Code § 105(b) tax dependents. Code § 105(b) provides the following:

gross income does not include amounts referred to in [Code § 105(a)] if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by him for the medical care (as defined in section 213(d)) of the taxpayer, his spouse and his dependents as defined in section 152, determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B) thereof.⁴

Similarly, Code § 213(a) allows a deduction for expenses for medical care of the taxpayer, spouse, or dependents “as defined in section 152, determined without regard to subsections (b)(1), (b)(2) and (d)(1)(B) thereof.”⁵

³ Federal tax rules will preclude use of a cafeteria plan to pay for a domestic partner’s (or domestic partner’s child’s) health coverage on a pre-tax basis unless the domestic partner or child qualifies as a Code § 105(b) tax dependent for the period in question.

⁴ Code § 105(b), reproduced in Appendix 1.

⁵ The effect of the “determined without regard” language in each of these provisions is to create a special rule (or modified definition of dependent) that allows the income exclusion to apply for dependents of a Code § 152 tax dependent, married dependents filing joint returns, and individuals with gross income equal to or more than the exemption amount, even though such individuals are generally not dependents under Code § 152. Consequently, such individuals can still obtain tax-free reimbursements from health plans so long as the other Code § 152 requirements are still met. See Section XI for a more detailed discussion of the conditions that must be met to qualify as a dependent for purposes of Code § 105, reproduced in Appendix 1.

Code § 105(b) Exclusion Applies to Fully Insured and Self-Insured Health Plans, Including Health FSAs. The Code § 105(b) exclusion applies not only to insured accident and health plans, but also to amounts reimbursed under a self-insured medical plan, such as a health FSA.*

* Code § 105(e), reproduced in Appendix 1.

b. Health Plan Funded by Employee After-Tax Contributions: Reimbursements Are Excluded From Income Under Code § 104(a)(3)

Some or all of the funding for an accident or health plan may come from an employee's after-tax contributions. To that extent, the applicable exclusion for reimbursements is in Code § 104(a)(3).

2. Value of Health Plan Coverage Is Excluded From Income Under Code § 106(a)

An employer that funds any portion of the cost of coverage of an accident or health plan (including a self-insured plan) is providing a benefit to its employees simply by making coverage available, whether or not the employee is ever actually reimbursed for any expenses. Consequently, the value of the employer-provided coverage (also known as the cost of coverage, employer contributions, the insurance feature, or payment of premiums) is taxable unless the Code provides an exclusion. The income exclusion for the value of employer-provided coverage is in Code § 106(a), which states that, with certain exceptions, “gross income of an employee does not include employer-provided coverage under an accident or health plan” and Treas. Reg. § 1.106-1, which states that “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.”⁶ This exclusion covers employer-funded contributions, such as payment of all or a portion of the health plan premiums, as well as contributions funded by employees on a pre-tax basis through salary reductions.⁷

C. Federal Tax Code Permits Tax-Free Health Coverage for Spouses and Tax Dependents Only

1. Domestic Partners Do Not Qualify as Spouses for Health Coverage

For purposes of federal law (including federal tax purposes), “spouse” means a person of the opposite sex who is a husband or wife.⁸ This means that a same-sex domestic partner or same-sex spouse (in those states where same-sex marriage is recognized) is not a spouse for

⁶ Treas. Reg. § 1.106-1, reproduced in Appendix 1. Although the definition of dependent in Treas. Reg. § 1.106-1 refers to Code § 152 (without the modifications—discussed in more detail in Section XI.D—that appear in Code § 105(b), reproduced in Appendix 1), IRS Notice 2004-79 provides that the IRS will revise the regulations under Code § 106, reproduced in Appendix 1, effective for taxable years beginning after December 31, 2004, so that the definition of dependent in the regulations will match the one in Code § 105(b), reproduced in Appendix 1. As a result, the cost of coverage for a Code § 105(b) tax dependent is excluded from an employee's income under Code § 106(a), reproduced in Appendix 1. IRS Notice 2004-79, 2004-49 I.R.B. 898. Prop. Treas. Reg. § 1.106-1, if finalized, would revise Treas. Reg. § 1.106-1, reproduced in Appendix 1, to reflect the modified definition in IRS Notice 2004-79. See 72 Fed. Reg. 46421 (Aug. 20, 2007).

⁷ Prop. Treas. Reg. § 1.125-1(r). Although Code § 106(a), reproduced in Appendix 1, refers only to coverage, not to contributions, Treas. Reg. § 1.106-1, reproduced in Appendix 1, does state that “gross income of an employee does not include contributions which his employer makes to an accident or health plan.”

⁸ DOMA, 1 U.S.C. § 7, reproduced in Appendix 1.

federal tax purposes.⁹ An unmarried, opposite-sex partner is also not a spouse for federal tax purposes (unless the relationship is recognized as a common-law marriage under applicable state law).¹⁰

2. But Domestic Partners May Qualify as Tax Dependents for Health Coverage

Although a domestic partner cannot qualify as a spouse for federal tax purposes, in certain situations, a domestic partner may qualify as the Code § 105(b) tax dependent of an employee, allowing the domestic partner to receive tax-free health coverage. The requirements are discussed in more detail subsection D.

3. Children of Domestic Partners May Also Qualify as Tax Dependents for Health Coverage

Similarly, the child of a domestic partner (who is not also the child of the employee) may qualify as the employee's Code § 105(b) tax dependent under relatively rare circumstances, so that health coverage provided to the child would be tax-free. The requirements are discussed in more detail in subsection D.

D. How Can a Domestic Partner Qualify as a Federal Tax Dependent for Health Coverage?

1. Satisfying the Qualifying Relative Test

To be a federal tax dependent under Code § 105(b), an individual must generally be either a "qualifying child" or a "qualifying relative" of the employee. A domestic partner who qualifies as an employee's Code § 105(b) tax dependent typically does so by being the employee's qualifying relative.¹¹

a. Conditions of the "Qualifying Relative" Test

The conditions of the qualifying relative test are discussed in greater detail in Section XI.F but, in summary, to be a qualifying relative, a domestic partner must generally meet the following conditions :

- (for the taxable year of the employee) have the same principal place of abode as the employee and be a member of the employee's household (if this does not violate local law);¹²

⁹ See Priv. Ltr. Ruls. 200339001 (June 13, 2003), 9850011 (Sept. 10, 1998), and 9717018 (Jan. 22, 1997). These applied the Defense of Marriage Act to conclude that a same-sex domestic partner cannot be a spouse for purposes of Code § 106, reproduced in Appendix 1, which excludes from an employee's gross income the value of health coverage provided by an employer to an employee, spouse, or dependents.

¹⁰ Priv. Ltr. Rul. 9717018 (Jan. 22, 1997), reproduced in Appendix 1.

¹¹ It should be noted that the relationship test to be a *qualifying child* is so broad that, in very rare circumstances, an individual who could satisfy that part of the test (e.g., a stepbrother or stepsister) might also be an employee's domestic partner and might qualify on that basis as the employee's Code § 105(b) tax dependent (assuming the other conditions of the qualifying child test were met, including the requirement add in 2008 that the qualifying child must be younger than the taxpayer). Full details regarding the qualifying child test can be found in Section XI.E. (Note: many health insurance plans offering domestic partner coverage require that domestic partners not be related by blood closer than permitted by state law for marriage.)

¹² A large number of the other relationships that satisfy the qualifying relative test would not be applicable for domestic partners (e.g., parent, stepparent, brother, sister, and similar relationships). (See Section XI.F for a detailed discussion.) With respect to the requirement that there be no violation of local law, while a few states continue to prohibit cohabitation by unmarried adults, the enforceability of such laws is subject to serious question under the U.S. Supreme Court's decision in *Lawrence v. Texas*, 539 U.S. 558 (2003). Based on *Lawrence*, for example, a North Carolina court struck down a state law making it illegal for unmarried persons to cohabit. *Hobbs v. Smith*, 2006 WL 3103008 (N.C. Super. Ct.). It should also be noted that someone who at any time during the taxable year was the federally-recognized (i.e., opposite-sex) spouse of the employee (determined without regard to Code § 7703) cannot be the employee's qualifying relative for that year. So, for example, the former spouse of an employee who continued to live with the employee as a domestic partner could not be claimed as a qualifying relative of the employee for the remainder of that tax year.

- receive over half of his or her support from the employee;
- not be anyone's qualifying child; and¹³
- be a (1) citizen or national of the U.S., or (2) a resident of the U.S. or a country contiguous to the U.S.

For most individuals, the taxable year is the calendar year.¹⁴

Certain Conditions Required to Be a Dependent Under Code § 152 Do Not Apply. For purposes of determining whether an individual is a qualifying relative for purposes of receiving employer-sponsored health coverage on a tax-free basis, certain of the conditions otherwise applicable to a qualifying relative under Code § 152 do not apply. These conditions relate to: (1) having gross income less than the exemption amount under Code § 152; (2) not being a dependent of a Code § 152 tax dependent; and (3) not being a married dependent filing a joint return. See Section XI for a detailed discussion.

b. Domestic Partners Enrolled for Health Coverage May Be More Likely to Meet the Qualifying Relative Test

As a practical matter, virtually all domestic partners satisfy the residency (place-of-abode/household) condition of the qualifying relative test because they live together with their employee partners. However, many domestic partners are self-supporting and thus will not satisfy the support condition to be a Code § 105(b) tax dependent. But it is interesting to note that it is domestic partners who are unable to support themselves—due to disability or unemployment—who are most likely to be enrolled for domestic partner benefits (because self-supporting domestic partners likely have health coverage through their own employers.) As a result, those domestic partners who are actually enrolled for health coverage are more likely to meet the qualifying relative test by reason of meeting both the residency and the support conditions.

Example 1: Domestic Partner Is Employee's Code § 105(b) Dependent. Hannah has a full-time job with Largeco. She and her domestic partner, Jane, have lived together for many years. Jane does not work outside the home and receives more than half of her support from Hannah. Jane is Hannah's Code § 105(b) dependent.

Example 2: Domestic Partner Is Not Employee's Code § 105(b) Dependent. John has a full-time job with Smallco. He and his domestic partner, Ted, have lived together for many years. Ted works full-time for another employer and does not receive more than half of his support from John. Ted is not John's Code § 105(b) dependent.

2. Employee Certifications to Verify the Conditions of the Qualifying Relative Test

a. The IRS Has Approved the Use of Employee Certifications

As already noted, the Code § 105(b) definition of a dependent requires a domestic partner to meet several conditions, including a residency test and a support test (for more details,

¹³ Code § 152(d).

¹⁴ See IRS Publication 538 (Accounting Periods and Methods).

see Section XI). How should residency and support be verified? Many plan sponsors require the employee to provide an affidavit or similar document, which indicates whether a domestic partner enrolled for health coverage qualifies as a Code § 105(b) tax dependent and which also imposes an affirmative obligation on the employee to notify the employer of any changes. In at least two instances, the IRS has approved an employer's use of employee certifications to establish that domestic partners were tax dependents. In each case, the signed certification recited the applicable conditions of the Code § 105(b) definition of tax dependent and stated that the domestic partner satisfied the conditions.¹⁵

b. The Look-Back Conundrum

To qualify as a Code § 105(b) tax dependent for a given taxable year, an individual must satisfy the applicable conditions of either the qualifying child or qualifying relative tests for the entire year.¹⁶ But at annual open enrollment, how will an employee know whether a domestic partner will be a Code § 105(b) tax dependent for the entire upcoming year, when that status requires, among other things, that the employee and domestic partner reside together for the entire period? What if, for example, the domestic partnership terminates during the middle of the year or the domestic partner provides too much of his or her own support to satisfy the qualifying relative test?

To address this issue, plans can ask the employee to certify that the domestic partner is the employee's tax dependent as of the date the annual enrollment form is completed and require the employee to notify the employer as soon as possible if this status changes. If during the upcoming year the domestic partner ceases to be a tax dependent, then the employee would need to notify the employer so that the imputed income implications, discussed in subsection F, can be addressed. In the case of a non-calendar-year plan, it seems reasonable to treat the domestic partner as a Code § 105(b) tax dependent during the "stub period" of the plan year that falls within the prior calendar year, and to impute income based on the value of coverage provided during the remainder of the plan year.¹⁷

c. Must the Employer Substantiate the Accuracy of Employee Certifications?

No formal IRS guidance addresses whether the employer must substantiate the accuracy of employee certifications. However, an example in the IRS regulations regarding permitted election changes under cafeteria plans indicates that analogous employee certifications (in the context of a mid-year election change request based on a marriage) are acceptable, so long as the employee certifies certain facts to the employer and the employer has no reason to believe the certification is incorrect.¹⁸ The preamble to these regulations states that, at least with respect to changes of election, "employers may generally rely on an employee's certification that the employee has or will obtain coverage under the other plan (assuming that the employer has no reason to believe that the employee certification is incorrect)."¹⁹ It seems reasonable to apply this standard to employee certifications regarding the tax status of covered domestic partners (or their children), as well. Taking that approach, an employer should be able to rely on an employee certification unless there is reason to believe that it is not correct or is no longer correct. If the employer has reason to believe that an employee's domestic partnership has ended, the employee should be contacted for explanation (and might be reminded of the tax consequences of covering

¹⁵ See Priv. Ltr. Ruls. 200339001 (June 13, 2003) and 200108010 (Nov. 17, 2000). With respect to the requirement that there be no violation of local law, while a few states continue to prohibit cohabitation by unmarried adults, the enforceability of such laws is subject to serious question under the U.S. Supreme Court's decision in *Lawrence v. Texas*, 539 U.S. 558 (2003). Based on *Lawrence*, for example, a North Carolina court struck down a state law making it illegal for unmarried persons to cohabit. *Hobbs v. Smith*, 2006 WL 3103008 (N.C. Super. Ct.).

¹⁶ See ABA Joint Committee on Employee Benefits, Questions and Answers for the IRS, Q/A-7 (May 20–21, 2005), available at <http://www.abanet.org/jceb/2005/qa05irs.pdf> (noting that "[d]ependent status is an 'on or off switch' for the year").

¹⁷ See subsection J for a discussion of the election changes issues presented for cafeteria plans.

¹⁸ Treas. Reg. § 1.125-4, Example 10.

¹⁹ Preamble to Treas. Reg. § 1.125-4, 66 Fed. Reg. 1838 (Jan. 10, 2001).