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Changes to NH Law Regarding Insurance Coverage for Dependents and Civil Unions Have Federal Income Tax Implications

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On July 17, 2007 Governor Lynch signed into law House Bill 790 ("HB 790"), which makes health coverage available to a larger universe of individuals by expanding the definition of a "dependent" for health insurance purposes. Unfortunately, this law has unintended tax consequences that may leave employers and their accountants scratching their heads.

Under HB 790, the new definition of "dependent" now includes a child who is:

- less than 26 years of age; and
- a resident of New Hampshire or enrolled as a student at an institution of higher education; and
- unmarried; and
- not provided coverage under any other health plan or Medicaid.

The tax consequences come into play because of the difference between the definition of "dependent" under HB 790 and the definition of "dependent" under the Internal Revenue Code (the "IRC"). For purposes of the sections of the IRC that deal with (i) amounts received under a health plan by an employee, his or her spouse or dependents and (ii) premiums paid by employer's with respect to health plans for such individuals, a "dependent" includes a "qualifying child" or a "qualifying relative" as defined under Section 152 with certain modifications. Such a "qualifying child" is a child who has:

- the same principal place of abode as the taxpayer for more than half of the taxable year, and
- not attained the age of 19 or is a student who has not attained the age of 24, and
- not provided over one-half of such individual's own support for the calendar year in which the taxable year of the taxpayer begins.

Such a "qualifying relative" is a relative:

- with respect to whom the taxpayer provides over half the support for the year; and
- who is not a "qualifying child" for the taxpayer or any other taxpayer

for the year.

The IRC and HB-790 definitions do not coincide and as a result HB 790 can confer dependent status under NH law on individuals who are not considered dependents under the IRC. Analysis of who constitutes a dependent for IRC purposes can require a review of multiple definitions and will require a great deal of information about the so-called dependent and his or her financial status.

When an employee's dependent who meets the HB 790 definition (an "HB-790 Dependent") does not meet the definition of dependent under the IRC (an "IRC Dependent"), the employer will need to consider whether, and how much of, any health insurance premium paid on the employee's behalf needs to be included in the employee's income and upon which the employer must pay its share of employment taxes. IRC §106(a) and Treasury Regulation §1.106-1 exclude from an employee's income employer-paid health insurance premiums only to the extent that the insurance covers the taxpayer, his/her spouse, and his/her dependents as defined under §152 of the IRC, as modified for this purposes.

When a portion of health insurance premiums is not excluded from income, the amount to be included in the income of the employee is the fair market value of the benefit to the HB-790 Dependent. The IRS has issued several private letter rulings in this area generally, but will not take a position on what constitutes the fair market value of the benefit. One approach that might be taken would be that based on all the facts and circumstances, for an IRC Dependent of an employee who participates in his or her employer's group medical plan, the fair market value would be the incremental cost of obtaining the same medical coverage under the employer's group medical plan. For example, if the addition of the HB-790 Dependent requires the employee to change from a "single" or "couple" health care plan to a "family" plan, then the difference in cost to the employer must be included in the employee's W-2 income. The IRS is likely to regard this approach as aggressive, especially in light of the fact that in a situation where the employee already participates in a family plan, has two children and adds one who is not an IRC Dependent, there would be no additional premium paid and, therefore, no income imputed to the employee. See for a more detailed discussion of alternative approaches to determining the fair market value of this benefit.

A few words about the recently passed Civil Unions Law (HB 437) are also appropriate in this context. In 1996, Congress enacted the Defense of Marriage Act ("DOMA"), which provides that for purposes of all federal laws, "the word 'marriage' means only a legal union between one man and one woman as husband and wife, and the word 'spouse' refers only to a person of the opposite sex who is a husband or wife." Therefore, under the IRC, the definition of "spouse" does not encompass a civil union partner, as it now does under NH law by virtue of HB 437. Consequently, under the IRC, the fair market value of health benefits for a civil union spouse (if any) must be included as income to the employee and is not excludable under IRC §106(a).

The same is true for divorced and legally separated spouses who may be eligible for continued coverage under another new law, Senate Bill 197 ("SB 197"). SB 197, signed into law on July 18, 2007, requires continuation of group health insurance coverage in the event of divorce or legal separation under certain circumstances. To the extent the bill extends benefits to a person who is not a spouse or a dependent under federal tax law, the fair market value of the benefit would be taxable as income to the employee.

These newly-enacted New Hampshire laws do not provide a mechanism for employers to determine when these tax issues are triggered. Employers could adopt a practice of asking any employee requesting a change in status of his/her health benefits whether the change results from the addition of a civil union spouse or an HB-790 Dependent who does not qualify as an IRC Dependent. However, this practice would not reveal situations where, for example, an employee with a family plan had a dependent who qualified as both an HB-790 Dependent and an IRC Dependent in one year and as an HB-790 Dependent but not an IRC Dependent in a following year. This latter case suggests that a proactive questionnaire should be provided to employees each year seeking to discern whether their spouse or dependents qualify for the §106(a) exclusion. If so, then the employer must take

appropriate action to ensure that the incremental cost of providing such coverage is included in the wages of the employee.

The text of HB 790 is available at http://www.gencourt.state.nh.us/legislation/2007/HB0790.htm and the text of SB 197 is available at http://www.gencourt.state.nh.us/legislation/2007/SB0197.html. The text of the civil unions bill, HB 437, is available at http://www.gencourt.state.nh.us/legislation/2007/HB0437.html .

Here are some examples demonstrating the tax issues:

Example 1
Employee has one child - a 25-year-old daughter who is single, is enrolled in graduate school in Massachusetts is not covered under any other health plan, and receives less than half of her support from the employee. The daughter qualifies as an HB-790 Dependent. Employer provides health care coverage for individuals (which includes couples without children) and families. The family coverage costs $100 a month more than the individual coverage and the employer pays the full amount of the premium. Employee elects family coverage. Daughter does not qualify as a dependent under the IRC. She is not a qualifying child either because she is too old or she receives less than half of her support from her family and she is not a qualifying relative because she receives less than half of her support from her family. As a result, under an incremental cost approach, the additional $1200/year paid for the family coverage is not excluded from the employee’s income and would be reported as compensation to the employee. Other valuation approaches could result in a greater amount being reported as compensation.

Example 2
Employee has two children: (i) 25-year old daughter who is single, is enrolled in graduate school in Massachusetts, is not covered under any other health plan, and receives less than half of her support from the employee; and (ii) a 23-year old son who is a student and otherwise meets the federal IRC criteria. Employer provides health care coverage for individuals (which includes couples with and without children) and families. The family coverage costs $100 a month more than the individual coverage and the employer pays the full amount of the premium. The family coverage costs the same amount regardless of the number of children covered. Employee elects family coverage. The daughter is an HB-790 Dependent but is not an IRC Dependent. She fails to qualify under the IRC for the reasons explained in Example 1. Applying the incremental cost approach, the additional $1,200/year paid for the family coverage should be excluded from the employee's income since the son is an IRC Dependent and there is no additional cost to include the daughter who is an HB-790 Dependent. However, the IRS is likely to regard this position as aggressive and require application of some other approach to determining fair market value that would result in an amount being reported as compensation to the employee.