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Changes to New Hampshire Law Regarding Insurance Coverage for Dependents and Civil Unions

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On July 24, 2007, we issued a Special Business Alert ("Alert") regarding recent New Hampshire legislation that affects employer-provided health insurance benefits and the potential tax implications related thereto. Specifically, HB-790 and HB-437 expand the class of dependents entitled to employer-provided health insurance to include certain individuals not treated as dependents for federal income tax purposes. Since we issued the Alert, our firm and others have focused extensively on this issue to ascertain for our business clients how the IRS is likely to determine the fair market value of the benefit provided to individuals who are not considered dependents for federal income tax purposes. The issue is significant because a fringe benefit such as health insurance coverage provided to an individual other than an employee, spouse and dependents is taxable to the employee and considered wages for employment tax purposes.

In the Alert, we discussed only one approach that might be used to value taxable health insurance benefits. In doing so, we may have given the impression that this was "the" approach that the IRS would use. This is not the case, nor was that our intent. In fact, our subsequent and extensive analysis confirms that there is wide-spread variance surrounding what methodologies might be appropriate for determining the value of taxable health insurance benefits. The Treasury Regulations that control this issue state that the value of the benefit is its fair market value, taking all of the facts and circumstances into account. Nothing surprising in that proclamation, but it is not particularly helpful. The IRS has clarified in private letter rulings that *group*, as opposed to *individual*, insurance can be used in determining fair market value, but neither Congress nor the IRS has yet addressed head-on how to determine the fair market value of a taxable health insurance fringe benefit.

The following description of possible valuation methodologies is presented to give you a sense of the range of methodologies that might apply.

At the aggressive end of the spectrum is the taxpayer-friendly approach that we described in our Alert, referred to as the "incremental approach." Under this approach the benefit is valued by determining the incremental price that the employee must pay to include the additional dependent under his or her employer's group insurance plan. This approach makes full use of the "facts and circumstances" involved in that it determines the value of the benefit in the context of the dependent's family relationship with the employee and the existence of a group policy that the dependent can be insured under pursuant to state law.

At the conservative end of the spectrum is the position that the value of

the benefit is determined on the basis of what the dependent would have to pay to acquire similar group coverage as an individual, the pure "replacement cost" approach. While this approach has the virtue of simplicity, including a relatively easy means of obtaining evidence of value, it fails to take into account all the facts and circumstances. At a minimum, it would appear that the fact that the individual is entitled to group insurance under state law as a member of a family or as a spouse or civil-union partner should be taken into account in determining what that individual would have to pay in the relevant market, i.e., not the market for insurance for an individual, but for a member of a family entitled under state law to obtain insurance through a group policy.

In between these two extremes are many positions. Among these is the modified version of the replacement cost approach discussed above – looking to replacement coverage that takes the status of the dependent as a family member into account. The primary disadvantage of this modification is the difficulty it introduces into the process of obtaining evidence of value. Another modified approach that may involve less difficulty in obtaining evidence of value is one in which the benefit is valued by looking to the cost to the individual of obtaining COBRA coverage through the insurance company that provided group coverage for the employee. The primary drawback of this approach is that by failing to address the relevant market (i.e., it looks to the cost of COBRA insurance for an individual not for a "family member") it fails to take all of the facts and circumstances into account. Finally, any number of approaches could be devised that modify the incremental approach to take into account some greater degree of replacement cost analysis. For example, whereas under a pure incremental approach, the value of adding a taxable child to existing family coverage might actually be zero under the employee's plan because there is no incremental cost, an approach might be designed that arbitrarily assigned some additional value to the addition of the taxable child. The advantage of such an approach is that it may strike a middle ground between the incremental and replacement cost approaches, but the disadvantage is that it offers no clear evidence or justification of value.

Unfortunately, until Congress changes the law or the IRS offers some guidance in this area, employers are left with a difficult decision. Under current law, only a more-likely-than-not legal opinion from a qualified tax lawyer will protect a client from penalties in the event the IRS determines that the client's approach was incorrect. Because of the dearth of authority in the area, only the more conservative approaches are likely to provide the basis for such a legal opinion, despite the fact that from a practical perspective, the overall economic consequences of the more conservative approaches seem oddly punitive at a time when the national dialogue regarding health insurance so clearly favors finding ways to provide coverage for more people at a reasonable cost. Business owners should work with their tax professionals to craft a practical approach to this problem, with the understanding that no solution will be 100% "bullet proof" without further guidance from the IRS or Congress.

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