TIR 07-16: Personal Income Tax Treatment of Employer-Provided Health Insurance Coverage for an Employee's Child

Introduction

The Massachusetts Health Care Reform Act at chapter 58 of the Acts of 2006, as amended, changed chapters 32A, 175, 176A, 176B and 176G of the General Laws to require a broadening of dependent coverage offered by health insurance carriers. The Legislature made several technical corrections to the health care reform law in the recent "Act further Regulating Health Care Access," St. 2007, c. 205, signed into law on November 29, 2007. Collectively, the amendments require that on or after January 1, 2008, carriers issuing or renewing insured health benefit plans with coverage for dependents make coverage available for persons "under 26 years of age or for 2 years after the end of the calendar year in which such persons last qualified as dependents under 26 U.S.C. 106, whichever occurs first." [1]

A noncash fringe benefit that is included in gross income is sometimes referred to as "imputed income." Under federal income tax law, extending employer-provided health insurance coverage to an employee's child up until age 26 may create imputed income for the employee. This TIR provides a summary of Internal Revenue Service Notice 2004-79, a federal notice that provides relief from imputed income in many instances where employer-provided health coverage includes an employee's grown child. Although this TIR provides general guidance, an employer or an employee seeking a case-specific determination on federal imputed income must contact the Internal Revenue Service.

The recent legislation provides an exemption for imputed income for Massachusetts personal income tax purposes where health care coverage is required by Massachusetts law. *See* G.L. c. 62, § 2(a)(2)(Q), as added by St. 2007, c. 205, § 6. As a result, Massachusetts will not follow federal law in the area of imputed income resulting from employer-provided health care fringe benefits.

Federal Income Tax

Section 61(a)(1) of the Code states that, except as otherwise provided, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. A fringe benefit is any property or service that an employee receives in lieu of or in addition to regular taxable wages. The extent to which a particular fringe benefit is excluded from gross income depends on the Code provisions that apply to the benefit. A noncash fringe benefit that is included in gross income is sometimes referred to as "imputed income."

Employer-provided health insurance coverage is a fringe benefit. Section 106(a) of the Code provides that gross income of an employee does not include employer-provided coverage under an accident or health plan. Section 1.106-1 of the U.S. Treasury Regulations provides:

> The 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.

Under the definition of dependent at § 152, an individual must be either a "qualifying child" dependent or a "qualifying relative" dependent. In general, § 152(c) provides that a "qualifying child" is a child who lives with an employee for more than half a year, who is either under age 19 or is a full-time student under age 24, and who does not provide over half of his or her own support for the calendar year.[2] Section 152(d)(1) provides, in general, that a "qualifying relative" is an individual who bears a relationship to the taxpayer (including any child of the taxpayer who is not a "qualifying child", regardless of the child's age), whose gross income is less than the exemption amount ($3,400 in 2007), and who receives over one-half of his or her support from the taxpayer. However, for purposes of the exclusion at § 106 for employer-provided health coverage, an Internal Revenue Service notice expands the definition of dependent at § 152 to eliminate the gross income limit at § 152(d)(1) for a qualifying relative.

In Notice 2004-79, 2004-2, C.B. 898, the Internal Revenue Service announced that U.S. Treasury Regulation § 1.106-1 would be amended effective for taxable years beginning after December 31, 2004 to reflect the same definition for the term dependent in § 105(b) as shown below in bold:

> 105(b) Amounts expended for medical care. Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include amounts referred to in subsection (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). Any child to whom section 152(e) applies shall be treated as a dependent of both parents for purposes of this subsection.[3]**

Accordingly, under Internal Revenue Service Notice 2004-79, an employee may exclude from gross income the value of employer-provided health insurance coverage for a child who, while not a "qualifying child," meets the definition of a "qualifying relative" determined without regard to the child's gross income. In effect, many children who do not meet the age requirements of a "qualifying child" will meet the requirements of a "qualifying relative" where the income limitation of $3,400 (for 2007) is not applied. For purposes of the exclusion from gross income at § 106 for employer-provided health insurance coverage, a child of an employee who exceeds the age to be a "qualifying child" is a "qualifying relative" if the taxpayer provides over half of the child's support for the calendar year; also, any child of divorced parents who meets the expanded definition of dependent in connection with one parent is treated as a dependent of both parents. In such a case, the child is considered a dependent for purposes of § 106 and there is no federal imputed income charged to the employee.

Valuation of Imputed Income is a Question of Federal Law. As a result of extended employer-provided health insurance coverage for children "under 26 years of age or for 2 years after the end of the calendar year in which such persons last qualified as dependents under 26 U.S.C. 106, whichever occurs first," there will be some instances where the benefits provided to an employee include health insurance for a nondependent child for purposes of IRC § 106 (*e.g.*, a child that is over the age to be a "qualifying child" *and* is not a "qualifying relative" because the child provides at least half of his or her own support). For federal income tax purposes, an employee who opts for coverage for a nondependent child will be taxed on the fair market value of the child's coverage to the extent that it exceeds any amount paid by the employee on an after-tax basis (employee pre-tax contributions are considered to be employer contributions). Pending specific guidance from the Internal Revenue Service, an employer must determine the amount of imputed income attributable to the health insurance coverage of an employee's nondependent child under valuation principles articulated in federal income tax law.

Massachusetts Personal Income Tax.

Effective for taxable years beginning on or after January 1, 2007, General Laws chapter 62,§ 2(a)(2)(Q) provides that the following item must be deducted from Massachusetts gross income:

> If an employee participates in an employer-provided health insurance plan, any amount which, but for this section, would be included in gross income of the employee by reason of coverage under the plan of any person other than the employee, to the extent such coverage is mandated by law.

Massachusetts gross income is federal gross income, as defined under the Code, with certain modifications. G.L. c. 62, § 2(a). Generally, with respect to the personal income tax, Massachusetts adopts the Code as amended and in effect on January 1, 2005. G.L. c. 62, § 1. Massachusetts follows IRC § 106 as amended and in effect of January 1, 2005, whereby employer-provided health and accident premiums are excluded from the gross income of an employee, as long as the benefits are for the employee, the spouse or dependents of the employee. Also, Massachusetts adopts IRS Notice 2004-79 which expands the definition of dependent for purposes of the exclusion from gross income at IRC § 106.

As a result, the value of employer-paid health insurance benefits for a child of an employee who is a dependent under the federal income tax rules at IRC § 106 is excluded from the employee's federal gross income and is likewise excluded from the employee's Massachusetts gross income. However, pursuant to G.L. c. 62, § 2(a)(2)(Q), any imputed income resulting from health insurance coverage for an employee's child who is not a dependent under IRC § 106 that is included in an employee's federal gross income is excluded from Massachusetts gross income to the extent such coverage is mandated by Massachusetts law. The exclusion from Massachusetts gross income under G.L. c. 62, § 2(a)(2)(Q) also applies to employees with coverage under self-funded or self-insured employer-provided health plans adopting dependent health coverage otherwise required for insured plans under the applicable Massachusetts insurance statutes.

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Appendix to TIR 07-16

Personal Income Tax Treatment of Employer-Provided Health Insurance Coverage for an Employee's Child under the Massachusetts Health Care Reform Law

As of January 1, 2008, the Massachusetts Health Care Reform Act expands employer-provided health insurance coverage to include an employee's child "under 26 years of age or for 2 years after the end of the calendar year in which such persons last qualified as dependents under 26 U.S.C. 106, whichever occurs first."[4] The reference to 26 U.S.C. 106 is section 106 of the Internal Revenue Code.

Recent legislation provides for the exclusion from Massachusetts gross income of any imputed income resulting from employer-provided health insurance of a person included in the employee's family health insurance plan where the coverage is required by state law. *See* G.L. c. 62, § 2(a)(2)(Q).

The purpose of this fact sheet is to provide general guidance on the federal and Massachusetts treatment of employer-provided health insurance coverage for an employee's child. As explained in TIR 07-16, whether a child of an employee is a dependent for purposes of the federal exclusion from gross income of employer-provided health insurance coverage is a question of federal income tax law pursuant to Internal Revenue Code section 106. An employer or an employee seeking a case-specific determination on imputed income for federal income tax purposes must contact the Internal Revenue Service.

A. What is imputed income?

The term "imputed income" is sometimes used to refer to the value of a noncash fringe benefit an employee receives where federal law requires the value of the fringe benefit to be included in the employee's gross income.

In the area of employer-provided health insurance coverage (which is a fringe benefit), the value of health insurance benefits for a child of an employee is excluded from gross income where the child is a dependent under the rules of IRC section 106. However, for federal income tax purposes, the value of health insurance benefits for a child of an employee is treated as imputed income in cases where the child does not qualify as a dependent under IRC section 106. This can happen, for example, when the child is over age 24 or is emancipated.

If a child does not meet the definition of dependent for these purposes, the value of the health coverage for this individual will be imputed as income to the employee for federal income tax purposes. The employee's federal gross income for the year, as reflected in his or her W-2, will be higher and this higher amount will be subject to taxation and withholding.

Although generally Massachusetts follows federal law in the area of noncash fringe benefits, in the case of imputed income with respect to employer-provided health insurance, the Legislature has chosen to depart from the federal treatment. Where an employee is charged with federal imputed income for employer-provided health coverage, the employee is not charged with the imputed income for Massachusetts purposes where the health care coverage is required by state law. For an affected employee, the Massachusetts gross income for the year, as reflected in his or her W-2, will be lower than federal gross income.

B. When does an employee's child meet the definition of dependent for purposes of employer-provided health insurance coverage so that the entire value of the coverage is excluded from gross income?

Under federal tax law, employer contributions for health insurance are excluded from an employee's gross income. However, the exclusion is limited to contributions made for coverage of the employee, the employee's spouse, and the employee's dependents.

In general, for a child to be considered a dependent under the Internal Revenue Code, the child must meet the requirements of a "qualifying child" or a "qualifying relative" as described below. Pursuant to IRS Notice 2004-79, the definition of "dependent" for purposes of the exclusion from gross income for employer-provided health insurance benefits is broader than the definition for purposes of claiming the dependency exemption for the child on the parent's federal income tax return. So a child may qualify as a dependent for purposes of the exclusion from gross income for employer-provided health insurance benefits whether or not the parent actually claims the dependency exemption for the child on the parent's federal income tax return.

Divorced Parents. For purposes of the exclusion from gross income for employer-provided health insurance, any child of divorced parents who meets the expanded definition of dependent in connection with one parent is treated as a dependent of both parents.

- **Qualifying Child (Age Requirement):**

1. *Relationship*: The child must be the taxpayer's son, daughter, stepchild, sibling or stepsibling. A descendant of any of the above also qualifies (*e.g.*, taxpayer's grandchild). A legally adopted child or a child lawfully placed with the taxpayer for adoption is treated as a taxpayer's child. A foster child legally placed with the taxpayer is also treated as the taxpayer's child.
2. *Residency*: The child must have the same principal place of abode as the taxpayer for more than half of the taxable year. Temporary absences because of special circumstances, including illness, education, business, vacation or military service, do not prevent the child from qualifying.
3. *Age*: In general, the child must be under age 19 (or under age 24 if a full-time student) as of the end of the calendar year. In the case of an individual who is permanently and totally disabled, the age limits are waived.
4. *Support*: The child must not have provided more than half of his or her support for the year.

If a taxpayer's child does not meet the requirements of a dependent as a "qualifying child," the child may still meet the requirements of a dependent as a "qualifying relative."

- **Qualifying Relative (No Age Requirement):**

1. *Support:* The child must have received over half of his or her support from the taxpayer for the calendar year. In contrast to the rules for a qualifying child (see above), there is no residency requirement for a taxpayer's child to meet the definition of a qualifying relative.[5]
2. *Income limits:* Under IRS Notice 2004-79, for purposes of determining whether there is an exclusion from gross income for employer-provided health care benefits, there is no limit on the child's gross income. (By contrast, for purposes of determining whether a child is a "qualifying relative" for the dependency exemption, the child's gross income must not exceed the exemption amount of $3,400 for 2007.)

C. When does employer-provided health insurance coverage for an employee's child result in imputed income to the employee?

In the context of employer-provided health insurance benefits, the following examples illustrate when imputed income occurs and when it does not.

Example 1. A child, age 25, who earns $10,000 receives over half of her support from her mother and is included in the mother's employer-provided health insurance coverage.

- The child is considered a dependent for purposes of the income exclusion for employer-provided health insurance coverage. Under IRS Notice 2004-79, the child is a "qualifying relative" because, (1) the child receives over half of her support from her mother, and (2) for purposes of the exclusion from gross income for employer-provided health insurance, the amount of the child's earnings is disregarded. As a result, there is no imputed income to the mother for federal or Massachusetts purposes.
- However, the mother is not allowed to claim either a federal or a Massachusetts dependency exemption for the child. The child is not a "qualifying child" because the child's age exceeds the maximum age. Also, the child is not a "qualifying relative" for purposes of the dependency exemption because the child's earnings exceed the exemption amount ($3,400 in 2007).

Example 2. A child of divorced parents, age 25, is a full-time student who lives with his mother. The father is a Massachusetts resident. The child is included in the father's employer-provided health insurance coverage. The child is supported by both his parents. Under the terms of the divorce agreement, the mother may claim the federal dependency exemption for him.

- The child is considered a dependent for purposes of the income exclusion for employer-provided health insurance coverage. Under IRS Notice 2004-79, the child is a "qualifying relative" because the child is supported by his parents. For both federal and Massachusetts purposes, there is no imputed income to the father as a result of the employer-provided health insurance coverage of the child.
- Because of the terms of the divorce agreement, the father does not take a dependency exemption for the child. However, the mother is entitled to take the federal dependency exemption for the child. The child is not a "qualifying child" because the child's age exceeds the maximum age. However, the child is a "qualifying relative" for purposes of the dependency exemption because the child has no earnings. If applicable, the mother is entitled to take the Massachusetts dependency exemption for the child.

Example 3. A child, age 25, who earns $30,000 does not live with the parent (and the parent does not otherwise provide over one-half of the child's support). As a result of the expanded coverage required by the Massachusetts health care reform law, the child is included in the parent's employer-provided health insurance coverage.

- The employer's carrier is required to make coverage available for this child for two years after the end of the calendar year in which such person last qualified as a dependent under IRC § 106 or until the child reaches 26 years of age, whichever occurs first.
- The child is not considered a dependent for purposes of the income exclusion for employer-provided health insurance coverage. The child does not come within the requirements of IRS Notice 2004-79 because the child does not receive over half of his or her support from the parent. Thus, for federal purposes, the value of health insurance coverage for the age-25 child will be imputed income to the employee. In contrast, under G.L. c. 62, § 2 (a)(2)(Q), Massachusetts does not impose tax on this imputed income because the coverage is required by state law.
- The parent is not allowed to claim a federal or Massachusetts dependency exemption for the child. The child is not a "qualifying child" because the child's age exceeds the maximum age; the child is not a "qualifying relative"

because (1) the child does not receive over half of his or her support from the parent, and (2) the child's earnings exceed the exemption amount of $3,400 in 2007.

[1] The reference to 26 U.S.C. 106 is section 106 of the Internal Revenue Code. Also, prior to the clarification in the technical corrections Act, the health care reform law required that on or after January 1, 2007, carriers issuing or renewing insured health benefit plans with coverage for dependents make coverage available for persons "under 26 years of age or for 2 years following loss of dependent status under the Internal Revenue Code, whichever occurs first."

[2]If a child of a taxpayer is a "qualifying child," there will be no imputed income resulting from employer-provided health insurance coverage. This TIR focuses on the instances where a child of a taxpayer who is not a "qualifying child" may be a "qualifying relative." Whether such children meet the requirements of "qualifying relative" is the determining factor as to whether the employee is charged with imputed income.

[3] Section 152(e) contains the special rules for divorced parents.

[4] Prior to the clarification in the technical corrections Act at St. 2007, c. 205, the health care reform law required that on or after January 1, 2007, carriers issuing or renewing insured health benefit plans with coverage for dependents make coverage available for persons "under 26 years of age or for 2 years following loss of dependent status under the Internal Revenue Code, whichever occurs first."

[5]For purposes of the qualifying relative definition, if a person does **not** have a "relationship" with the taxpayer as defined in section 152(d) of the Internal Revenue Code (*e.g.*, child, brother, sister, father, mother, etc.), there is a residency requirement; a qualifying relative also includes an individual (other than an individual who at any time during the taxable year was a spouse) who has the same principal place of abode as the taxpayer and is a member of the taxpayer's household.