

November 22, 2004

IRS Clarifies Dependent Definition for Employer-Provided Health Benefits

On November 17, 2004, the Internal Revenue Service ("IRS") published Notice 2004-79 ("Notice"), clarifying some confusion over the definition of dependent created by the Working Families Tax Relief Act of 2004 ("Act"). In the Notice, the IRS says it will conform the definition of dependent under Internal Revenue Code ("Code") section 106, through regulation, to mirror the new definition of dependent under Code section 105, provided by the Act.

Code section 105 permits employer-provided group health benefits to be provided tax-free. Code section 106 permits the employer's premium payments not to be taxable income to the employee.

As indicated in our previous Management Alert ([click here](#)), the Act amended section 152 and other Code sections to unify the definition of dependent for various tax purposes. In some ways that new definition is more restrictive, causing the term dependent to encompass fewer individuals. For example, a domestic partner meeting all other qualifications as a "qualifying relative" will not be a dependent under Code section 152 if that domestic partner receives more than approximately \$3100 in income.

The Act specifically exempted Code section 105 (value of health benefits tax-free), from the specific provision requiring a dependent to receive less than approximately \$3100 in income. This means, for example, that even though a domestic partner who receives more than approximately \$3100 in income is not a dependent for other Code purposes, that individual remains a dependent under Code section 105 and any health benefits paid on that individual's behalf will not be taxed.

The Act contained no similar exemption in Code section 106 (value of health coverage such as premiums paid by employer, tax-free), however, because the definition of dependent under that section appears in regulations. With no exemption, a qualifying relative dependent receiving more than approximately \$3100 in income would be taxed on premiums paid by an employer for health coverage.

This inconsistent treatment of sections 105 and 106 indicated that, without further guidance from the IRS, certain individuals who previously qualified as a dependent under section 106 might no longer qualify and be taxed on the value of the coverage to the extent provided by an employer.

To clarify this confusion, the IRS published Notice 2004-79, stating that it will revise the definition of dependent contained in regulations under Code section 106 to mirror the definition under Code section 105. Therefore, while a qualifying relative dependent does have to meet all other requirements to be a dependent, that individual does not have to earn less than approximately \$3100. Instead, under both section 105 and section 106, an individual may meet the definition of dependent and receive tax-free benefits and premium payments without regard to that individual's amount of income.

The IRS has not yet provided any guidance on how the new definition of dependent will apply to other benefits that can only be provided to dependents, including medical and dependent care flexible spending accounts and 401(k) plan hardships withdrawals to pay medical or tuition expense for dependents.

For further details on the requirements for dependent status for employee benefits, please do not hesitate to contact your Seyfarth Shaw LLP attorney for assistance or contact any Employee Benefits attorney on the website at www.seyfarth.com.



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