

August 2005

Open Enrollment: Beware - Dependent Definition May Not Be What You Intend

As we explained in our November 2004 *One Minute Memo*, which can be accessed by clicking [here](#), the Working Families Tax Relief Act of 2004 (Act) changed the definition of "dependent" under Section 152 of the Internal Revenue Code (Code) for various tax purposes. The changes, which took effect January 1, 2005, are forcing employers faced with upcoming enrollment periods for health and dependent care plans and health spending accounts to review coverage under their employee benefit programs with a careful eye for technical changes. This Management Alert highlights some of the pitfalls if the new Code Section 152 is not fully understood.

Full-Time Students

Many employer health plans provide coverage for dependent children over the age of 23 who are full-time students. In order for the coverage to be provided tax-free, the child must be either a "qualifying child" or a "qualifying relative."

To meet the new definition of a "qualifying child," the individual must satisfy the following:

1. Relationship Test - Must be the taxpayer's child, stepchild, foster child, sibling, step-sibling or a descendent of one of these;
2. Residence Test - Must have the same principal residence as the taxpayer for more than one-half of the tax year;
3. Age Test - Must be under the age of 19 (or 24 if a full-time student) at the close of the calendar year, unless permanently and totally disabled; and
4. Support Test - Must not provide more than one-half of his or her own support for the year.

Obviously, under the new definition of dependent, a child turning age 24 during the calendar year will no longer be considered a qualifying child. This is different than many plans which had based the age cut-off on the individual's birthday. However, the child turning 19 or the student turning 24 may nonetheless qualify as a

dependent if he or she fits within the definition of a "qualifying relative." In order to be a "qualifying relative," Code Section 152 now requires that an individual who is not a qualifying child meet the following:

1. Relationship Test - Must have a specified relationship with the taxpayer (e.g., child, sibling or step-sibling, parent or step-parent, niece or nephew, aunt or uncle, or a non-spouse who has the same place of abode and is a member of the taxpayer's household);
2. Support Test - Must receive more than one-half of his or her support from the taxpayer.

For purposes of health plans and health spending accounts, a child who is a full-time student and over the age of 23 will be a qualifying relative, provided that the employee provides over one-half of the child's support. Many health plans already have a support requirement for coverage of students and thus may not have any real change in coverage result.

For full-time students over the age of 23 who are not qualifying relatives, employers have two options. First, employers can choose to impute income equal to the value of the coverage to their employees who elect to cover these individuals. Second, employers can choose to amend their plans to provide that full-time students over the age of 23 are eligible for coverage only if they receive over one-half of their support from the employee, thus excluding any coverage that might trigger imputed income. Note that, depending on the description in summary plan descriptions (SPDs) and enrollment materials, the second alternative may require a plan amendment and distribution of a summary of material modification (SMM) within 60 days of the date of the change in coverage.

Joint Custody Cases

Many employer provided health plans cover biological children, stepchildren and adopted children regardless of whether the child lives with the employee. Under the new definition of dependent, a child must live with the

taxpayer for more than one-half of the taxable year in order to be a qualifying child. However, special rules permit divorced or separated parents to agree that the child will be treated as the qualifying child of the non-custodial parent.

Domestic Partners

Many employer provided health plans cover all “dependents” as defined in Code Section 152. Employees need to review their plans to make sure that they accurately reflect their intent to cover or not cover domestic partners or same sex spouses because such individuals may now fall within the definition of a qualifying relative and, thus, would be covered under a plan that covers all Section 152 dependents if the individual were a qualifying relative. If a medical plan that uses Code Section 152 to define “dependent” is not intended to provide domestic partner coverage, the plan would have to be amended. Some health plans specifically extend coverage to domestic partners or same sex spouses. Under the new definition of dependent, a domestic partner/same sex spouse must receive over one-half of his or her support from the taxpayer in order to qualify as a dependent. If the domestic partner does not qualify as a dependent, the employee will have to recognize imputed income.

Dependent Care Assistance Programs

A participant with a dependent care spending account may use pre-tax dollars to pay for certain expenses incurred caring for a “qualifying individual.” A qualifying individual includes a Section 152 dependent who is either a qualifying child under age 13 or is a qualifying child, qualifying relative or spouse who is physically or mentally incapable of caring for himself or herself. Under the new definition of dependent, an adult Section 152 dependent (such as an elderly parent) must have gross income of less than \$3,200 in 2005 and must have the same principal place of abode as the employee for more than one-half of the tax year. Thus, it is possible that an individual could be a covered dependent for health plan benefits but not for dependent care spending account benefits. (Note that the Joint Committee on Taxation has introduced technical corrections that would remove the income test from the definition of dependent for purposes of administering both health and dependent care spending accounts.)

Exactly how the new definition of dependent affects an employee’s choice of coverage should be made clear in both open enrollment materials and plan documents. Employers should review their plans to make sure that the terms of their plans reflect their intention to continue coverage for the individuals described and impute income as needed, or to exclude these individuals from coverage. Employers may also have to make significant administrative changes to track and report imputed income for affected individuals if plan coverage exceeds coverage permitted under the new Code Section 152.

If you have any questions concerning the impact of Code Section 152 on the dependent coverage under your health and welfare plans, please contact the Seyfarth Shaw LLP Employee Benefits Group attorney with whom you work, or any Employee Benefits attorney on the website at www.seyfarth.com.

This newsletter is a periodical publication of Seyfarth Shaw LLP and should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult a lawyer concerning your own situation and any specific legal questions you may have. For further information about these contents, please contact the firm’s Employee Benefits Practice Group.

ATLANTA

One Peachtree Pointe
1545 Peachtree Street, N.E., Suite 700
Atlanta, Georgia 30309-2401
404-885-1500
404-892-7056 fax

BOSTON

Two Seaport Lane, Suite 300
Boston, Massachusetts 02210-2028
617-946-4800
617-946-4801 fax

CHICAGO

55 East Monroe Street, Suite 4200
Chicago, Illinois 60603-5803
312-346-8000
312-269-8869 fax

HOUSTON

700 Louisiana Street, Suite 3700
Houston, Texas 77002-2797
713-225-2300
713-225-2340 fax

LOS ANGELES

One Century Plaza
2029 Century Park East, Suite 3300
Los Angeles, California 90067-3063
310-277-7200
310-201-5219 fax

NEW YORK

1270 Avenue of the Americas, Suite 2500
New York, New York 10020-1801
212-218-5500
212-218-5526 fax

SACRAMENTO

400 Capitol Mall, Suite 2350
Sacramento, California 95814-4428
916-448-0159
916-558-4839 fax

SAN FRANCISCO

560 Mission Street, Suite 3100
San Francisco, California 94105
415-397-2823
415-397-8549 fax

WASHINGTON, D.C.

815 Connecticut Avenue, N.W., Suite 500
Washington, D.C. 20006-4004
202-463-2400
202-828-5393 fax

BRUSSELS

Boulevard du Souverain 280
1160 Brussels, Belgium
(32)(2)647.60.25
(32)(2)640.70.71 fax