

November 2004

Changing Definition of Dependent Could Impact Employee Benefit Programs

The Working Families Tax Relief Act of 2004 ("Act"), signed by President Bush on October 4, 2004, changed who is a "dependent" under section 152 and other sections of the Internal Revenue Code ("Code") in an attempt to unify the definition of dependent for various tax purposes. The changes are effective for tax years beginning after December 31, 2004 - generally January 1, 2005. Absent immediate guidance from the IRS, this change could have the unintended consequence of adversely impacting several areas of employee benefits and unsuspecting participants.

New Definition

Under the new definition of dependent:

- ♦ a domestic partner (or other person other than the taxpayer's child) may not qualify as a dependent if he or she receives more than approximately \$3,100 in income;
- ♦ a child generally may not qualify as a dependent after the age of 19, or age 24 for a student, unless the child is disabled; and
- ♦ a child may qualify as a dependent even though the taxpayer provides less than one-half of the child's support (although the child cannot provide more than one-half of his or her own support).

More specifically, the new definition of dependent under Code section 152 divides individuals into two groups - "qualifying child" and "qualifying relative." To satisfy the definition of "qualifying child", a "child" must meet several requirements, including that the child: (a) live with the taxpayer for more than one-half of the taxable year; (b) unless disabled, be under age 19 if not a student or, if a student, under age 24; and (c) not provide more than one-half of his or her own support. The requirement that the taxpayer provide more than one-half the child's support is no longer a part of the definition.

The definition of "qualifying relative" has several requirements, including that the individual: (a) bear a specified relationship to the taxpayer or be an individual (other than a spouse) who has the same principal residence as the taxpayer and is a member of the taxpayer's household; (b) have gross

income for the taxable year less than the exemption amount (*i.e.*, \$3,100 for 2004, and estimated to be \$3,200 in 2005); (c) be an individual for whom the taxpayer provides more than one-half of the support; and (d) not be a qualifying child with respect to any taxpayer.

Effect on Welfare Plans

The Act may affect an employer's welfare plans in several ways. First, a welfare plan may use the definition of "dependent" as defined in Section 152 in delineating its eligibility requirements. If so, an individual who was a "dependent" and eligible for coverage under the old definition may no longer be a dependent and eligible for coverage under the new definition. For example, a domestic partner may have qualified under the old Section 152 definition of dependent because a domestic partner was a member of the taxpayer's household and the taxpayer provided over one-half of the domestic partner's support. Under the new definition, however, if the domestic partner earns over \$3,100 in 2004, the domestic partner would fail to qualify as a dependent.

Second, although the value of employer-provided health coverage (*e.g.* premiums paid by the employer) is usually excludable from an employee's gross income, the new definition creates a disconnect with applicable Treasury regulations so that the value of coverage provided to an individual who does not qualify as a dependent for tax purposes will have to be included in the employee's gross income. (Notably, the Act did tweak the Code so that health benefits paid or reimbursed to a tax dependent are not included in income even if the dependent earns more than the limit.)

Third, a participant with a dependent care spending account may use pre-tax dollars to pay for certain expenses incurred in caring for a qualifying individual. A qualifying individual includes a "dependent" under age 13 for whom the taxpayer is entitled to a deduction for a personal exemption, and the regulations specify that a "dependent" is an individual as defined in Section 152. Thus, a qualifying individual must now meet the new requirements of Section 152 in order for dependent care expenses on that person's behalf to be reimbursed on a pre-tax basis.

Effect on Retirement Plans

Both non-qualified deferred compensation plans and qualified 401(k) plans may permit distributions upon the participant incurring a hardship. In case of a non-qualified deferred compensation plan, under the recently passed American Jobs Creation Act of 2004, a severe financial hardship includes an illness or accident of the participant or a dependent (as defined in Section 152). Due to the new definition of dependent, certain distributions that may have been permissible under the prior definition to cover expenses incurred for a child's illness or accident may no longer be permissible if the child no longer qualifies as a dependent.

A 401(k) or 403(b) plan may permit hardship distributions for medical or educational expenses incurred for a dependent (as defined in Section 152). Due to the new definition of dependent, certain hardship distributions that may have been permissible under the prior definition may no longer be permissible if the individual no longer qualifies as a dependent. Note that hardship withdrawals to pay educational expenses of a participant's children are still permitted, even if the child no longer qualifies as a dependent.

To Do List

We are hoping for imminent relief from the Internal Revenue Service to correct certain tax problems that have arisen under the Act, and we will schedule a teleconference briefing shortly after further guidance is issued. In the meantime, we recommend that employers review their employee benefit plans to make sure that all individuals intended to be covered by a benefit program will still be covered, given the new definition of dependent.

If you have any questions concerning any provisions of the Working Families Tax Relief Act affecting employee benefits, 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.

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

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.