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HEALTH CARE REFORM

ADULT CHILDREN COVERAGE TO AGE 26

May 11, 2010

This is the first in a series of memos for employers on selected topics under Health Care Reform (Patient Protection and Affordable Care Act, modified by the Health Care and Education Reconciliation Act of 2010 (collectively "PPACA")). On April 28, 2010, we sent a memo briefly summarizing PPACA.

- Under PPACA, health plan coverage for insured and self-insured plans is mandated for children of employees until they reach age 26. Separate, unbundled dental and vision plans are not subject to the mandate.
- The mandate is effective for health plan years beginning on or after September 23, 2010 (January 1, 2011 for calendar year plans).

Generally, under the Internal Revenue Code, the portion of premiums paid by employers and the benefits paid under those plans do not result in taxable income to an employee with respect to coverage for the employee, the spouse, and tax dependents. Since the mandate for coverage up to age 26 applies to children who may not be tax dependents, PPACA also amended the Internal Revenue Code to provide a federal tax exemption for the mandated coverage.

- Health care premiums paid by the employer and health care reimbursements attributable to adult children covered by an employer's health plan are excludible from the

parent/employee's taxable income for all years ending prior to the year the child turns age 27 (in other words, through the end of the year the child turns 26).

- The effective date for this income tax exclusion is March 30, 2010.

On May 7, 2010, the U.S. Department of Labor, Internal Revenue Service and the U.S. Department of Health and Human Services jointly issued Interim Final Regulations (with opportunity for comment) that addresses some of the issues on extending health coverage to adult children up to age 26 who do not otherwise qualify as tax dependents.

The regulations, are available at <http://www.dol.gov/ebsa/pdf/dependentcoverage.pdf>.

And, FAQs are available at <http://www.dol.gov/ebsa/faqs/faq-dependentcoverage.html>.

For mandated coverage to age 26, who qualifies as a “child”?

The term “child” includes children, stepchildren, legally adopted children, children placed with the employee for adoption, and eligible foster children.

What proof should an employer obtain as to the age of an employee’s child?

There is no requirement to obtain a birth certificate or other evidence of the child’s age. Employers can rely on an employee’s representation as to the date of birth of the child.

Does the child’s marital status, student status, income level, or place of residence matter with respect to the mandated coverage?

No. Age of the child is the only determining factor.

What if the child is working and eligible for health care coverage at his or her employer?

This is the one exception for mandated coverage for children under age 26. With respect to grandfathered plans (health plans in existence on March 23, 2010), prior to 2014, if a child is eligible for coverage under his or her own employer’s health plan, the employer of the parent does not have to cover that child. However, an employer may voluntarily want to extend coverage to such a child if the employer decides that it is administratively difficult to determine eligibility for other health care coverage. In an insured plan, approval from the carrier will likely be required for this expanded coverage.

Does an employer have to cover an eligible child’s spouse or children (grandchildren of the employee)?

No.

What if a health plan only covers employees, or employees and spouses, but not dependents?

In that case, the mandate to cover adult children up to age 26 does not apply.

How will adult children enroll in health plans?

Sponsors of plans have to provide qualifying adult children an opportunity to enroll. The enrollment period must extend for at least 30 days, with the written notice given no later than the first day of the plan year beginning on or after September 23, 2010. If the 30 days extends beyond the start of a plan year, coverage will be retroactive to the start of the plan year. Even plans without an open enrollment period will have to provide the opportunity for eligible adult children to enroll.

The notice can be satisfied by giving the notice to the parent/employee of the adult child and can be provided with normal enrollment material during open enrollment as long as the 30-day requirement is met.

The benefits under the plan cannot vary based on age of the child.

While plans are not required to enroll adult children before the first plan year beginning on or after September 23, 2010, the U.S. Department of Labor is encouraging insurance companies and employers to prevent a gap in coverage for adult children who are aging off their parents' coverage prior to the effective date. As of May 7, 2010, 65 insurance companies have volunteered to do so.

Can additional premiums be charged for children under age 26 to remain on or be added to the health plan coverage?

PPACA does not specifically address the premiums or costs that can be charged for the children under age 26 who are no longer tax dependents. However, the interim final regulations state that the adult child or parent/employee cannot be required to pay more for coverage than dependents who do not lose coverage. Thus, an additional charge cannot be made based on the age of the child. Most plans will likely provide coverage under a plan's family coverage as if the adult child was still a dependent child (or as another person if coverage is based on employee, employee + 1, employee +2, etc.) This is a matter to discuss with your insurance carrier, or your third party administrator in the case of a self-insured plan (or legal counsel).

How does the tax exclusion for mandated coverage work?

The mandated coverage requires coverage up to the date the child turns age 26. However, the tax exclusion for coverage carries through the end of the year in which the child turns age 26. Also, the effective date for tax exclusion is coverage after March 30, 2010.

With respect to plans that already include children who are not tax dependents and where there has been imputed income charged to the employee for that coverage, if the child is under age 27 as of the end of 2010, an employer no longer has to charge an employee imputed income for that coverage. Thus there would be imputed income between January 1, 2010 and March 30, 2010, but not for coverage after March 30, 2010.

Because the federal tax exclusion carries through the end of the year in which the adult child turns age 26, employers may want to consider whether administratively it is easier to also go ahead and extend coverage until the end of that year rather than terminating coverage upon the child reaching age 26.

Does the favorable tax treatment apply to dental and vision benefits?

Yes, it does. However, dental and vision benefits that are not bundled with a health plan are HIPAA-excepted benefits and therefore the age 26 coverage requirement does not apply. An employer who provides self-funded, unbundled dental and vision benefits (separate election and separate premium payment for coverage) will need to decide whether the dental and vision benefits will be extended to age 26 for adult children even though not mandated. Employers with insured, unbundled dental and vision benefits will need to check with their insurance carrier on voluntarily extending benefits to adult children up to age 26.

How does the new federal mandate for coverage of adult children and the new federal tax exclusion dovetail with the Iowa mandate for adult children coverage and Iowa tax exemption that has been in place for the last couple of years?

This gets complicated.

First, with respect to mandated coverage for non-tax dependents, keep in mind that the Iowa mandate is only for insured health plans. It does not apply to self-insured plans. The federal mandate applies to both insured and self-insured plans. Thus, self-insured plans only need to focus on the federal mandate as to required coverage.

Second, employers with insured plans should focus on the federal mandate for adult children under age 26 and on the Iowa mandate once a child reaches age 26. With respect to children age 26 or over, coverage is mandated under Iowa law for insured plans if the child (1) is unmarried and (2) is a full-time student at an accredited institution of post-secondary education.

That appears to be the only additional mandated situation under Iowa law over and above the federal mandate.

With respect to exemption from taxation for health coverage, the rules are also different under federal law compared to Iowa law.

First, for both federal and Iowa tax exclusion, health benefits and the value of employer-paid premiums are not taxable as long as the individual qualifies as a dependent under the Internal Revenue Code (either a “qualifying child” or a “qualifying relative¹”). Coverage for spouses is also exempt (opposite-sex spouses under federal law and all spouses under Iowa law).

Second, under federal tax law, coverage through the end of the year in which the child turns age 26 is exempt from federal taxation even if the individual does not qualify as a “dependent”.

Under Iowa Code §422.7.29A, if coverage includes any “nonqualified tax dependent as determined by the Internal Revenue Service”, the value of such coverage is nontaxable for Iowa purposes. A “nonqualified tax dependent” would appear to be anyone who is not a dependent for federal income tax purposes. That appears to be much more expansive than the federal exclusion under PPACA. Thus, coverage of an individual by a health plan would not result in Iowa taxation to the employee regardless of age and regardless of whether the individual was even a child of the employee (for instance, the value of domestic partner coverage would be excluded from Iowa income tax). We are not aware of the Iowa Department of Revenue issuing any guidance on this relatively new statute (2009 legislature).

What about payments under cafeteria plans for additional premiums for the federal mandated coverage and reimbursement for medical expenses for adult children through the medical flexible spending account?

The Internal Revenue Service issued IRS Notice 2010-38 on April 27, 2010, dealing with the tax exclusion under PPACA for coverage of adult children in health plans. Notice 2010-38 also covers issues dealing with cafeteria plans, flexible spending arrangements and health reimbursement arrangements (HRAs).

Basically, cafeteria plans can be expanded to cover, on a pre-tax basis, expenses for the new mandated coverage, and which could extend to the end of the year in which the child turns age 26 if a plan voluntarily wants to extend coverage to the end of that year rather than cutting off coverage at age 26. New coverage for such a child will be considered a “change in status”

¹ It is possible for an individual regardless of age (child, domestic partner, same-sex spouse or any other individual) to meet the definition of “qualifying relative” for the health care tax exclusion as long as the employee provides over ½ of the individual’s support for the year and, if the individual is not among a long list of relatives, the individual has the same principal place of abode as the employee and is considered a member of the employee’s household.

for allowing participants to make election changes for such coverage. Plans can institute these changes for expenses incurred after March 30, 2010 as long as the plan is amended by December 31, 2010. Or, an employer can wait to institute these changes starting with the plan year that begins on or after September 23, 2010.

Can HSA accounts allow reimbursement for expenses for an adult child under age 26 on a tax favored basis even though the adult child does not otherwise qualify as a tax dependent?

Apparently not. PPACA did not amend the Internal Revenue Code section dealing with HSAs to provide the favorable tax treatment for payments through the HSA account. Even though the high deductible health plan that permits establishment of an HSA must cover adult children up to age 26 and provides favorable tax treatment for expenses paid from that plan, at the present time there is no corresponding provision to allow tax favored treatment for reimbursement of expenses through the HSA account. We are not sure whether this will get corrected later through technical corrections or by regulation or whether this omission was intentional.

Is there any impact on federal COBRA coverage with these new mandates?

First, since the mandated coverage extends to the date the child reaches age 26, COBRA eligibility would not start until the child loses coverage under the plan, either at age 26 or at the end of the year in which the child turns age 26 if the employer wants to extend coverage until the end of that year. COBRA coverage would still be available generally for 3 years beyond loss of coverage. So the impact is mainly the possibility that a child may stay on a health plan at the parent's place of work until age 29.

The interim final regulations make it clear that an eligible adult employee who is now on COBRA because of previously becoming ineligible will have the right to come on the plan as a "regular" participant, and then will have new COBRA rights after losing coverage upon reaching age 26.

With respect to taxation, if an employer does cut off coverage at age 26 for a child, and COBRA begins, there is the possibility to provide COBRA coverage on a pre-tax basis until the end of the year in which the child turns age 26 by expanding the cafeteria plan to allow an employee to run the cost of the child's coverage through the flex plan until the end of that year. Further guidance will likely be forthcoming with respect to the interplay between COBRA and the new federal mandates.

What action should an employer take now with respect to the new mandate for coverage for adult children?

1. Determine whether you want to provide coverage for adult children prior to the mandated effective date--plan years beginning on or after September 23, 2010. As mentioned earlier, some insurance companies are accelerating the date for coverage of these children under insured plans.

2. For self-funded plans, amend health plans to provide for the expanded coverage as of the effective date chosen (no later than January 1, 2011 for calendar year plans).

3. Develop communication to employees regarding the new mandated coverage. Your insurance carrier or TPA may be able to help in this regard. Keep in mind the initial 30-day election period for eligible adult children or the parent/employee to elect coverage for the adult child.

4. If your plan now covers individuals who do not qualify as tax dependents and you are imputing income with respect to that coverage to the employee/parent, cease imputing income (and stop withholding FICA taxes) with respect to the value of coverage after March 30, 2010.

5. Determine if and when you want to expand pre-tax coverage under a cafeteria plan (mandatory under the medical flexible spending account for plan years beginning on and after September 23, 2010).

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