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Part III – Administrative, Procedural, and Miscellaneous

Section 105 - Amounts Received Under Accident and Health Plans (Also Sections 106-Contributions by Employers to Accident and Health Plans, 162(l)-Special Rules for Health Insurance Costs of Self-Employed Individuals, 401(h)-Medical, Etc. Benefits for Retired Employees and Their Spouses and Dependents, 501(c)(9)-Voluntary Employees' Beneficiary Association, 3121-Definitions, 3231-Definitions, 3306-Definitions, 3402-Income Tax Collected at Source).

Tax Treatment of Health Care Benefits Provided With Respect to Children Under Age 27

Notice 2010-38

I. PURPOSE

This Notice provides guidance on the tax treatment of health coverage for children up to age 27 under the Affordable Care Act. (In this Notice, the "Affordable Care Act" refers to the Patient Protection and Affordable Care Act, Public Law No. 111-149 (PPACA), and the Health Care and Education Reconciliation Act of 2010, Public Law No. 111-152 (HCERA), signed into law by the President on March 23 and 30, 2010, respectively.)

The Affordable Care Act requires group health plans and health insurance issuers that provide dependent coverage of children to continue to make such coverage available for an adult child until age 26. The Affordable Care Act also amends the Internal Revenue Code (Code) to give certain favorable tax treatment to coverage for adult children. This Notice addresses a number of questions regarding the tax treatment of such coverage.

Specifically, this Notice provides guidance on the Affordable Care Act's amendment of § 105(b) of the Code, effective March 30, 2010, to extend the

general exclusion from gross income for reimbursements for medical care under an employer-provided accident or health plan to any employee's child who has not attained age 27 as of the end of the taxable year. (See § 1004(d) of HCERA.) The Affordable Care Act also makes parallel amendments, effective March 30, 2010, to § 401(h) for retiree health accounts in pension plans, to § 501(c)(9) for voluntary employees' beneficiary associations (VEBAs), and to § 162(l) for deductions by self-employed individuals for medical care insurance. (See § 1004(d) of HCERA.)

The Affordable Care Act amended the Public Health Service Act (PHS Act) to add § 2714, which requires group health plans and health insurance issuers that provide dependent coverage of children to continue to make such coverage available for an adult child until age 26. (See § 1001 of PPACA.) Section 2714 of the PHS Act is incorporated into § 9815 of the Code by § 1562(f) of PPACA. In certain respects, the rules of § 2714 of the PHS Act extending coverage to an adult child do not parallel the gross income exclusion rules provided by the Affordable Care Act's amendments of §§ 105(b), 401(h), 501(c)(9), and 162(l) of the Code. For example, § 2714 of the PHS Act applies to children under age 26 and is effective for the first plan year beginning on or after September 23, 2010, while, as noted above, the amendments to the Code addressed in this Notice apply to children who have not attained age 27 as of the end of the taxable year and are effective March 30, 2010.

II. EXCLUSION OF EMPLOYER-PROVIDED MEDICAL CARE REIMBURSEMENTS FOR EMPLOYEE'S CHILD UNDER AGE 27

Section 105(b) generally excludes from an employee's gross income employer-provided reimbursements made directly or indirectly to the employee for the medical care of the employee, employee's spouse or employee's dependents (as defined in § 152 (determined without regard to §152(b)(1), (b)(2) or (d)(1)(B)). As amended by the Affordable Care Act, the exclusion from gross income under §105(b) is extended to employer-provided reimbursements for expenses incurred by the employee for the medical care of the employee's child (within the meaning of § 152(f)(1)) who has not attained age 27 as of the end of the taxable year. (The Affordable Care Act does not alter the existing definitions of spouse or dependent for purposes of § 105(b).) Under § 152(f)(1), a child is an individual who is the son, daughter, stepson, or stepdaughter of the employee, and a child includes both a legally adopted individual of the employee and an individual who is lawfully placed with the employee for legal adoption by the employee. Under § 152(f)(1), a child also includes an "eligible foster child," defined as an individual who is placed with the employee by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.

As amended by the Affordable Care Act, the exclusion from gross income under § 105(b) applies with respect to an employee's child who has not attained age 27 as of the end of the taxable year, including a child of the employee who is not the employee's dependent within the meaning of § 152(a). Thus, the age

limit, residency, support, and other tests described in § 152(c) do not apply with respect to such a child for purposes of § 105(b).

The exclusion applies only for reimbursements for medical care of individuals who are not age 27 or older at any time during the taxable year. For purposes of §§ 105(b) and 106, the taxable year is the employee's taxable year; employers may assume that an employee's taxable year is the calendar year; a child attains age 27 on the 27th anniversary of the date the child was born (for example, a child born on April 10, 1983 attained age 27 on April 10, 2010); and employers may rely on the employee's representation as to the child's date of birth.

III. EXCLUSION OF EMPLOYER-PROVIDED ACCIDENT OR HEALTH COVERAGE FOR EMPLOYEE'S CHILD UNDER AGE 27

Section 106 excludes from an employee's gross income coverage under an employer-provided accident or health plan. The regulations under § 106 provide that the exclusion applies to employer-provided coverage for an employee and the employee's spouse or dependents (as defined in § 152, determined without regard to § 152(b)(1), (b)(2) or (d)(1)(B)). See Prop. Treas. Reg. § 1.106-1. Prior to the Affordable Care Act, the exclusion for employer-provided accident or health plan coverage under § 106 paralleled the exclusion for reimbursements under § 105(b). There is no indication that Congress intended to provide a broader exclusion in § 105(b) than in § 106. Accordingly, IRS and Treasury intend to amend the regulations under § 106, retroactively to

March 30, 2010, to provide that coverage for an employee's child under age 27 is excluded from gross income. Thus, on and after March 30, 2010, both coverage under an employer-provided accident or health plan and amounts paid or reimbursed under such a plan for medical care expenses of an employee, an employee's spouse, an employee's dependents (as defined in § 152, determined without regard to §152(b)(1), (b)(2) or (d)(1)(B)), or an employee's child (as defined in § 152(f)(1)) who has not attained age 27 as of the end of the employee's taxable year are excluded from the employee's gross income.

The following examples illustrate this rule. In these examples, any reference to a "dependent" means a dependent as defined in § 152, determined without regard to §152(b)(1), (b)(2) or (d)(1)(B). Also, in these examples, it is assumed that none of the individuals are disabled.

Example (1). (i) Employer X provides health care coverage for its employees and their spouses and dependents and for any employee's child (as defined in § 152(f)(1)) who has not attained age 26. For the 2010 taxable year, Employer X provides coverage to Employee A and to A's son, C. C will attain age 26 on November 15, 2010. During the 2010 taxable year, C is not a full-time student. C has never worked for Employer X. C is not a dependent of A because prior to the close of the 2010 taxable year C had attained age 19 (and was also not a student who had not attained age 24).

(ii) C is a child of A within the meaning of § 152(f)(1). Accordingly, and because C will not attain age 27 during the 2010 taxable year, the health care coverage and reimbursements provided to him under the terms of Employer X's plan are excludible from A's gross income under §§ 106 and 105(b) for the period on and after March 30, 2010 through November 15, 2010 (when C attains age 26 and loses coverage under the terms of the plan).

Example (2). (i) Employer Y provides health care coverage for its employees and their spouses and dependents and for any employee's child (as defined in § 152(f)(1)) who has not attained age 27 as of the end of the taxable year. For the 2010 taxable year, Employer Y provides health care coverage to Employee E and to E's son, G. G will not attain age 27 until after the end of the 2010 taxable year. During the 2010 taxable year, G earns \$50,000 per year, and

does not live with E. G has never worked for Employer Y. G is not eligible for health care coverage from his own employer. G is not a dependent of E because G does not live with E and E does not provide more than one half of his support.

(ii) G is a child of E within the meaning of § 152(f)(1). Accordingly, and because G will not attain age 27 during the 2010 taxable year, the health care coverage and reimbursements for G under Employer Y's plan are excludible from E's gross income under §§ 106 and 105(b) for the period on and after March 30, 2010 through the end of the 2010 taxable year.

Example (3). (i) Same facts as Example (2), except that G's employer offers health care coverage, but G has decided not to participate in his employer's plan.

(ii) G is a child of E within the meaning of § 152(f)(1). Accordingly, and because G will not attain age 27 during the 2010 taxable year, the health care coverage and reimbursements for G under Employer Y's plan are excludible from E's gross income under §§ 106 and 105(b) for the period on and after March 30, 2010 through the end of the 2010 taxable year.

Example (4). (i) Same facts as Example (3), except that G is married to H, and neither G nor H is a dependent of E. G and H have decided not to participate in the health care coverage offered by G's employer, and Employer Y provides health care coverage to G and H.

(ii) G is a child of E within the meaning of § 152(f)(1). Accordingly, and because G will not attain age 27 during the 2010 taxable year, the health care coverage and reimbursements for G under Employer Y's plan are excludible from E's gross income under §§ 106 and 105(b) for the period on and after March 30, 2010 through the end of the 2010 taxable year. The fair market value of the coverage for H is includible in E's gross income for the 2010 taxable year.

Example (5). (i) Employer Z provides health care coverage for its employees and their spouses and dependents. Effective May 1, 2010, Employer Z amends the health plan to provide coverage for any employee's child (as defined in § 152(f)(1)) who has not attained age 26. Employer Z provides coverage to Employee F and to F's son, K, for the 2010 taxable year. K will attain age 22 in 2010. During the 2010 taxable year, F provides more than one half of K's support. K lives with F and graduates from college on May 15, 2010 and thereafter is not a student. K has never worked for Employer Z. Prior to K's graduation from college, K is a dependent of F. Following graduation from college, K is no longer a dependent of F.

(ii) For the 2010 taxable year, the health care coverage and reimbursements provided to K under the terms of Employer Z's plan are excludible from F's gross income under §§ 106 and 105(b). For the period

through May 15, 2010, the reimbursements and coverage are excludible because K was a dependent of F. For the period on and after March 30, 2010, the coverage is excludible because K is a child of F within the meaning of § 152(f)(1) and because K will not attain age 27 during the 2010 taxable year. (Thus, for the period from March 30 through May 15, 2010, there are two bases for the exclusion.)

IV. CAFETERIA PLANS, FLEXIBLE SPENDING ARRANGEMENTS, AND HEALTH REIMBURSEMENT ARRANGEMENTS

Section 125 allows employees to elect between cash and certain qualified benefits, including accident or health plans (described in § 106) and health flexible spending arrangements (health FSAs) (described in § 105(b)). Section 125(f) defines “qualified benefit” as any benefit which, with the application of § 125(a), is not includible in the gross income of the employee by reason of an express provision of chapter 1 of the Code (other than §§ 106(b) (which applies to Archer MSAs), 117, 127, or 132). Accordingly, the exclusion of coverage and reimbursements from an employee’s gross income under §§ 106 and 105(b) for an employee’s child who has not attained age 27 as of the end of the employee’s taxable year carries forward automatically to the definition of qualified benefits for § 125 cafeteria plans, including health FSAs. Thus, a benefit will not fail to be a qualified benefit under a cafeteria plan (including a health FSA) merely because it provides coverage or reimbursements that are excludible under §§ 106 and 105(b) for a child who has not attained age 27 as of the end of the employee’s taxable year.

A cafeteria plan may permit an employee to revoke an election during a period of coverage and to make a new election only in limited circumstances,

such as a change in status event. See Treas. Reg. § 1.125-4(c). A change in status event includes changes in the number of an employee's dependents. The regulations under § 1.125-4(c) currently do not permit election changes for children under age 27 who are not the employee's dependents. IRS and Treasury intend to amend the regulations under § 1.125-4, effective retroactively to March 30, 2010, to include change in status events affecting nondependent children under age 27, including becoming newly eligible for coverage or eligible for coverage beyond the date on which the child otherwise would have lost coverage.

In general, a health reimbursement arrangement (HRA) is an arrangement that is paid for solely by an employer (and not through a § 125 cafeteria plan) which reimburses an employee for medical care expenses up to a maximum dollar amount for a coverage period. Notice 2002-45, 2002-2 C.B. 93. The same rules that apply to an employee's child under age 27 for purposes of §§ 106 and 105(b) apply to an HRA.

V. FICA, FUTA, RRTA, AND INCOME TAX WITHHOLDING TREATMENT

Coverage and reimbursements under an employer-provided accident and health plan for employees generally and their dependents (or a class or classes of employees and their dependents) are excluded from wages for Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) tax purposes under §§ 3121(a)(2) and 3306(b)(2), respectively. For these purposes, a child of the employee is a dependent. Treas. Reg. §§ 31.3121(a)(2)-

1(c) and 31.3306(b)(2)-1(c). No age limit, residency, support, or other test applies for these purposes. Thus, coverage and reimbursements under a plan for employees and their dependents that are provided for an employee's child under age 27 are not wages for FICA or FUTA purposes. For this purpose, child has the same meaning as in § 152(f)(1), as discussed in the first paragraph in Section II of this Notice. A similar exclusion applies for Railroad Retirement Tax Act (RRTA) tax purposes under § 3231(e)(1)(i) and Treas. Reg. § 31.3231(e)-1(a)(1).

Such coverage and reimbursements are also exempt from income tax withholding. See Rev. Rul. 56-632, 1956-2 C.B. 101.

VI. VEBAS, SECTION 401(h) ACCOUNTS, AND SECTION 162(l) DEDUCTIONS

A VEBA is a tax-exempt entity described in § 501(c)(9) providing for the payment of life, sick, accident, or other benefits to members of the VEBA or their dependents or designated beneficiaries. The regulations provide that, for purposes of § 501(c)(9), "dependent" means the member's spouse; any child of the member or the member's spouse who is a minor or a student (within the meaning of § 151(e)(4) (now § 152(f)(2))); any other minor child residing with the member; and any other individual who an association, relying on information furnished to it by a member, in good faith believes is a person described in § 152(a). Treas. Reg. § 1.501(c)(9)-3. As amended by the Affordable Care Act, § 501(c)(9) provides that, for purposes of providing for the payment of sick and

accident benefits to members of the VEBA and their dependents, the term dependent includes any individual who is a member's child (as defined in § 152(f)(1)) and who has not attained age 27 as of the end of the calendar year.

Section 401(h) provides that a pension or annuity plan can establish and maintain a separate account to provide for the payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees, their spouses and their dependents if certain enumerated conditions are met ("401(h) Account"). The regulations provide that, for purposes of § 401(h) and § 1.401-14, the term "dependent" shall have the same meaning as that assigned to it by § 152. Treas. Reg. § 1.401-14(b)(4)(i). As amended by the Affordable Care Act, § 401(h) provides that the term dependent includes any individual who is a retired employee's child (within the meaning of § 152(f)(1)) and who has not attained age 27 as of the end of the calendar year.

Section 162(l) generally allows a self-employed individual to deduct, in computing adjusted gross income, amounts paid during the taxable year for insurance that constitutes medical care for the taxpayer, his or her spouse, and dependents, if certain requirements are satisfied. As amended by the Affordable Care Act, § 162(l) covers medical insurance for any child (within the meaning of § 152(f)(1)) who has not attained age 27 as of the end of the taxable year.

VII. TRANSITION RULE FOR CAFETERIA PLAN AMENDMENTS

Cafeteria plans may need to be amended to include employees' children who have not attained age 27 as of the end of the taxable year. Pursuant to §

1.125-1(c) of the proposed regulations, cafeteria plan amendments may be effective only prospectively. Notwithstanding this general rule, as of March 30, 2010, employers may permit employees to immediately make pre-tax salary reduction contributions for accident or health benefits under a cafeteria plan (including a health FSA) for children under age 27, even if the cafeteria plan has not yet been amended to cover these individuals. However, a retroactive amendment to a cafeteria plan to cover children under age 27 must be made no later than December 31, 2010, and must be effective retroactively to the first date in 2010 when employees are permitted to make pre-tax salary reduction contributions to cover children under age 27 (but in no event before March 30, 2010).

VIII. EFFECT ON OTHER DOCUMENTS

IRS and Treasury intend to amend the regulations at §§ 1.105-1, 1.105-2, 1.106-1, 1.125-1, 1.125-4, 1.125-5, and 1.401-14 to include children (as defined in §152(f)(1)) who are under age 27. Additionally, IRS and Treasury intend to amend the regulations at § 1.501(c)(9)-3 to include children (as defined in §152(f)(1)) who are under age 27, with respect to sick and accident benefits. Taxpayers may rely on this Notice pending the issuance of the amended regulations.

IX. EFFECTIVE DATES

The changes relating to §§ 105(b), 106, 501(c)(9), 401(h) and 162(l) are effective on March 30, 2010.

DRAFTING INFORMATION

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