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RE: Health insurance for dependents - taxability

Facts:

In 2008, Governor Chet Culver signed bill 2539, which took affect on July 1, 2008, that requires a state regulated group health plan to continue coverage of an employee's child if the child is under the age of 26 regardless of whether they are a student or not. If the child is a student, the coverage continues until the point in time after age 25 that the child is no longer a student.

The Iowa Insurance Division has issued a Q&A fact sheet that states that if a child that is covered does not meet the definition of dependent for federal income tax purposes, the value of the cost for covering that child is considered additional taxable income to the employee.

Question:

Is the cost of coverage for a 26 year old child of an employee under the employee's group health coverage, who is a resident of Iowa and a student at an Iowa college, considered taxable to the employee?

Answer:

Contrary to the Q&A fact sheet issued by the Iowa Insurance Division, the health insurance being provided to this child may be considered non-taxable to the employee if certain rules to be considered a "dependent" are met.

If the child meets the definition of a "Qualifying Relative", they may still be considered a dependent for the non-taxability of the health insurance premiums paid on the employee's behalf.

Discussion:

The taxability of reimbursements from health insurance for medical expenses is discussed in Internal Revenue Code ("IRC") Section 105. This section states that an employee can exclude from income any reimbursements from an accident and health insurance plan for

medical expenses for medical care under IRC Section 163 for the employee, his spouse, and dependents. (IRC Section 105(b) and Treas. Regs. Section 1.105-2)

Secondly, the taxability of employer provided health insurance to an employee is discussed in IRC Section 106. This section states that the gross income of an employee will not include contributions that the employer makes for health insurance as compensation to the employee, for any personal injuries or sickness incurred by the employee, his spouse, or his dependents. (IRC Section 106(a) and Treas. Regs. Section 1.106-1)

Under both provisions above, the exclusion from income refers to the definition of dependent under IRC Section 152. The definition of dependent under IRC Section 152 is a two prong test. A person will qualify as someone's dependent if they are considered either a "qualifying child" or a "qualifying relative". (IRC Section 152(a)). The U.S. Department of Treasury has issued proposed regulations that specifically state that Section 152 is to be used, with the exception that the following sub-paragraph's of Section 152 are to not be taken into consideration in making the determination of who is a dependent or not:

1. It is not to be taken into consideration whether a child that is a dependent of another has dependents of their own (Prop. Regs. Section 1.106-1),
2. It is not to be taken into consideration whether a child is filing a joint return with another individual. (Prop. Regs. Section 1.106-1),and
3. It is not to be taken into consideration whether a dependent that qualifies as a "qualifying relative" has gross income for the year that is less than that year's exemption amount under Section 151(d). (Prop. Regs. Section 1.106-1).

Since these three exclusions under the regulations are only in proposed form, it is considered substantial authority to rely upon until the regulations are either revised or withdrawn in the future.

Under the "Qualifying Child" test of 152, it states a child must meet the following to be considered a "Qualifying Child":

1. be in a certain relationship to the person claiming the child as a dependent,
2. maintains the same principal place as an abode for more than one-half of the year,
3. meets age requirements of being either under age 19 or under age 24 and a full-time student,
4. does not provide more than one-half of their own support for the year, and
5. has not filed a joint return with a spouse.

(IRC Sections 152(c)(1)(A) through (E) and 152(c)(3))

Under the new Iowa rule, a child who is not a student and between the age of 19 and 25 is not considered a dependent under the "qualifying child" test of Section 152, but they can still receive health benefits under a parent's health insurance policy. This would normally

put the insurance premiums associated with such a child in the realm of being considered taxable. But, if a child of an employee is between the age of 19 and 25 and not a student or if they are a full-time student and are over the age of 24, they could meet the requirements to be considered a "qualifying relative". Under Section 152, for purposes of Section 106, to be considered a "qualifying relative", the child needs to:

1. be a child of the taxpayer (152(d)(1)(A) and (152(d)(2))
2. have over one-half of their support for the calendar year be provided by the employee/parent (152(d)(1)(C)), and
3. who is not a qualifying child of the employee or any other taxpayer for the calendar year (152(d)(1)(D))

Therefore, a child of an employee that doesn't meet the definition for "qualifying child", could meet the definition of "qualifying relative". An example would be for a 20 year-old child that still lives at home, receives \$20,000 of support for the year that is 65% of their living expenses, and does not meet the "qualifying child" requirements, can still be considered a dependent under Section 152 and thus be included as an allowable dependent for consideration of non-taxable health insurance premiums as compensation from employment for the child's parent.

Lastly, it should be noted that under HF 2539 as signed into law, coverage must be continuous in order for the above to be allowed. For example, if a child is not currently covered on an employee's policy and is under the age of 25, the child cannot be added to the policy. The new law states that insurers are not required to continue coverage if the child is no longer a resident of Iowa or marries.