Family Ties: Congress Provides New Dependent Definition Affecting Benefit Plan Taxability; Review Plan Documents Now to Determine Impact

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Congress recently enacted the Working Families Tax Relief Act of 2004 ("WFTRA"), which provides a uniform definition of "child" for several tax purposes (dependent exemption under Code Section 151, child tax credit under Code Section 24, the earned income credit under Code Section 32, and the child care credit under Code Section 21). Consequently, the definition of "dependent" under Code Section 152 and the definition of "qualifying individual" under Code Section 21 have been revised. We will discuss below the changes made to Sections 152 and 21 and the impact these changes have on the tax exclusion for health plans and for dependent care flexible spending accounts.

Generally, Code Section 105 (as amended) excludes from an employee's gross income health plan reimbursements for medical expenses incurred by the employee and the employee's dependents as defined generally by Code Section 152, with a special rule for children of divorced parents. Under the new rules, most individuals who could receive excludable health coverage before the change can continue to receive excludable health coverage (due in part to conforming amendments made by WFTRA to Code Section 105).

The only significant change relates to "children" (son, daughter, grandchildren, brother, sister, niece, nephew) of the employee who are under the age of 19 or 24 if a full time student. In the past, such a child was a dependent of the employee/parent who provided over half of his or her support generally without regard to where the child resided. After WFTRA, such a child is a dependent of the person with whom the child has the same principal place of abode for more than half the year without regard to whether that person provides support for the child. In other words, the support requirement for such children has been replaced with a residence requirement. This change could impact the taxability of coverage for "children" of employees who don't reside with the employee even though the employee provides over half of the child's support (except in the case of children of divorced parents). Note that the support requirement still exists for any child who is age 19 or older.

The changes to the definition of "qualifying individual" under Section 21, which impact Section 129 dependent care flexible spending accounts, appear to be slightly more significant. First, the "head of household" requirement was eliminated, which opens the door for working parents who do not maintain a household (e.g. an employee who lives with his or her parents) to receive tax free reimbursement for child care. Second, expenses for care of a disabled dependent with income over the exemption amount in Code Section 151 (currently $3100) will no longer qualify for tax free reimbursement.

A final area of concern relates to election changes under Section 125 cafeteria plans. The change-in-status rules under Section 125 assume changes in dependent status under Section 152. Under the new dependent definition, certain individuals may receive excludable coverage under the special rules applicable under Section 105. ECFC will ask the IRS to modify the regulations to reflect changes of ineligibility for excludable coverage under Section 105 and not continue to be tied into Section 152's dependent definition.

The WFTRA changes are effective January 1, 2005. There is some indication that transition relief may be extended given the impact on plan eligibility and practical issues related to making last minute election changes.

So stay tuned. In the meanwhile, to help you understand who is a dependent generally and how the new rules impact health plans and dependent care flexible spending accounts, we have provided the following below:

- A summary of who a dependent is generally under Code Section 152 after WFTRA
- A summary of the differences between the old definition of dependent under Code Section 152 and the new definition
- A summary of the impact the new definition has on health plans
- A chart of typical familial situations that is intended to help you identify who would be a dependent for health plan purposes both before and after WFTRA
- A summary of the changes made to the definition of "qualifying individual" under Code Section 21
- A summary of the impact the new definition has for Code Section 129 dependent care assistance plans.

What is the new Section 152 definition of dependent under WFTRA?

In order to understand the impact of the new rules on health plans, it is important to understand who qualifies as Section 152 dependent under the new rules. Under the new definition of dependent, an individual qualifies as a dependent if the individual is either a) a qualifying relative or a b) qualifying child of the taxpayer.

Who is a qualifying relative?

A "qualifying relative" is any individual who satisfies four conditions: (i) the individual bears a specific familial-type relationship to the taxpayer (ii) the individual has gross income for the year that is less than the exemption amount under Section 151(d) (currently $3,100) (iii) the individual is not a "qualifying child" of any taxpayer and (iv) the individual receives over half of his/her support from the taxpayer. [As noted below, a special rule under Section 105 eliminates the second condition (income less than exemption amount) above for purposes of excludable health coverage].

Only individuals who bear the following familial type relationships with the taxpayer satisfy the first condition:

i. A child (including natural, adopted, foster, and/or step child) and descendant of either (i.e., grand and great grand children)

ii. A brother or sister (including step siblings)

iii. parent or ancestor

iv. step parent (not including ancestors)

v. aunt/uncle

vi. niece/nephew

vii. in-laws, or

viii. Any other individual not listed above (i.e., a non-relative) who has the same principal place of abode as the taxpayer and is a member of the taxpayer's household (i.e., the individual resides with the taxpayer). Even though not related, the fact that they receive over half of their support from the taxpayer and reside with the taxpayer cause them to be treated the same as other family members.

Who is a qualifying child?

A "qualifying child" is an individual who satisfies the following four conditions: (i) the individual bears a specific familial-type relationship to the taxpayer (ii) the indivi dual does not provide over half of his/her own support (iii) the individual has the same principal place of abode as the taxpayer for more than half the year and iv) the individual does not turn age 19, or 24 if a full time student, by the end of the taxable year*. Only individuals who bear the following familial type relationship with the taxpayer qualify as a "qualifying child" of the taxpayer:

i. A child (including natural, adopted, foster, and/or step child) and descendant of either (i.e., grand and great grand children), and

ii. A brother or sister (including step) and a descendant of either (i.e., nieces or nephews, including step nieces and nephews).

The new rules have also established ordering rules where an individual may be a qualifying child of two or more taxpayers. In this case, if one of the taxpayers who could claim the child as a "qualifying child" is the parent, then the parent may claim the child as a dependent. If neither of the two taxpayers who can claim the child as a "qualifying child" are a parent of the individual, then the taxpayer with the highest adjusted gross income can claim the child as a dependent. Where both taxpayers who claim the child as a "qualifying child" are the parents of the child and they file separate tax returns, then the child is a dependent with respect to the parent with whom the child lived the longest during the taxable year. If the child lived with both parent for an equal amount of time, then the parent with the highest adjusted gross income treats the child as a qualifying child

For example, consider the situation where Parent and 16-year old Child both live with Grandmother. Parent works full time and fully-supports child; however, the Child has the same principal place of abode as the Parent and Grandmother. In that situation, Child would qualifying as a "qualifying child" of both Grandmother and Parent (remember, there is no support requirement for qualifying children). However, because of the ordering rules, Child is only considered a dependent with respect to Parent.

***Note: There is a special rule for children who are permanently and totally disabled. The age requirement is considered satisfied if the child is permanently and totally disabled at any time during the calendar year in which the child turns the limiting age without regard to whether the child is a student or not.**

Are there other special rules regarding the definition of dependent generally under Code Section 152?

Yes, there are some special rules, most of which also existed under the old definition of dependent. The rule regarding the dependent status of children of divorced parents is retained and WFTRA clarifies the rule that support provided by a stepparent is considered provided by the parent to whom the stepparent is married. In addition, the new law provides that a Code Section 152 dependent of a taxpayer cannot also claim dependents and a married individual who files a joint tax return with his/her spouse cannot be a dependent of any taxpayer.

How does the new definition of dependent differ from the old definition of dependent under Code Section 152?

The old definition of "dependent" was similar to the new definition of qualifying relative. Most of the changes are relatively minor. However, there are two changes that are significant.

The first significant change is that "qualifying relatives" (i.e. someone who is not a qualifying child of any taxpayer) only include individuals who do not have gross income in excess of the exemption amount set forth under Code Section 151. Previously, there was no gross income limitation set forth in Code Section 152. However, as described herein, a conforming

amendment to Section 105 enables individuals who would otherwise qualify as a "qualifying relative" but for the income requirement to receive excludable health coverage even if they have income in excess of the exemption amount

Also, under the new definition of qualifying child, a "child" of the taxpayer who is under age 19 (or 24 if a full time student) and who does not provide over half of his/her own support will be a dependent of the taxpayer with whom the child shares the same principal place of abode for more than half of the year, without regard to who provides over half of the child's support. This a change from the prior definition of dependent which generally based dependent status on which individual provided over half of the individual's support for the year. This change to the definition may cause some non-resident children to lose eligibility for excludable health benefits (except in the case of most children of divorced parents). For example, the natural 13-year old child of a taxpayer who lives with grandmother but who receives over half of his support from the parent will be a Code Section 152 dependent of grandmother (assuming the taxpayer does not also live with grandmother) even though the taxpayer provides over half of the child's support.

Who is a "dependent" for purposes of tax-free health benefits/reimbursements under Section 105 in light of WFTRA?

Section 105 generally restricts tax free health benefits to the taxpayer, the taxpayer's spouse, and the taxpayer's dependents (as generally defined under Code Section 152). Also, as alluded to earlier, in addition to revising the definition of dependent under Code Section 152, WFTRA also made conforming amendments to Code Section 105. Accordingly, for purposes of Code Section 105, medical reimbursements can be tax free for dependents and the following individuals (even though such individuals would not otherwise qualify as Code Section 152 dependents):

- A qualifying relative that has gross income in excess of the exemption amount.
- A child of divorced parents without regard to which parent has custody and without regard to who is entitled to claim the exemption for dependents so long as over half of the child's support is provided by the parents (this is not a new rule; it was simply retained under the WFTRA).
- A dependent of a dependent.
- A dependent that is married and files a joint tax return with the dependent's spouse.

The net result is that under the new law there is only one significant change to the definition of dependent that practitioners need to be concerned with when applying Code Section 105 and that is the change to the rule regarding certain children under age 19 (or under 24 if a full time student). This determination is now based on residency rather than support.

Who is a "dependent" for purposes of tax-free health coverage (rather than reimbursement benefits) under Section 106 in light of WFTRA?

The rules allowing for exclusion of health coverage (rather than expense reimbursements) under Section 106 are currently unclear. Section 106 (by virtue of the regulations thereunder) provides an income tax exclusion for health coverage provided by an employer to its employees and his or her Section 152 dependents. WFTRA **did not** include a conforming amendment to Section 106 to match the definition of "dependent" for health reimbursement purposes under Section 105. As it currently stands under the regulations, certain individuals such as individuals who would be a qualifying relative but for gross income in excess of the exemption amount would not qualify for tax free coverage under Section 106 even though they could qualify for tax free benefits under Section 105. It is our understanding that Treasury intends to correct this as soon as possible so that dependents for Section 106 purposes match dependents for Section 105 purposes.

What does all of this really mean for health plans?

Admittedly, you may be reading this and be thoroughly confused. Don't shoot the messenger.

To better illustrate the differences between the old rules and the new rules, we have provided some common familiar situations below and with each one we have identified whether the individual would qualify as a dependent for purposes of tax free benefits under the employee's health plan. For purposes of these examples, we will assume the health plans in the examples cover any person who might otherwise qualify as a "dependent" for purposes of tax free health coverage.

	Fact Situation	Current Rules	WFTRA Rules	Comment
1.	Employee has a 12-year old son who lives with Employee A and for whom Employee A provides over half of his support. Is the 12-year son a "dependent" for health plan purposes?	Yes	Yes	For purposes of the new rules, the child is a qualifying child of Employee A because (i) the child is under age 19 (ii) the child has a specified familial relationship with Employee A (iii) the child has the same principal place of abode as Employee A and (iv) the child does not provide over half of his own support. For purposes of the old rules, the child has a specified relationship with Employee A and Employee A provides over half of the child's support.

	Fact Situation	Current Rules	WFTRA Rules	Comment
2.	An employee's 10 year granddaughter lives with her while the child's parent works out of town (assuming parent also does not reside with the employee). The child has lived with the employee/grandmother for the entire year but the parent provides over half of the child's support. Is the child a dependent of employee/grandmother for health plan purposes?	No.	Yes. (or maybe depending on where parent lives)	Under the new rules, the grandchild is a "qualifying child" of the employee/grandmother. Although the employee/grandmother does not provide over half of the child's support, the child has a specified familial relationship with grandmother (granddaughter), does not provide over half of her support, and has the same principal place of abode as grandmother for over half the year. Thus, the child is a qualifying child of grandmother. Under the old rules, the child could only be a "dependent" of the employee/grandmother for health plan purposes if, among other things, the employee/grandmother provided over half of the child's support. In this example, grandmother does not provide over half of the child's support.

	Fact Situation	Current Rules	WFTRA Rules	Comment
3.	Same facts as #2. Is the child the dependent of parent for health plan purposes?	Yes.	No.	Under the new rules, the child is not a dependent of parent for health plan purposes because the child is a qualifying child of the grandmother. Although the child satisfies most of the requirements to be a "qualifying

				relative" of the Parent, a child cannot be a qualifying relative of a taxpayer if the child is a qualifying child of another taxpayer. Under the old rules, the child has a specified familial relationship with the Parent and the Parent provides over half of the child's support. Therefore, the child was a dependent of parent for health plan purposes under the old rules.
	Fact Situation	**Current Rules**	**WFTRA Rules**	**Comment**
4.	Child of employee who is age 25 and full-time student. The child lives at school during the school year but lives with the employee when school is out. In addition, the child has a job in which the child makes $5,000 a year. Is student a dependent of employee for health plan purposes?	Yes.	Yes	Under the new rules, the student is not a qualifying child of the employee or any other person because the student is over the age limit. Thus, we must determine whether the student is a qualifying relative of the employee. Although the student satisfies most of the requirements to be a qualifying relative under the new rules, the student makes more than the exemption amount. Consequently, the student is not a Code Section 152 dependent. Nevertheless, as we noted above, Code Section 105 disregards the gross income requirement for individuals who would otherwise qualify as a qualifying relative. Therefore, the student qualifies as a qualifying relative for health plan purposes. Under the old rules, the student has a specified familial relationship with the employee and the employee provides over half of the student's support; therefore, the student is a dependent of the employee for health plan purposes.
	Fact Situation	**Current Rules**	**WFTRA Rules**	**Comment**
5.	Jane and Susan are domestic partners. Jane is the primary breadwinner and provides over half of Susan's support; however, Susan has a part time job where she makes $5000 per year. The relationship does not violate of state or local law. Is Susan a dependent of Jane for health plan purposes?	Yes	Yes	Susan would be a qualifying relative but for the fact that she has gross income greater than the exemption amount. However, as stated above, WFTRA revised Code Section 105 to disregard that rule for health plan purposes. Therefore, Susan is a qualifying relative of Jane's for health plan purposes. Under the old rules, Susan would qualify as a dependent even though they were not related because she resided with Jane and Jane provided over half of her support.

Did the WFTRA change to the definition of dependent impact any other health-related Code provisions?

WFTRA revised Code Section 213(a) to allow a deduction by a taxpayer for medical care expenses incurred by any dependent who would otherwise qualify as a dependent under Code Section 105 for health plan purposes. In addition, Code Section 220(d)(2) (Archer MSAs) was

revised to allow for tax free reimbursement of medical expenses incurred by dependents who would otherwise qualify as a dependent under Code Section 105 for health plan purposes. Interestingly, Code Section 223, the Code section for health savings accounts (HSAs), was not similarly revised. Thus, distributions from an HSA for medical expenses incurred by the following "dependents" of the account holder that would otherwise qualify for tax free health coverage under Code section 105 will be taxable (and possibly subject to an excise tax):

- Any individual who would otherwise be a qualifying relative of the account holder but who has gross income in excess of the exemption amount. This would include students who are over the age limit for a qualifying child and for whom the account holder provides over half of their support but where the student makes more than the exemption amount.

- Any married dependent who files a joint tax return with his/her spouse.

What must plan sponsors do to ensure compliance with the new rules?

Plan sponsors should review their health plans to determine the scope of "dependents" covered under the Plan. In many cases, blanket references to "tax dependent" or "dependent as defined in Section 152" will need to be changed to pull in the special rules under section 105. Also, plans that cover a broader range of individuals than the group permitted to be covered on a tax-free basis under Sections 105 and 106 should be revisited (and possibly amended to conform to the new definition) to avoid possible imputed income issues. In addition, communication and claims processing procedures should be modified to accommodate the change in the law and any changes to the plans.

What do plan sponsors/administrators need to do to administer this?

The IRS has indicated that certification from the employee that the enrolled dependent is a "dependent" under the Code for health plan purposes is sufficient so long as the plan sponsor/administrator has no reason to doubt that certification. As a result, the plan sponsor need merely make a settlor decision as to which individuals should be covered – and then communicate that through normal channels (SPD, SMM, etc) to employees. It should be permissible for an employer to require employees to self-determine whether any covered dependent is ineligible for tax free coverage, and then impute income on such individuals accordingly. If no dependents are certified as being "taxable" dependents, coverage should be able to continue to be provided on an excludable basis.

What are changes WFTRA made to the Section 21 dependent care credit?

The new law eliminates the requirement that a taxpayer maintain a household in order to claim the Dependent Care Tax Credit (DCTC) under Section 21. WFTRA also changed the definition of "qualifying individual". Under the new rules, a taxpayer may claim the credit with respect to expenses incurred with respect to care for a Qualifying Child (i.e. one who has the same principal place of abode as taxpayer for more than half the year, doesn't provide over half of his or her support) and is under the age of 13, even if the taxpayer does not provide over half of the child's support. In addition, a taxpayer may claim the credit with respect to expenses incurred for the care of a disabled dependent (as defined in Section 152) or spouse who has the same principal place of abode as the taxpayer. Here, the law imposes, for the first time, a gross income limitation -- $3,100 for 2004 on disabled dependents. It appears that if an adult dependent earns more than the exemption amount, he/she cannot be a qualifying individuals for purposes of the Section 21 credit. Since section 129 relies on Section 21 (the DCTC) for its definition of "qualifying individual", dependent care flexible spending accounts will be impacted by these changes.

What impact do the WFTRA changes to Section 21 have on Section 129 dependent care flexible spending accounts?

The actual impact on such plans could be significant for individuals who have dependents, but did not qualify as "head of household" and certain disabled dependents who have income in excess of the exemption amount. Otherwise, the impact should not be too significant.

Under Section 21 the head of household requirement has been eliminated. Thus, an employee who does not maintain his or her own household (e.g. an employee who still lives at home) could receive tax free reimbursements for qualifying expenses. Two other changes were made to Section 21 that impact Section 129 dependent care flexible spending accounts are as follows: a) all qualifying individuals must have the same principal place of abode as employee and b) individuals who would otherwise qualify as a qualifying relative under Section 152 (i.e. individuals age 19 or older) cannot have income in excess of the exemption amount.

When you review the rules that apply to Section 129 rules as a whole, it doesn't appear (at first glance anyway) that the **"principal place of abode"** requirement is an entirely new requirement, at least in a practical sense. For example, an expense is not reimbursable unless it is necessary to enable the employee to work or look for work; therefore, the individual would have to live with the employee in order for the expense to meet that threshold requirement both before and after the new rules. Also, any care provided for a disabled dependent outside of the taxpayer's home qualifies for tax free reimbursement only if the dependent regularly spends at least 8 hours each day in employee's household. Lastly, we can think of only limited situations under the old rules where an individual who lived with the employee for less than half the year would have qualified as a qualifying individual under the old rules (e.g. an employee who provides over half of the support for a child under age 13 who lives with grandmother for more than half the year while the employee works out of town. That employee may have been able to receive tax free reimbursement under a Code Section 129 plan for care that enabled the employee to work while the child stayed with the employee).

On the other hand, the income limitations for disabled dependents appear to result in a significant change. Under the old rules, a disabled adult individual qualified as a qualifying individual if the employee provided over half of the individual's support without regard to the income of the individual. Now any disabled adult individual who might otherwise qualify as a "qualifying relative" under Section 152 but for the income limitation will not qualify as a qualifying individual.

Now is the time to communicate these changes so that election changes can be made, as necessary.