

Update

Nov. 12, 2008



Which family members can have tax-free health coverage?

Summary

Employer-provided family health coverage is tax-free to employees only if their family members meet certain tax rules. Congress and the IRS have recently revised these rules, creating uncertainty about which family members can have employer-provided health coverage exempt from federal taxes. This *Update* reflects the latest changes in federal tax law and guidance and lays out a process to help employees understand the tax treatment of their family health benefits.

Tax-free coverage for children, other family members

Employer-provided health care coverage for employees, spouses and certain other family members is exempt from federal income and employment taxes. These individuals usually can receive tax-free medical expense reimbursements as well. However, family members must meet various criteria for these tax advantages to apply – and the criteria can change.

For example, a new law ([HR 6893](#), Pub. L. No. 110-351), enacted Oct. 7 and effective in 2009, tightened the definition of “qualifying child” to require that the child generally must be unmarried and younger than the employee. On the other hand, the IRS earlier this year relaxed certain restrictions on tax-free dependent coverage. Though a taxpayer usually can’t receive tax-free benefits for another taxpayer’s “qualifying child,” this restriction doesn’t apply, the IRS said, if the other taxpayer isn’t required to file a tax return and doesn’t do so, except to get a tax refund ([Notice 2008-5](#)). Additionally, when parents are divorced, separated or live apart for the last six months of a year, their children can receive tax-free coverage from either parent’s health plan ([Rev. Proc. 2008-48](#)).

Definitions

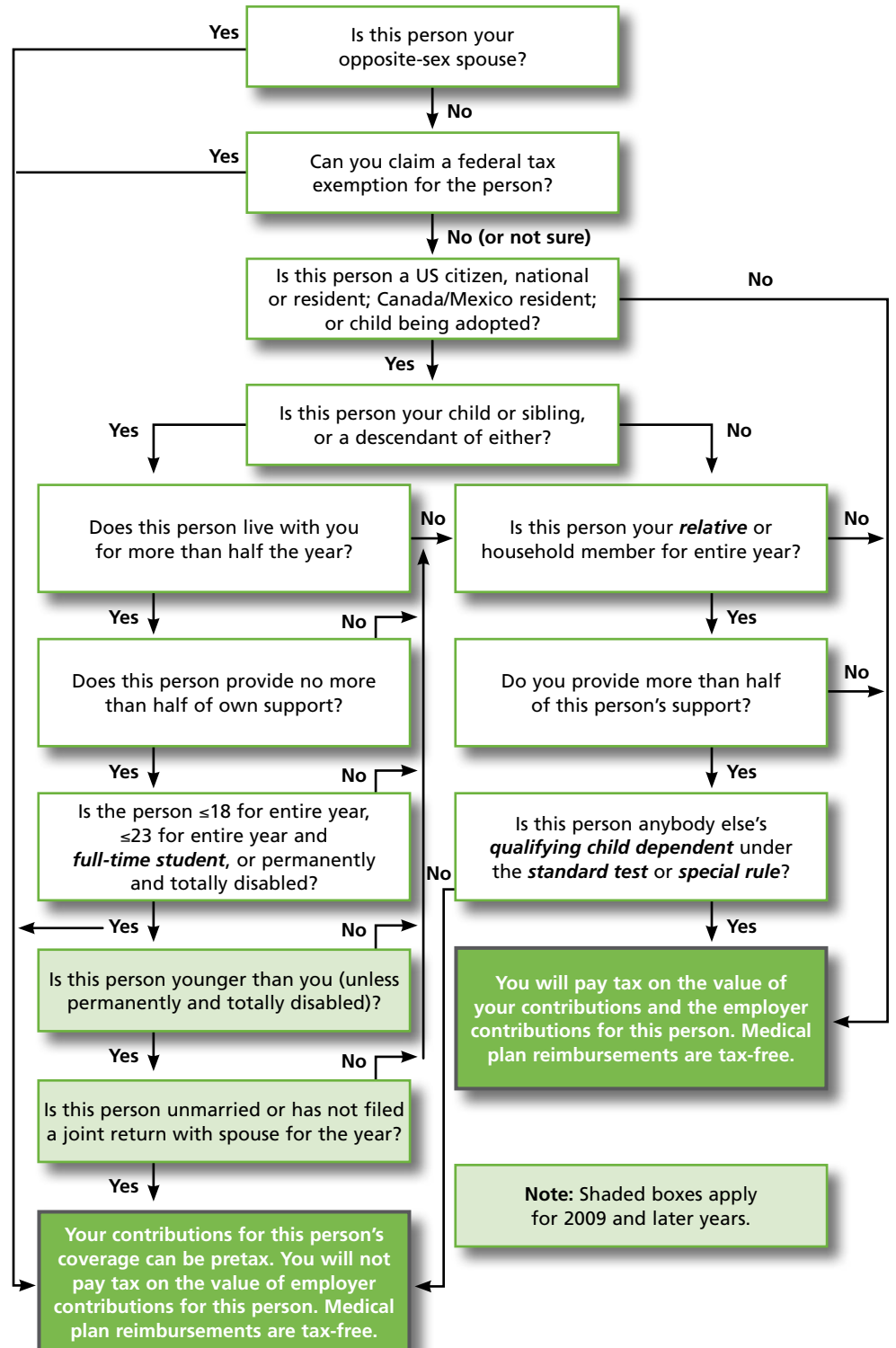
Qualifying child dependent

Standard test. A qualifying child dependent must meet all these requirements:

- Is unmarried
- Is not anyone else's dependent
- Is one of the following:
 - US citizen, national or resident
 - Resident of Canada or Mexico
 - Child being adopted by a US citizen or national whose household the child shares
- Is your child, sibling or step-sibling; or a descendant of your child, sibling or step-sibling
- Is age 18 or younger, or a full-time student age 23 or younger, for the entire calendar year; or is totally and permanently disabled at any point in year
- Lives with you for more than half the year
- Doesn't provide more than half his or her own support for the year

Special rule. A taxpayer's qualified child dependent may include a child who could be claimed as someone else's qualified child dependent if that other person isn't required to file a federal tax return and only does so to get a tax refund.

Decision tree: Which family members can get tax-free health coverage?



Definitions

Full-time student

A full-time student must be enrolled for five months in the calendar year at an educational institution that has a full-time faculty and must satisfy the school's full-time requirements.

Relative

Any of these people qualify as relatives:

- Your children and their descendants
 - Biological, step-, adopted (or placed for adoption) and foster children qualify
- Your parents and their ancestors (grandparents, etc.)
- Your stepmother and stepfather
- Your siblings, step-siblings, nieces and nephews
- Your aunts and uncles
- Your parents-in-law, children-in-law and siblings-in-law

The decision tree and detailed checklist in this *Update* can help employees determine whether their employer's health coverage for family members is subject to federal taxes – although plan documents still determine who is eligible for coverage. These tools cover the general rules that most commonly apply when determining which family members qualify for tax-free health benefits. However, neither tool addresses state tax issues or exceptional circumstances (for example, if a child enrollee is not claimed as a tax dependent by either parent). Terms in **bold italics** in the decision tree are defined in the sidebars on page 2 and this page.

Checklist for tax-free employer health plan benefits

If your employer's group health plan extends coverage to your spouse, domestic partner or other family members, this checklist can help determine the federal tax treatment of that coverage. If you are divorced, legally separated or living apart from your child's other parent for the last six months of a calendar year, this checklist ends with a special test to use.

Opposite-sex spouse

Coverage is tax-free and contributions can be pretax if the person you're covering is:

- Your opposite-sex spouse

Otherwise, go to Test 1 to see whether coverage is tax-free.

Test 1: Domestic partner, same-sex spouse or other family member

Coverage is tax-free and contributions can be pretax if the person you're covering is:

- Someone for whom you can claim an exemption on your federal taxes [Not sure if you can claim an exemption for this person? See IRS Publications [501](#) and [17](#)]

If you can't or aren't sure whether you can claim an exemption for this person, go to Test 2.

Test 2: Family member who doesn't satisfy Test 1

Coverage is tax-free and contributions can be pretax if you check all five boxes below as true:

- This person is any of the following:
 - A. Your child (by birth or adoption), stepchild or foster child
 - B. Your sibling or step-sibling
 - C. Descendant of someone listed in A or B
- This person lives with you for more than half the year

- This person is one of the following:
 - A. US citizen, national or resident
 - B. Resident of Canada or Mexico
 - C. Child who is being adopted by a US citizen or national whose household the child shares
- This person doesn't provide more than half his or her own support for the year
- This person is one of the following:
 - A. Age 18 or younger for the entire calendar year
 - B. Age 23 or younger and a **full-time student** for the entire calendar year
 - C. Permanently and totally disabled at any time during the calendar year (regardless of age)

For **2009 and later years**, you also must check **both** boxes below as true:

- This person is younger than you (unless permanently and totally disabled)
- This person is unmarried (or does not file a joint return with spouse for the year, except to claim a refund)

If you could not check the **first five** boxes above (**and all seven** boxes for 2009 and later years), go to Test 3.

Test 3: Family member or other person who doesn't meet Test 1 or 2

Coverage is tax-free and contributions can be pretax if you check all four boxes below as true:

- This person is one of the following:
 - A. Your **relative**
 - B. Unrelated to you but lives with you for the entire calendar year as a member of your household and the relationship isn't in violation of local law
- You provide more than half this person's support during the calendar year
- This person is one of the following:
 - A. US citizen, national or resident
 - B. Resident of Canada or Mexico
 - C. Child being adopted by a US citizen or national whose household the child shares
- This person meets either of the following tests:
 - A. Can't be claimed as any other taxpayer's **qualifying child dependent**
 - B. Can be claimed as another taxpayer's **qualifying child dependent**, but that taxpayer isn't required to file a federal tax return and doesn't do so (or only files a return to get a refund of previously withheld income taxes)

If you did not check **all** the boxes above, then you will be taxed on the employer contribution and your own contribution toward this person's coverage.



For more information

For additional information, please contact your Mercer consultant. You also may want to review our Sept. 10 [Update](#) for tips on conducting a dependent eligibility audit.

*This **Update** is for information only and does not constitute legal advice; consult with legal and tax advisers before applying this information to your situation.*

Test 4: Special test for child of parents living apart

If you are divorced, legally separated or living apart from the other parent for the last six months of a calendar year, your child may be treated as the dependent of **both** parents for tax-free health coverage if three conditions are met:

- Over half of the child's support comes from one or both parents
- Child is in the custody of one or both parents for more than half the year
- Child otherwise meets Test 2 or Test 3 above for **one** of the parents

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