

Tax Issues Related to PEBB Non Tax-Qualified Dependent Insurance

January 1, 2012

Internal Revenue Code (IRC) Section 152 Tax-Qualified Dependents

Employer contributions toward payment for health care are taxable to the employee if they are made for an individual who is not the employee's spouse or dependent child (i.e., a non tax-qualified dependent). Employees adding a non tax-qualified dependent (e.g., domestic partner, child of a domestic partner) to their employer sponsored insurance must identify their family tax status for the upcoming calendar year.

The employee will need to verify whether their dependents are dependents for tax purposes under IRC Section 152. If the dependent qualifies under IRC Section 152 for the entire tax year, the employer contribution toward the payment for the dependent's premium should not be treated as additional taxable income to the employee. If the dependent does not qualify under IRC Section 152, the fair market value of the employer contribution toward the coverage should be treated as additional taxable income to the employee (see below and Tables 1 and 2).

Required Retroactive Tax Treatment

The Health Care Authority (HCA) recommends that employees enrolling a non tax-qualified dependent review their tax status declaration annually during the PEBB open enrollment period. The declaration requires the employee to anticipate the status of their dependent for the upcoming year.

It is also important for employees to report to their employer any changes in dependent status during the year because IRC Section 152 requires a "look-back" at the dependency status at the end of each calendar year. If dependency changes during the calendar year, a retroactive adjustment will be necessary.

Identified below are examples of anticipated status and status changes and instructions.

Examples of initial dependency status and mid-year dependency status changes and instruction:

| Situation: | Initial Result and Action: | Employee notifies you of a change in dependent tax status: | Agency must: | Agency Action: |
|---|---|---|--|--|
| 1. Employee indicates at the beginning of the year that the dependent qualifies as an IRC Section 152 dependent | The Fair Market Value (FMV) of coverage for a tax qualified dependent <u>is not</u> taxable income for the employee for the entire year | During the tax year, employee notifies employer that the dependent only qualifies for a portion of the year (e.g., January – July) ¹ | Collect the appropriate number of months of: <ul style="list-style-type: none"> • Federal Income Tax • Social Security Tax • Medicare Tax from the employee | <ul style="list-style-type: none"> • On the next 941 filed, reflect the correction and file a 941c with an explanation • Verify W-2 provided in January reflects the FMV for the year |
| | | After the end of the tax year, employee notifies employer that the dependent only qualified for a portion of the year (e.g., January – July) ¹ | Collect appropriate months of : <ul style="list-style-type: none"> • Social Security Tax • Medicare Tax from the employee | <ul style="list-style-type: none"> • Verify W-2 provided in January reflects the FMV for the year • If W-2 has already been filed, file a W-2c showing corrected amount |
| 2. Employee indicates at the beginning of the year that the dependent does not qualify as an IRC Section 152 tax dependent for the tax year (<i>January-December</i>) | The Fair Market Value (FMV) of the coverage for a non tax-qualified dependent <u>is</u> taxable income for the employee for the entire year | During the tax year, employee notifies employer that the dependent does qualify for the entire tax year. | Refund or credit the employee the appropriate months of: <ul style="list-style-type: none"> • Social Security Tax • Medicare Tax Optional, but not required, refund <ul style="list-style-type: none"> • Federal Income Tax to the employee | <ul style="list-style-type: none"> • On the next 941, reflect the correction and file a 941c with an explanation • Verify W-2 provided in January <u>does not</u> reflect the FMV for the year |
| | | After the end of the tax year, employee notifies employer that the dependent does qualify for the entire tax year. | Refund or credit the employee the appropriate months of: <ul style="list-style-type: none"> • Social Security Tax • Medicare Tax to the employee | <ul style="list-style-type: none"> • Verify W-2 provided in January <u>does not</u> reflect the FMV for the year • If W-2 has already been filed, file a W-2c showing corrected amount |

¹A dependent must qualify as an IRC Section 152 dependent for the entire year in order to receive favorable tax treatment.

Note: A dependent's death does not change his or her status for the portion of the year during which the dependent was alive. No adjustments would be required in the case of a death of a dependent.

IRC Section 152 Non Tax-Qualified Dependents

Employees adding a dependent who does not meet the IRC Section 152 definition of qualified dependents (i.e., a non tax-qualified dependent) will have additional taxable income, which needs to be taxed and reported.

There will be two taxation issues to be addressed.

| Issue: | Action: | Resource: |
|---|--|--|
| 1. State-share premium paid to the insurance carrier for non tax-qualified dependents | The Fair Market Value (FMV) of the coverage, less any after-tax contributions, is taxable to the employee and subject to: <ul style="list-style-type: none"> • Federal Income Tax • Social Security Tax • Medicare Tax <i>(Not subject to retirement)</i> | Appendix A, Tables 1 – 2 reports the fair market value (FMV) |
| 2. Employee contribution for non tax-qualified dependents | <ul style="list-style-type: none"> • Do not deduct employee contributions for the IRC Section 152 non tax-qualified dependent on a pre-tax basis. <i>Payroll systems provide the ability to deduct pre and post-tax based on IRC Section 152 non tax-qualified dependents</i> | Appendix A, Tables 3 - 7 |

“Declaration of Tax Status” Form

Employees are required to complete a Declaration of Tax Status form to indicate whether his/her dependent is an IRC Section 152 qualified dependent or not.

The IRS provides information on how to determine a dependent’s tax status. The employee may use the *Worksheet for Determining Support* in IRS Publication 501 to assess whether a dependent enrolled on the employee’s PEBB coverage qualifies as a dependent for tax purposes under IRC Section 152. The publication is available at www.irs.gov.

Employees with dependents that do not meet the Section 152 definitions will be able to continue to make premium contributions for their own insurance coverage with pre-tax payroll deductions even though contributions for the non tax-qualified dependents must be deducted on a post-tax basis.

Questions

Direct any questions you have to your legal or tax advisor. Employees with questions should be directed to the IRS web site: www.irs.gov or to their tax advisor.

Note: There is new federal law which requires reporting of medical and dental related contributions and costs on employee W-2 Forms beginning with the 2012 W-2 Form furnished to employees in January 2013. Refer to separate guidance provided for reporting the cost of health care on the W-2 form.

Appendix A – HCA Finance and Administration Final 2012 PEBB Rates

Additional Taxable Income for Non tax-qualified Dependents

Table 1: Employer Share Medical and Dental (FMV)

2012 Monthly State Premium Contribution for Medical and Dental for Active Employees Additional Taxable Income for Non Tax-Qualified Dependent Coverage

| Medical and Dental Plan | Partner* | Subscriber's or Partner's Child(ren)* | Partner and Child(ren)* |
|-------------------------|----------|---------------------------------------|-------------------------|
| All Medical Plans | \$ 479 | \$ 378 | \$ 857 |

Table 2: Employer Share Dental Only (FMV)

Sample chart for dental only enrollment – taxable amount for dependents

| Dental Plan | Partner* | Subscriber's or Partner's Child(ren)* | Partner and Child(ren)* |
|------------------|----------|---------------------------------------|-------------------------|
| All Dental Plans | \$ 45 | \$ 45 | \$ 90 |

*Premiums displayed are rounded to the nearest dollar, consistent with IRS tax reporting. The maximum state contribution (or index rate) is changed annually with the new insurance contracts, currently effective January 1 of each year, for the entire calendar year. The state contribution for employee is not displayed.

State and Higher Education Active Employee Monthly Contributions (Deductions) for Non tax-qualified Dependents

Table 3: Total Monthly Employee Contribution Owed for All Coverage (Pre-tax and post-tax combined)

| Plan Name | Subscriber | Subscriber and Spouse | Subscriber and Child(ren) | Full Family |
|------------------------------|------------|-----------------------|---------------------------|-------------|
| Group Health Classic | \$ 101 | \$ 212 | \$ 177 | \$ 288 |
| Group Health Value | \$ 52 | \$ 114 | \$ 91 | \$ 153 |
| Group Health CDHP | \$ 26 | \$ 62 | \$ 46 | \$ 82 |
| Kaiser Permanente Classic | \$ 89 | \$ 188 | \$ 156 | \$ 255 |
| Kaiser Permanente CDHP | \$ 24 | \$ 58 | \$ 42 | \$ 76 |
| Uniform Medical Plan Classic | \$ 82 | \$ 174 | \$ 144 | \$ 236 |
| Uniform Medical Plan CDHP | \$ 27 | \$ 64 | \$ 47 | \$ 84 |

Table 4: Post-Tax Partner Share for "Subscriber and Spouse" Tier

| Plan Name | Subscriber and Spouse | Subscriber | Partner |
|------------------------------|-----------------------|------------|---------|
| Group Health Classic | \$ 212 | \$ 101 | \$ 111 |
| Group Health Value | \$ 114 | \$ 52 | \$ 62 |
| Group Health CDHP | \$ 62 | \$ 26 | \$ 36 |
| Kaiser Permanente Classic | \$ 188 | \$ 89 | \$ 99 |
| Kaiser Permanente CDHP | \$ 58 | \$ 24 | \$ 34 |
| Uniform Medical Plan Classic | \$ 174 | \$ 82 | \$ 92 |
| Uniform Medical Plan CDHP | \$ 64 | \$ 27 | \$ 37 |

Table 5: Post Tax Partner Share for "Full Family" Tier

| Plan Name | Full Family | Subscriber and Child(ren) | Partner |
|------------------------------|-------------|---------------------------|---------|
| Group Health Classic | \$ 288 | \$ 177 | \$ 111 |
| Group Health Value | \$ 153 | \$ 91 | \$ 62 |
| Group Health CDHP | \$ 82 | \$ 46 | \$ 36 |
| Kaiser Permanente Classic | \$ 255 | \$ 156 | \$ 99 |
| Kaiser Permanente CDHP | \$ 76 | \$ 42 | \$ 34 |
| Uniform Medical Plan Classic | \$ 236 | \$ 144 | \$ 92 |
| Uniform Medical Plan CDHP | \$ 84 | \$ 46 | \$ 37 |

Table 6: Post Tax Partner and Child(ren) Share for "Full Family" Tier

| Plan Name | Full Family | Subscriber | Partner and Child(ren) |
|------------------------------|-------------|------------|------------------------|
| Group Health Classic | \$ 288 | \$ 101 | \$ 187 |
| Group Health Value | \$ 153 | \$ 52 | \$ 101 |
| Group Health CDHP | \$ 82 | \$ 26 | \$ 56 |
| Kaiser Permanente Classic | \$ 255 | \$ 89 | \$ 166 |
| Kaiser Permanente CDHP | \$ 76 | \$ 24 | \$ 52 |
| Uniform Medical Plan Classic | \$ 236 | \$ 82 | \$ 154 |
| Uniform Medical Plan CDHP | \$ 84 | \$ 27 | \$ 57 |

Table 7: Post Tax Partner's Child(ren) Share for "Subscriber and Child(ren)" Tier

| Plan Name | Subscriber and Child(ren) | Subscriber | Partner's Children |
|------------------------------|----------------------------------|-------------------|---------------------------|
| Group Health Classic | \$ 177 | \$ 101 | \$ 76 |
| Group Health Value | \$ 91 | \$ 52 | \$ 39 |
| Group Health CDHP | \$ 46 | \$ 26 | \$ 20 |
| Kaiser Permanente Classic | \$ 156 | \$ 89 | \$ 67 |
| Kaiser Permanente CDHP | \$ 42 | \$ 24 | \$ 18 |
| Uniform Medical Plan Classic | \$ 144 | \$ 82 | \$ 62 |
| Uniform Medical Plan CDHP | \$ 47 | \$ 27 | \$ 20 |

Appendix B – Scenarios as possible combinations of pre-tax and post-tax combinations

| | |
|---|---|
| Subscriber <u>has</u> IRC Section 152: | Health Insurance Deduction should be: |
| Qualified Domestic Partner | Pre-Tax for employee's entire health insurance deduction ¹ (employee + partner) |
| Qualified Domestic Partner and Qualified Dependent Children | Pre-Tax for employee's entire health insurance deduction ¹ (employee + partner + children) |
| Qualified Dependent Child(ren) | Pre-Tax for employee's entire health insurance deduction ¹ (employee + child(ren)) |
| Subscriber <u>does not</u> have IRC Section 152: | Health Insurance Deduction should be: |
| Domestic Partner | Employee's portion – Pre-Tax Domestic Partner's portion – Post-Tax <i>Note: Tax employee for dollar value of state's share coverage for non-qualifying domestic partner also</i> |
| Domestic Partner and Dependent Child(ren) | Employee's portion – Pre-Tax Partner's portion – Post-Tax Child(ren)'s portion – Post-Tax <i>Note: Tax employee for dollar value of state's share coverage for non-qualifying domestic partner also</i> |
| Dependent Child(ren) | Employee's portion – Pre-Tax Child(ren)'s portion – Post-Tax <i>Note: Tax employee for dollar value of state's share coverage for non-qualifying child(ren) also</i> |
| Subscriber has a combination of IRC Section 152 Qualified and Non-Qualified Dependents: | Health Insurance Deduction should be: |
| Non-Qualified Domestic Partner and Qualified Dependent Child(ren) | Employee's portion – Pre-Tax Partner's portion – Post-Tax ¹ Child(ren)'s portion – Pre-Tax ¹ <i>Note: Tax employee for dollar value of state's share coverage for non-qualifying domestic partner also</i> |
| Non-Qualified Domestic Partner and Combination of Qualified and Non-Qualified Dependent Children | Employee's portion – Pre-Tax Partner's portion – Post-Tax Child(ren)'s portion – Post-Tax ² <i>Note: Tax employee for dollar value of state's share coverage for non-qualifying domestic partner also</i> |

¹ Any tax status change from/to non-qualifying during a calendar year will require adjustment to a non-qualifying taxable situation for the entire calendar year, including making retroactive tax changes. **Tax status should be re-verified annually to ensure employers accurately report taxable income and take appropriate employment taxes.**

² Since Health Care Authority does not split the premium on a child by child basis, there is no way to determine separately the portion of the employee's total deduction to pre-tax any qualified 152 children.