

In order to be a dependent, an individual must fit the description of either “qualifying child” or “qualifying relative” under Internal Revenue Code Section 152. A qualifying child is 18 or younger (age 23 or younger if a fulltime student), and resides with the taxpayer for more than half the year. No age limit applies to disabled individuals. Students who are over the age of 23, are less than full-time students, or fail the residency or support test may still qualify as a dependent within the qualifying relative definition. Qualifying relatives include the taxpayer’s children or their descendants, brothers, sisters and stepsiblings, parents and step parents, aunts or uncles of the taxpayer, sons- and daughters-in-law, and mothers- and fathers-in-law. Employees may pay for benefits on a pre-tax basis for dependents and exclude the value of the benefits from gross income. If the child or domestic partner does not meet the Section 152 definition of qualifying child or qualifying dependent, the employer would need to impute the fair market value (FMV) of the coverage to the employee.

There is limited IRS guidance available, mainly in the form of Private Letter Rulings (PLRs). One generally accepted methodology to impute income for FMV is to use the benefit plan’s COBRA rate without the 2% admin fee or to pay for the non-tax-qualified person’s coverage on an after-tax basis. In an instance where the non-tax-qualified dependent can be distinguished or segregated, it would be appropriate to impute the value of a COBRA single coverage as FMV. Another method is to determine the difference between the cost of employee-plus-one and employee-only coverage, after deducting any portion of the cost the employee has paid. The second method typically results in a smaller amount of income being imputed to the employee. Differences in employer plan contribution between single, employee + one, and family coverage levels can give varied results between imputation methods. Employers should review both methods to determine which provides a reasonable result for their plan structure.

Example 1:

Employee pays \$1,192/month for family medical coverage on a pre-tax basis where oldest child is a single 25-year old college graduate. Employer imputes a single COBRA rate (less the 2% admin fee) of \$412/month x 12 months= \$4,944/year imputed income.

Example 2:

Employee pays \$886/month for employee + one coverage that includes a domestic partner. Employer imputes difference between the cost of employee + one and single. $\$886 - \$412 = \$474/\text{month} \times 12 \text{ months} = \$5,688$ imputed income.

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