# Tax Issues Related to PEBB Non-Tax Qualified Dependent Insurance

**January 1, 2010**

## 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, students who aren't tax-qualified dependents) to their employer sponsored insurance must identify their family tax status for the upcoming calendar year. This means that the employee will need to verify whether their dependents are "qualified dependents" under Internal Revenue Code (IRC) Section 152. If the dependent qualifies under IRC Section 152, 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.

## Required Retroactive Tax Treatment

Health Care Authority (HCA) recommends that employees enrolling a non-tax qualified dependent review their tax status declaration annually during the open enrollment period. The declaration requires the employee to anticipate the dependency status of their dependent for the upcoming year. It is also important for employees to report any changes in dependency 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. Some examples of status changes and how to correct them are identified below.

Example 1 – An employee's dependent qualifies as an IRC Section 152 dependent from January 1 through July 31, but ceases to qualify for the remainder of 2009. This requires treating the fair market value (FMV) of the coverage provided for the non-tax qualified dependent as taxable to the employee (subject to federal income tax, social security, and Medicare taxes) for the entire 2009 year. To correct for incorrect treatment prior to notification:

(A) – If notification of the change is received during 2009 it is necessary to collect seven months of federal income tax, social security and Medicare taxes on the FMV of the dependent's coverage from the employee and include the collected taxes in your agency's next tax deposit. The next Form 941 filed must reflect the correction and include Form 941c with an explanation. Be sure the Form W-2 provided in January 2010 includes the FMV of the employer contribution toward the coverage for the entire year.

(B) – If notification of the change is received after 2009, the same corrections as immediately above must be made with respect to social security and Medicare taxes. Federal income taxes cannot be corrected after the calendar year. Be sure the Form W-2 provided in January 2010 includes the FMV of the non-tax qualified dependent's coverage for the entire year. If Form W-2 has already been filed, file Form W-2c showing the corrected amount.

Example 2 – The employee did not indicate that their dependent would qualify as an IRC Section 152 dependent on the tax status form for 2009. However, the dependent actually does qualify for all of 2009. This requires that the FMV of the dependent's coverage not be treated as taxable income to the employee for the entire 2009 year. To correct for incorrect treatment prior to notification:

(A) – If notification of the change is received during 2009, it is necessary to refund or credit to the employee the social security and Medicare taxes already withheld on the FMV of the dependent's coverage during the year. Federal income taxes already withheld on the FMV of the dependent's coverage during the year may be refunded as well, although it is not required. The next Form 941 filed must reflect the correction and include Form 941c with an explanation. Be sure the Form W-2 provided in January 2010 does not include the FMV of the dependent's coverage for any part of the year.

(B) – If notification of the change is received after 2009, the same steps as immediately above must be taken with respect to social security and Medicare taxes. Federal income taxes cannot be corrected after the calendar year. Be sure the Form W-2 provided in January 2010 does not include the FMV of the dependent's coverage for any part of the year. If Form W-2 has already been filed, file form W-2c showing the corrected amount.

Example 3 – The employee indicates that their non-tax qualified dependent , who did not qualify as an IRC Section 152 dependent from January 1 to July 31, will qualify for the rest of the year. This requires no changes or corrections, as the dependent must qualify for the entire year in order to receive favorable tax treatment.

Example 4 – An employee's dependent qualifies as an IRC Section 152 dependent and is properly treated as such from January 1 until her death on August 15. The dependent's death does not change her status for the portion of the year during which she was alive and no adjustments will be necessary.

## IRS Section 152 Non-Qualified Dependents

Employees adding a dependent who does not meet the IRC Section 152 definition of qualified dependents will have additional taxable income, which needs to be taxed and reported. There will be two taxation issues to be addressed.

**The first taxation issue is the state-share premium paid to the insurance carrier.** The FMV of the coverage provided for the non-tax qualified dependent, less any after-tax contributions, is taxable to the employee, and subject to federal income tax, social security, and Medicare taxes. The FMV is not subject to retirement. The taxable amounts are to be regularly taxed as part of payroll reporting and reported in employees' paychecks and their annual Forms W-2, Wage and Tax Statements.

The FMV captured will represent the *actual* premium paid by the HCA to the insurance carrier for the coverage selected. Although the state funding mechanism uses a composite employer contribution per full-time equivalent employee, the state payments for insurance coverage are paid on a "tiered" basis and "capped" at a maximum state contribution per tier. The actual state contribution can be captured and reported per tier, reflecting the enrollment of a non-tax qualified dependent.

Premiums for calendar year 2010 are in Appendix A. Tables 1 and 2 represent taxable amounts for non-tax qualified dependents. Both tables reflect the *net* taxable value to employees. The responsible employing agency is to tax the employee the taxable amount based on the appropriate tier in tables 1 and 2 in Appendix A.

**The second taxation issue is the treatment of the employee contributions for non-qualified dependents.** The part of the employee contributions for non-qualifying Section 152 dependents cannot be deducted on a pre-tax basis because they are not eligible for the IRC Section 125 treatment. Payroll systems will provide a means whereby the employees can continue to have deductions for their own portion of the total contribution pre-taxed if they have opted for this choice. However, that portion of the employee's deduction attributable to a non-qualifying dependent(s) will need to be taken on an after-tax (post–tax) basis. Tables 3-7 with the correct combination of pre-tax and post-tax amounts, depending on the employee's family enrollment, are in Appendix A. Scenarios identified as possible combinations of pre-tax and post-tax contributions are in Appendix B.

## "Declaration of Tax Status" Form

Employees are required to fill out a Declaration of Tax Status form to indicate whether his/her non-tax qualified dependent is an IRC Section 152 qualified dependent or not. The tax status form has a worksheet (modeled from an Internal Revenue Service (IRS) form) to help the employee determine the tax status. The tax status form references the state's Section 125 payroll deductions, established under IRC Section 125. Employees with dependents that do not meet the Section 152 definitions will be able to continue to make their own premium contributions with pre-taxed payroll deductions even though contributions for the dependents must be deducted on a post-tax basis.

## Determining Dependent Tax Status Worksheet

The Determining Dependent Tax Status form packet includes a Worksheet for Determining Dependent Status modeled after the IRS worksheet in the IRS publication 17, entitled Table 3-1. If employees have questions or would like to see the full text of Publication 17, Chapter 3, they can download this information from the IRS web site. The IRS address is http://www.irs.gov/pub/irs-pdf/p17.pdf. Employees can also order Publication 17 by calling the IRS publications request number – 1-800-829-3676.

## Who to Contact if You Have Questions

If you have questions related to this document, you may contact the HCA training unit at 1-800-700-1555.

## **Appendix A –** *HCA Finance and Administration Final 2010 PEBB Rates*

**Table 1:** Employer Share Medical and Dental

2010 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 | $ 428 | $ 340 | $ 768 |

**Table 2:** Employer Share Dental Only
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 Domestic 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 |
|---|---|---|---|---|
| Aetna Public Employee Plan | $ 132 | $ 274 | $ 231 | $ 373 |
| GHC Classic | $ 71 | $ 152 | $ 124 | $ 205 |
| GHC Value | $ 22 | $ 54 | $ 39 | $ 71 |
| Kaiser Classic | $ 72 | $ 154 | $ 126 | $ 208 |
| Kaiser Value | $ 42 | $ 94 | $ 74 | $ 126 |
| Uniform Medical Plan PPO | $ 41 | $ 92 | $ 72 | $ 123 |

**Table 4**: Post-Tax Partner Share for “Subscriber and Spouse” Tier

| Plan Name | Subscriber and Spouse | Subscriber | Partner |
|---|---|---|---|
| Aetna Public Employee Plan | $ 274 | $ 132 | $ 142 |
| GHC Classic | $ 152 | $ 71 | $ 81 |
| GHC Value | $ 54 | $ 22 | $ 32 |
| Kaiser Classic | $ 154 | $ 72 | $ 82 |
| Kaiser Value | $ 94 | $ 42 | $ 52 |
| Uniform Medical Plan PPO | $ 92 | $ 41 | $ 51 |

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

| Plan Name | Full Family | Subscriber and Child(ren) | Partner |
|---|---|---|---|
| Aetna Public Employee Plan | $ 373 | $ 231 | $ 142 |
| GHC Classic | $ 205 | $ 124 | $ 81 |
| GHC Value | $ 71 | $ 39 | $ 32 |
| Kaiser Classic | $ 208 | $ 126 | $ 82 |
| Kaiser Value | $ 126 | $ 74 | $ 52 |
| Uniform Medical Plan PPO | $ 123 | $ 72 | $ 51 |

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

| Plan Name | Full Family | Subscriber | Partner and Child(ren) |
|---|---|---|---|
| Aetna Public Employee Plan | $ 373 | $ 132 | $ 241 |
| GHC Classic | $ 205 | $ 71 | $ 134 |
| GHC Value | $ 71 | $ 22 | $ 49 |
| Kaiser Classic | $ 208 | $ 72 | $ 136 |
| Kaiser Value | $ 126 | $ 42 | $ 84 |
| Uniform Medical Plan PPO | $ 123 | $ 41 | $ 82 |

**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 |
|---|---|---|---|
| Aetna Public Employee Plan | $ 231 | $ 132 | $ 99 |
| GHC Classic | $ 124 | $ 71 | $ 53 |
| GHC Value | $ 39 | $ 22 | $ 17 |
| Kaiser Classic | $ 126 | $ 72 | $ 54 |
| Kaiser Value | $ 74 | $ 42 | $ 32 |
| Uniform Medical Plan PPO | $ 72 | $ 41 | $ 31 |

## Appendix B

## Scenarios identified as possible combinations of pre-tax and post-tax contributions:

**A. Subscriber + Qualified 152 Domestic Partner**
Pre-tax employee's entire health insurance deduction[1] (employee + partner)

**B. Subscriber + Qualified 152 Domestic Partner + Qualified 152 Dependent Child(ren)**
Pre-tax employee's entire health insurance deduction[1] (employee + partner + child(ren))

**C. Subscriber + Qualified 152 Dependent Child(ren)**
Pre-tax employee's entire health insurance deduction[1] (employee + child(ren))

**D. Subscriber + Non-Qualified 152 Domestic Partner**
Pre-tax employee's portion of total deduction and post-tax partner's portion
(Also tax employee for $ value of state's share coverage for non-qualifying partner)

**E. Subscriber + Non-Qualified 152 Domestic Partner + Qualified 152 Dependent Child(ren)**
Pre-tax employee and child(ren)'s portion of total deduction and post-tax partner's portion[1]
(Also tax employee for $ value of state's share coverage for non-qualifying partner)

**F. Subscriber + Non-Qualified 152 Domestic Partner + Non-Qualified 152 Dependent Child(ren)**
Pre-tax the employee's portion of total deduction, and post-tax the partner and child(ren)'s portion. (Note: Tax the employee for $ value of state's share coverage for non-qualifying partner and child(ren))

**G. Subscriber + Non-Qualified 152 Child(ren)**
Pre-tax employee's portion of total deduction and post-tax child(ren)'s portion.
(Also tax employee for $ value of state's share coverage for non-qualifying child(ren))

**H. Subscriber + Non-Qualified 152 Domestic Partner + Combination of Qualified 152 and Non-Qualified 152 Children**
Pre-tax employee's portion of total deduction and post-tax partner and all children's portions.[2] (Tax the employee for $ value of state's share coverage for non-qualifying partner and children)

(1) Any tax status change from/to non-qualifying during the 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 separately determine a portion of the employee's total deduction to pre-tax any Qualified 152 children.