SEGAL Bulletin

Benefits, Compensation and HR Consulting

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Benefit Implications of the New IRC Definition of "Dependent"

The recently enacted Working Families Tax Relief Act of 2004 (WFTRA)[1] included some surprises for health and welfare plans. The law was intended to establish one uniform definition of the term "qualifying child" for the Internal Revenue Code (IRC) provisions that provide tax benefits to taxpayers with children (*e.g.*, the dependency exemption and the dependent care credit). Although the law was not designed primarily with employee benefit plans in mind, benefit plans are affected because the law significantly revises a critical IRC section (§152's definition of "dependent"). As of January 1, 2005, plan sponsors of dependent care assistance programs (DCAPs) must adhere to new eligibility criteria for certain dependents. In addition, health plan sponsors may need to make technical amendments to their plan documents if they want to continue providing coverage to the same types of dependents.

THREE SIGNIFICANT CHANGES

The WFTRA makes three significant changes to the definition of dependent in IRC §152 that will affect group health plans:[2]

- ***New Age Limit for a "Qualifying Child"*** A qualifying child must be age 18 or younger. (Full-time students must be age 23 or younger.)[3]
- ***Residence Test for a "Qualifying Child"*** A qualifying child must have the same principal place of abode as the employee for more than half of the year.[4]
- ***Gross Income Test Established for "Qualifying Relatives"*** A dependent (including a child) who is not a "qualifying child" may be a "qualifying relative." Such a dependent must have gross income less than a certain amount (for 2005, that amount will be $3,200). The gross income test can be negated by health plans, but plan documents may require amendments to do so. This change also affects DCAPs.

IMPLICATIONS FOR BENEFIT PLANS

These changes have important implications for DCAPs and health plans. Plan sponsors will need to act immediately to assure compliance by January 1, 2005.

Immediate Impact on DCAPs

Under DCAPs, employees may be reimbursed for certain dependent care expenses incurred for either (1) a dependent under age 13 for whom the employee is entitled to a tax deduction (for example, day care expenses for a two-year-old dependent child), or (2) a dependent or spouse who is physically or mentally incapable of caring for himself or herself, such as an elderly parent who is in adult day care. Beginning January 1, 2005:

- An adult dependent under a DCAP plan, such as an employee's parent, must have gross income that is less than $3,200 in 2005.
- An adult dependent under a DCAP plan must have the same principal place of abode as the employee for more than half of the tax year.

[1] The WFTRA, Public Law No. 108-311, was signed by President Bush on October 4, 2004. Treasury Notice 2004-79, issued on November 17, 2004, clarified a technical issue raised by the lack of certain conforming language in the statute.

[2] The Segal Company has prepared a chart describing the eligibility criteria for specific types of dependents, which is available on the following Web page: http://www.segalco.com/publications/presentations/dependent.pdf

[3] Under the new law, a qualifying child is a child who has *not* reached age 19 by the end of the calendar year or is a full-time student who has *not* reached age 24 by the end of the calendar year.

[4] Special rules apply to children of divorced or separated parents.

If the DCAP plan does not ensure that each dependent meets these two new requirements before reimbursing expenses incurred by the employee for caring for such individuals, the DCAP plan may lose its tax-favored status.

These new requirements must be clear in open enrollment materials and plan documents. For plans that have already completed open enrollment for 2005, all individuals that have elected coverage under the DCAP should be notified that these two new rules now apply. The Treasury Department has stated informally that the changes required by the WFTRA can qualify as a change in status under relevant regulations. Thus, a participant may drop the adult dependent from coverage under the plan and stop or lower the salary reduction in response to this change in law.

Immediate Impact on Health Plans

All health plan sponsors should examine their plan documents (including §125 documents) and summary plan descriptions (SPDs) to determine whether they should be revised in light of the WFTRA. Some examples of revisions that will be necessary are the following:

- Health plans that currently define eligibility for dependent coverage (for children, parents, other relatives or domestic partners) by referring to §152 (or by using such language as "federal tax dependents") — and that wish to negate the otherwise applicable gross income test — should amend governing plan documents before the end of calendar year 2004.

- Health plans that provide benefits to children over age 23 (or to children who do not live with the employee) should review their plan documents. Under the new law, such children must generally have gross income less than a certain amount ($3,200 in 2005). The WFTRA allows plan sponsors to negate the income limitation and cover such children if the employee provides over half of the child's support. However, a plan amendment would likely be necessary to accomplish this.

Plan sponsors may also wish to review the certification requirements currently in place for designating dependents for health benefits purposes.

Special Issues for HSAs

Due to a technical problem in the statute, distributions from Health Savings Accounts (HSAs) will only be permitted if the dependent satisfies all the requirements of §152, including the gross income test (which would apply both to non-child dependents as well as to children who do not meet the age or residence limits noted on page 1 of this *Bulletin*).

Opportunity to Reassess Dependent Coverage Requirements

Under the guise of simplicity, the WFTRA actually makes dependent qualification more complicated for plan sponsors. One illustration of this complexity is the two tracks that children can take to become eligible dependents — via the "qualifying child" route or the "qualifying relative" route. These alternate routes of qualifying for dependent status mean that plans have various options for defining who is an eligible dependent. Whether a plan sponsor decides to keep the plan's existing eligibility criteria (and make technical amendments to the plan, as necessary) or make changes to more closely track the new §152, the enactment of the WFTRA provides a good opportunity to confirm that the plan's dependent coverage priorities are being met.

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As with all issues involving the interpretation or application of laws and regulations, employers should rely on their attorneys for authoritative advice on the interpretation and application of the WFTRA. Segal can be retained to work with employers and their attorneys to review whether amendments are advisable and to assist in making amendments.

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