



PAYSTATE UPDATE

The Latest State and Local Payroll Compliance News from the American Payroll Association

State Conformity to Federal Tax Treatment of Health Care Benefits for Children Under Age 27

Two federal laws – the Patient Protection and Affordable Care Act (Pub. L. No. 111-148) and the Health Care and Education Reconciliation Act of 2010 (Pub. L. No. 111-152) (known jointly as the Affordable Health Care Act) – were signed into law on March 23 and 30, 2010, respectively. Effective March 30, 2010, the Affordable Health Care Act amended the Internal Revenue Code (IRC) to extend the general exclusion from gross income for employer-provided health insurance and reimbursements for medical care under an employer-provided accident or health plan to any employee's child who has not attained age 27 as of the end of the taxable year. When the Affordable Health Care Act took effect, many payroll professionals wondered which states would conform to this federal tax treatment.

Federal tax treatment

This new age 27 standard replaces the lower age limits that applied under prior federal tax law, as well as the requirement that a child generally qualify as a dependent for tax purposes. Under the Affordable Health Care Act, if a child is age 26 or less at the end of the tax year, the income exclusion applies even if the child provides more than one-half of his or her own support, earns more income than the exemption amount, does not live with the taxpayer, is married, or if any other restriction applies which prevents the employee from claiming a dependency exemption. A "child" includes a son, daughter, stepchild, adopted child, or eligible foster child.

The Internal Revenue Service has issued guidance on the federal tax treatment of the exclusion (IRS Notice 2010-38, Tax Treatment of Health Care Benefits Provided With Respect to Children Under Age 27, 5-17-10, at www.irs.gov/irb/2010-20_IRB/ar08.html; see *PAYROLL CURRENTLY*, Issue No. 5, Vol. 18) and interim final regulations (75 F.R. 27122, 5-13-10, at <http://edocket.access.gpo.gov/2010/pdf/2010-11391.pdf>; see *PAYROLL CURRENTLY*, Issue No. 6, Vol. 18).

Conforming states

States that use the current version of the IRC automatically adopt changes to the IRC, so the exclusion applies in those states. These states are: Alabama, Colorado, Connecticut, Delaware, District of Columbia, Illinois, Kansas, Louisiana, Maryland, Michigan, Missouri, Montana, Nebraska, New Mexico, New York, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, Utah, and Vermont.

Nonconforming states

Other states do not conform to the IRC as of the enactment date of the Affordable Health Care Act (March 30, 2010). Therefore, the income exclusion does not apply for those states' tax purposes. These states are: Arizona, Arkansas, California, Georgia, Hawaii, Idaho, Indiana, Iowa, Kentucky, Maine, Massachusetts, Minnesota, North Carolina, Oregon, South Carolina, Virginia, West Virginia, and Wisconsin.



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Mississippi and New Jersey make no reference to the Internal Revenue Code as a basis for calculating state taxable income.

Due to the timing of the Act's passage, many of the nonconforming states' legislatures had already adjourned for the year. Only three states – California, Minnesota, and Wisconsin – have directly addressed the issue, stating that they will not be following the amended federal exclusion this year:

- California did consider, but failed to pass, conforming legislation. California's conformity date is January 1, 2009. "For taxable years beginning on or after January 1, 2010, California conforms by reference to IRC §105, relating to exclusions from income for amounts received under accident and health plans, as of the 'specified date' of January 1, 2009, with modifications. Because this provision was enacted after the 'specified date,' California does not conform to the federal change..." explains the California Franchise Tax Board (see pages 128 and 129 at www.ftb.ca.gov/law/legis/2010FedHealthCareActs.pdf). A California bill (A.B. 1178) was introduced to conform California law to many of the tax provisions of the federal health care legislation. However, the bill failed to pass during the 2010 legislative session, which ended on September 1, 2010.

- Minnesota withholding not required. Minnesota does not follow the current version of the IRC, and it did not enact conforming legislation. However, until the Minnesota legislature has had the opportunity to fully address this issue (it reconvenes on January 4, 2011), the Minnesota Department of Revenue will not require employers to withhold taxes from those federally exempt employer-provided benefits. Employees must still include the benefits as income on their 2010 Minnesota income tax returns. If employees think they will be underwithheld, they may complete Form W-4MN, Minnesota Employee Withholding Allowance/Exemption Certificate, to elect additional withholding [DOR, What's New for Employers for Tax Year 2010?].

- Wisconsin provides that child must qualify as a dependent. The Wisconsin legislature adjourned prior to adopting conforming legislation. It is anticipated that it will consider whether to adopt these provisions in the next session which will begin in January 2011. The Wisconsin Department of Revenue advises that, for Wisconsin purposes, the child under age 27 must qualify as a dependent for income tax purposes. If not, the fair market value of the adult child's health insurance coverage is income and reimbursements from a medical flexible spending account are income and taxable wages to the employee. Employers must either: (1) include the amount that is taxable for Wisconsin purposes (but not taxable for federal purposes) in Box 16 of the 2010 Form W-2; or (2) provide employees with a supplemental "Wisconsin only" Form W-2 with the taxable benefits shown in Box 16 [DOR, News for Tax Professionals, 8-3-10].

States must follow eligibility requirements

Be advised that many states have their own eligibility requirements for adult children to be covered under their parents' health insurance plans. Federal law, which now requires employer-provided health insurance plans to cover adult children until they



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reach age 26, takes precedence over these state laws unless a state has a more favorable eligibility entitlement. For example, Ohio law permits a child to be covered until age 28. The Ohio Department of Taxation instructs employers that provide health coverage plans – the costs of which are partially excluded under the IRC and partially deductible under the Ohio Revised Code – to report the difference on the Forms W-2 of the affected employees. The employer will show in Box 14, “Other,” the amount the employee paid with taxable wages for health coverage. This will be one of the adjustments made on Line 2 of the Ohio personal income tax return.