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IRS Clarifies Rules Regarding Adult Dependents

On April 27, 2010, the IRS issued [Notice 2010-38](#), relating to the tax exclusion for medical care reimbursement of adult children. These changes are a result of the two health care reform laws passed in March: the Patient Protection and Affordable Care Act (PPACA) and the Health Care and Education Reconciliation Act (HCERA).

The Notice collectively refers to these laws as the Affordable Care Act. Two major changes resulted for adult children of covered employees. First, group health plans must begin to cover adult children up to age 26 for plan years starting after September 23, 2010. Second, the definition of a "dependent" includes adult children up to age 27 for medical care reimbursements under Sec. 105(b) of the Internal Revenue Code. *Notice 2010-38 is concerned with the second change.*

The IRS clarified that the expansion of the tax exclusion went into effect when HCERA became law on March 30, 2010. This has an immediate effect on plans that define eligibility based on Sec. 105(b), including Health FSAs and health reimbursement arrangements (HRAs).

The Notice makes several important points:

- The tax exclusion applies for medical care reimbursements of individuals who are not age 27 or older at any time during the calendar year. For example, if an adult child turns 27 in any month of 2010, a Health FSA/HRA cannot reimburse any 2010 expenses for that adult child. *However, expenses for adult children who are 26 or younger as of the end of the calendar year may be reimbursed if incurred on or after March 30, 2010.*
- Employers may rely on an employee's representation as to the birth date of the adult child.
- An adult child is defined by reference to Sec. 152(f)(1): son/daughter, stepson/stepdaughter, adopted child or eligible foster child. **The other qualifying child requirements in Sec. 152 no longer apply for establishing dependent status. These other requirements include residency and amount of support provided. The amount of the dependent's income does not matter.**
- **This expansion applies to married and unmarried adult children.** It does not apply to the spouse or children of those adult children.
- Current Sec. 1.125-4 rules allow election changes for change in status events. A change in status includes the addition of a dependent under Sec. 152. The IRS indicated that it will change (retroactive to March 30, 2010) this rule to include adult children under age 27. *What this means is that participants who add an adult child dependent can increase their current year Health FSA election.*
- The IRS will permit a onetime exception to the rule that all plan changes must be prospective. Employers may amend their cafeteria plans retroactively to allow pre-tax salary reductions for adult children as long as they execute the amendment by December 31, 2010. *Most plan documents currently refer to Sec. 105(b), so they include the expansive definition of an adult child already.*
- The IRS will amend its Sec. 106 Regulations (relating to accident and health insurance) to match the changes to Sec. 105, even though the Affordable Care Act did not specifically address Sec. 106.
- This expansion also applies to health care accounts in pension plans (Sec. 401(h)), voluntary employee benefit associations, or VEBA's (Sec. 501(c)(9)), and the self-employed medical tax deduction (Sec. 162).
- This expansion does not appear to apply to Health Savings Accounts.

The following is a summary of the two provisions relating to adult children:

	Plan Coverage Mandate	Tax Deductibility of Medical Care Coverage and Claims
Brief description	Plans that cover dependent children must provide for coverage of adult children until they turn age 26.	Medical care coverage and claims for adult children are tax deductible until the year in which an adult child turns age 27.
Application to spouse/children of adult child	Not applicable.	Not applicable.
Additional effect	Grandfathered plans can prohibit adult children who are eligible for other group coverage.	Election changes are permitted for adding a new dependent.
Effective date	Plan years starting after September 23, 2010.	March 30, 2010.
Health Care Reform law provision	Sec. 1001 of PPACA and Sec. 2301 of HCERA.	Sec. 1004 of HCERA.
Applies to existing law	Sec. 2714 of the Public Health Service Act.	Sec. 105(b) of the Internal Revenue Code.

Several major insurance carriers (e.g., CIGNA, UnitedHealth Group and Humana) have already announced they are adding eligible adult children ahead of September 23, 2010, unless plan sponsors object. Some self-funded employers are doing likewise.

Recall that prior to the Affordable Care Act, tax-free coverage was available for dependent children up to age 19, or age 25 from most plans with or without student status. Dependent status was based on satisfying one of two tests as either a qualifying child or a qualifying relative under Sec. 152(c) and (d), respectively. For purposes of providing tax-free medical coverage, the Affordable Care Act has now made it much easier for adult children to qualify.