



AMERICAN BENEFITS  
COUNCIL

April 27, 2010

ANALYSIS OF IRS NOTICE 2010-38,  
GUIDANCE FOR TAX TREATMENT OF CERTAIN EMPLOYEE BENEFIT PLANS  
UNDER NEW HEALTH LEGISLATION

PREPARED FOR THE COUNCIL BY SETH PERRETTA OF DAVIS & HARMAN LLP

The Internal Revenue Service (IRS) has released Notice 2010-38, which provides important guidance for plan sponsors regarding certain changes made to the Internal Revenue Code (IRC) by the health reform legislation that was enacted earlier this year, specifically the Patient Protection and Affordable Care Act, Pub. L. No. 111-149 (PPACA), and the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152 (HCERA).

Generally, PPACA § 1001 amended the Public Health Service Act (PHSA) to require group health plans and health insurance issuers that provide dependent child coverage to make corresponding coverage available to an employee's adult children until age 26. HCERA included a corresponding change to IRC § 105(b), which makes excludable from an employee's income any employer-paid coverage attributable to the employee's child to the extent such child is not yet age 27 during the taxable year. HCERA also included numerous conforming changes to the IRC regarding voluntary employees beneficiary associations (VEBAs), IRC § 401(h) transfer accounts, and the deduction for medical insurance for self-employed persons under IRC § 162(l). Notice 2010-38 specifically addresses the tax changes made by HCERA in connection with the new adult child coverage provisions of the PHSA, as added by the PPACA.

Highlights of the guidance are as follows:

- ***IRC § 152 dependency tests do NOT apply in determining qualifying adult child status.*** Notice 2010-38 makes clear that the age, limit, residency and support tests applicable to IRC § 152 dependents do not apply in determining whether an individual qualifies as an adult child for purposes of tax-free employer-paid coverage. Thus, to qualify, an adult child need only be less than 27 for the

taxable year at issue and be a legal child, step-child or eligible foster child of the employee in order to qualify.

- ***“Taxable year” means employee’s taxable year and employers may assume a calendar year.*** As noted above, HCERA amended IRC § 105(b) to make excludable from an employee’s income any employer-paid coverage attributable to the employee’s child to the extent such child is not yet age 27 during the “taxable year” at issue. Notice 2010-38 makes clear that “taxable year” means the employee’s taxable year. The guidance goes on to state that employers may assume that an employee’s taxable year is the calendar year.
- ***Employers may rely on employees’ representations regarding children’s date of birth.*** Notice 2010-38 provides that employers may rely on an employee’s representation as to the child’s date of birth. This is obviously welcome news for employers. Notably, the guidance is silent as to whether such representations must be in writing.
- ***Effective March 30, 2010, extends IRC § 105(b) changes to IRC § 106; announces anticipated formal regulations regarding the same.*** Although HCERA amended IRC § 105(b) (regarding amounts received by an employee under employer-paid coverage), HCERA did not make a corresponding change to IRC § 106 (which makes excludable the employer-paid coverage itself). Notice 2010-38 addresses this issue and notes that “[t]here is no indication that Congress intended to provide a broader exclusion in § 105(b) than in § 106”, and that, therefore, “IRS and Treasury intend to amend the regulations under § 106, retroactively to March 30, 2010, to provide that coverage for an employee’s child under age 27 is excluded from gross income.” The Notice goes on to state that –

Thus, on and after March 30, 2010, both coverage under an employer-provided accident or health plan and amounts paid or reimbursed under such a plan for medical care expenses of ... an employee’s [qualifying adult] child ... are excluded from the employee’s gross income.

- ***Announces anticipated regulations extending mid-year election change rules regarding qualifying adult children.*** Existing Treas. Reg. § 1.125-4(c) does not permit mid-year changes to cafeteria plan elections where a coverage change results from an individual either qualifying or no longer qualifying as an adult child (this is because such election changes may only apply with respect to an employee, spouse, and dependents based on a modified IRC § 152 definition). This could have posed significant administrative difficulties and employee relations issues for employers in administering extended adult child coverage. Thankfully, Notice 2010-38 expressly states that “IRS and Treasury intend to amend the regulations under § 1.125-4, effective retroactively to March 30, 2010, to include change in status events affecting nondependent children under age 27,

including becoming newly eligible for coverage or eligible for coverage beyond the date on which the child otherwise would have lost coverage.” This is obviously welcome news for employers and employees alike.

- ***Provides transition rule for cafeteria plan amendments relating to 2010 plan year.*** Notice 2010-38 provides a transition rule for cafeteria plan amendments. Pursuant to Prop. Treas. Reg. § 1.125-1(c), cafeteria plan amendments generally may only be effective on a prospective basis and may not be retroactive. The guidance acknowledges, however, that some cafeteria plans may need to be amended to include an employee's qualifying adult child for purposes of the 2010 plan year. Accordingly, the guidance states as follows:

Notwithstanding this general rule, as of March 30, 2010, employers may permit employees to immediately make pre-tax salary reduction contributions for accident or health benefits under a cafeteria plan (including a health FSA) for children under age 27, even if the cafeteria plan has not yet been amended to cover these individuals. However, a retroactive amendment to a cafeteria plan to cover children under age 27 must be made no later than December 31, 2010, and must be effective retroactively to the first date in 2010 when employees are permitted to make pre-tax salary reduction contributions to cover children under age 27 (but in no event before March 30, 2010).

Thus, under the transition rule, plans are permitted to allow employees to pre-tax premiums for coverage attributable to a qualifying adult child, even in the absence of a plan amendment, so long as the plan is amended on or before December 31, 2010. Moreover, under the terms contained in the Notice, the amendment must relate back to the first date in 2010 when employees were permitted to make pre-tax salary reduction contributions to cover children under age 27, but in no event before March 30, 2010.

- ***Clarifies that tax changes apply to Health Reimbursement Arrangements (HRAs).*** Notice 2010-38 clarifies that that the guidance applies equally to health reimbursement arrangements (HRAs).
- ***Adult Child coverage excepted from wages for FICA/FUTA purposes.*** Notice 2010-38 makes clear that qualifying adult child coverage, and any benefits received thereunder, are not wages for purposes of FICA and FUTA.
- ***Clarifies conforming changes to VEBAs, IRC § 401(h) transfer accounts and deductions for self-employed individuals under IRC § 162(l).*** Notice 2010-38 describes certain conforming changes included in the health reform legislation with respect to VEBAs, IRC § 401(h) accounts, and the deduction for medical insurance for self-employed persons under IRC § 162(l).

- Regarding VEBA, the guidance makes clear that for purposes of providing for the payment of sick and accident benefits to members of a VEBA and their dependents, the term dependent includes any qualifying adult child (i.e., a child who has not attained age 27 by the close of the calendar year).
- Regarding IRC § 401(h) accounts, the guidance explains that, as amended by the PPACA, IRC § 401(h) “provides that the term dependent includes any individual who is a retired employee’s [qualifying adult] child” (i.e., a child who has not attained age 27 by the close of the calendar year).
- Regarding IRC § 162(l), the guidance states that IRC § 162(l), as amended, now covers expenses associated with medical insurance attributable to a qualifying adult child (i.e., a child who has not attained age 27 by the close of the calendar year).