

Client Advisory | July 2010

## Health Care Reform: Extension of Group Health Plan Coverage to Adult Children

The Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 (collectively, the “Affordable Care Act”) require group health plans and insurers that provide dependent coverage to extend health care coverage to adult children until they reach age 26.



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The Affordable Care Act also expands the Internal Revenue Code’s (the “Code”) favorable tax treatment for employer-provided health benefits and coverage provided to an employee’s child who has not reached age 27. Interim final regulations (the “Regulations”) jointly issued by the Departments of Treasury, Labor and Health and Human Services and IRS Notice 2010-38 (the “Notice”) relating to the income exclusion of employer-provided health care benefits for adult children offer plan sponsors useful information necessary to implement the Act’s mandate and the related changes to the tax treatment of such coverage.

The extended dependent coverage is generally effective for plan years beginning on or after September 23, 2010. (See below “Delayed Effective Date for Grandfathered Plans”.)

### Definition of Adult Child

For purposes of extending dependent coverage to children who have not yet reached age 26, the Regulations make clear that a plan must define “dependent” only in terms of the relationship between the child and the participant. Factors including financial dependency on the participant, residency with the participant, student status, employment, marital status and eligibility for other coverage cannot be used to determine dependent status.

### Uniform Cost and Coverage

Under the Regulations, dependent coverage cannot vary based on the age of a child,

except for children age 26 or older. For example, imposing a surcharge only on children older than a certain age is prohibited. Likewise, a plan cannot vary benefits based on the age of a child; all benefit options available to a minor child must be made available to an adult child.

However, the Regulations make clear that plans may offer different levels of coverage, the cost of which increases based on the number of dependents covered. For example, as long as the coverage distinctions are not age-based, a plan may offer a choice among coverage tiers based on the number of individuals enrolled (such as employee, employee-plus-one, employee-plus-three) and charge different amounts for each coverage tier.

### Special Enrollment Rights

Special enrollment rights are afforded to adult children who become eligible for coverage by reason of the Affordable Care Act. An adult child who, prior to the mandate’s applicability, lost coverage or whose coverage was denied (and was never enrolled in the plan) because the plan terms did not extend dependent coverage to age 26, will have the right to enroll in the plan, even if such child is receiving healthcare continuation coverage benefits under COBRA. A group health plan must give such children an enrollment opportunity that continues for at least 30 days, including written notice of such opportunity to enroll. The enrollment opportunity must be provided no later than the first day of the first plan year

beginning on or after September 23, 2010 (for calendar year plans, January 1, 2011).

The written notice explaining the availability of dependent coverage and the special enrollment rights may be given to the employee on behalf of the employee's child. The notice may be included with other enrollment materials provided to employees as long as the notice is prominent.

A child enrolling in group health coverage under this special enrollment opportunity is treated as a "special enrollee", as under the HIPAA rules. Accordingly, the adult child must be offered all benefit packages available to similarly situated individuals who did not lose coverage because of age. If the employee/parent is otherwise eligible but not enrolled in the plan, the plan must provide an opportunity to enroll the parent in addition to the child. Similarly, the plan must allow a parent to change benefit package options.

Many plans can use their existing annual enrollment period to satisfy this special enrollment opportunity requirement. If the child elects coverage during this special enrollment period, the coverage must be provided effective as of the first day of *that* plan year, even if the request for enrollment is made after the first day of the plan year. For example, if the special enrollment period begins on December 15, 2010 and the adult child elects to enroll in the plan on January 5, 2011, coverage will be retroactive to January 1, 2011.

### **Delayed Effective Date for Grandfathered Plans**

The Regulations provide a temporary exemption for "grandfathered" health plans -- those group health plans in existence on March 23, 2010, the Act's enactment date. For plan years beginning before January 1, 2014, grandfathered plans may exclude an adult child who has not attained age 26 if the child is eligible to enroll in another employer-sponsored group health plan, other than a group health plan of the parent. Thus, if an adult child is eligible for health plan coverage from his or her employer, the parent's grandfathered plan will not be required to extend dependent coverage to that adult child. For plan years beginning on or after January 1, 2014, the extended dependent coverage requirement will apply to all group health plans, including grandfathered plans

and regardless of whether other coverage is available to the child.

### **Favorable Tax Treatment**

The Code generally excludes from an employee's gross income the cost of coverage and reimbursements for medical care expenses under an employer-provided health plan to an employee, an employee's spouse or an employee's dependents. Prior to the Affordable Care Act, the definition of "dependent" was limited to an employee's child under age 19, or age 24 if a full-time student.

The Affordable Care Act does not change the existing tax-law definition of dependent but adds children who have not attained age 27 as of the end of the taxable year as a separate group eligible for the favorable exclusion from income for employer-provided health care benefits. Under the Code, a child is defined to include an individual who is the son, daughter, stepson or stepdaughter, or eligible foster child of the employee, including an individual legally adopted by the employee or placed with the employee for adoption by the employee. Thus, an individual who qualifies as a child and will not reach age 27 at any time during the taxable year will be eligible to receive the favorable tax treatment even if the individual otherwise does not qualify as a dependent under the Code (for example, does not satisfy the principal residence or financial support requirements to be a tax dependent). Employers that are currently imputing income to an employee for coverage provided to adult children who do not qualify as the employee's tax dependent should immediately cease doing so, for periods beginning after March 30, 2010.

Although the Affordable Care Act does not require a plan to cover adult children until the first plan year beginning on or after September 23, 2010, the Notice states that the favorable tax treatment is effective as of March 30, 2010. Further, the income exclusion continues to apply to children who have not attained age 27 (as of December 31) while the Affordable Care Act mandate applies to children under age 26. The difference in the age limits appears to be intended to ensure that the income exclusion would continue to apply if the employer-sponsored group health plan voluntarily allows coverage to continue through the end of the year of the child's 26<sup>th</sup> birthday.

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## Impact on Cafeteria Plans, FSAs and HRAs

The Notice makes it clear that employees may pay for the cost of health plan coverage for a child under age 27 on a pre-tax basis under a Code Section 125 cafeteria plan, and may make pre-tax salary reduction contributions to a health flexible spending account plan (FSA) that may be used to reimburse medical expenses incurred by a child under age 27, even if the cafeteria plan has not been amended to cover these individuals. Further, expenses incurred by a child under age 27 may be reimbursed from a health reimbursement arrangement (HRA). However, since the Affordable Care Act did not amend Code Section 223, which governs health savings accounts (HSA), and the Notice does not mention HSAs, it appears that expenses incurred for an adult child who does not otherwise qualify as a tax dependent cannot be reimbursed from an HSA.

A retroactive plan amendment to the 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 (on or after March 31, 2010) on which employees are permitted to make such pre-tax salary reduction contributions.

The Notice indicates that the IRS intends to amend the change in status

election rules, effective retroactively to March 31, 2010, to permit employees to revoke and make a new election upon change-in-status events affecting nondependent children under age 27, including becoming newly eligible for coverage or remaining eligible for coverage beyond the date on which the child otherwise would have lost coverage.

### Other Clarifications

The Notice clarifies:

- Expenses incurred by a child under age 27 may be reimbursed from a health reimbursement arrangement.
- Coverage and reimbursements under an employer-provided health plan for children under age 27 are not considered wages for FICA/FUTA purposes and are exempt from income tax withholding.
- The definition of “dependent” includes an employee’s child under age 27 for VEBAs, 401(h) accounts and deductions for self-employed individuals under Code Section 162(l).

We continue to monitor the relevant federal agencies as the implementation of health-care reform moves forward and will provide timely updates as notable developments occur.

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