

## Health Care Reform: California Adopts Favorable Federal Tax Treatment of Health Coverage for Adult Children Under Age 27

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Employers and plan administrators that have operations in California should take steps to ensure that their reporting and payroll systems comply with recent state law changes affecting health coverage provided to children under age 27.

On April 7, 2011, Governor Jerry Brown signed into law California Assembly Bill 36 (AB 36). AB 36 conforms certain California income and employment tax laws to certain changes to the United States Internal Revenue Code (the Code) and Internal Revenue Service (IRS) guidance relating to the favorable tax treatment of health benefits coverage for adult children under age 27. The favorable state tax treatment afforded under AB 36 applies retroactively as of March 30, 2010, which also conforms to the effective date of the parallel provisions under the Code.

### Background

The Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010 (collectively, the Act), generally requires group health plans that provide dependent coverage for children to continue to make such coverage available for adult children until age 26, beginning as of the first plan year commencing on or after September 23, 2010 (e.g., January 1, 2011 for calendar-year plans). Effective as of March 30, 2010, the Act also afforded certain favorable tax treatment under the Code with respect to such coverage. For example, the Act (1) extended the general exclusion from gross income under Code Section 105(b) for 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, (2) extended the deduction from adjusted gross income for self-employed individuals under Code Section 162(l) to include amounts paid for medical insurance for any child who has not attained age 27 as of the end of the taxable year and (3) allowed voluntary employees' beneficiaries associations (VEBAs) to provide sick and accident benefits to a member's child who has not attained age 27 as of the end of the calendar year.

The IRS subsequently issued guidance under the Act concerning the tax treatment of health coverage and reimbursements for children under age 27, including clarification that (1) the general exclusion from gross income under Code Section 106 for coverage under an employer-provided accident or health plan extends to coverage for an employee's child who has not attained age 27 as of the end of the employee's taxable year, and (2) such coverage and reimbursements are not "wages" for unemployment tax (FICA, FUTA, and RRTA) purposes and are exempt from

income tax withholding. For our previous *On the Subject* that describes this IRS guidance, please see [Health Care Reform: IRS Guidance on Health Coverage for Children Under Age 27](#).

## Discrepancies Between State and Federal Tax Laws

Some states' tax laws do not automatically conform to corresponding changes in federal tax laws. Thus, although the Act made various changes to the Code relating to the tax treatment of health coverage and reimbursements for children under age 27 (as described above), some states' tax laws did not automatically conform to those changes. In such cases, a state must take legislative or regulatory action to adopt conforming changes. Most recently, California adopted AB 36 to conform certain of its income and employment tax laws to certain changes to the Code resulting from the Act that relate to the favorable tax treatment of health coverage for adult children under age 27.

## Conforming Changes to California Tax Laws Affecting Health Coverage for Children Under Age 27

Until recently, unlike federal tax laws, California did not extend favorable tax treatment for health coverage of children under age 27. Thus, for example, while employees were able to exclude from their gross income the value of their employer-provided health coverage for children under age 27 under federal tax law, the value of such coverage was deemed taxable income under California law. AB 36, which is effective retroactively back to March 30, 2010, conforms California tax laws with the following changes to the Code relating to the favorable tax treatment of health coverage for adult children under age 27:

- Allowance of the general exclusion from gross income under Code Section 105(b) for 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 (note: although not directly addressed in AB 36, the corresponding exclusion from gross income under Code Section 106 would likely also apply based on informal [guidance](#) issued by the California Employment Development Department, which addresses how employers should handle (or correct) state tax reporting and withholding for 2010 and 2011 with regard to imputed income on employer-provided health coverage for adult children);
- Allowance of the deduction from adjusted gross income for self-employed individuals under Code Section 162(l) to include amounts paid for medical insurance for any child who has not attained age 27 as of the end of the taxable year;
- Allowance of VEBA's to provide sick and accident benefits to a member's child who has not attained age 27 as of the end of the calendar year; and
- Exclusion from "wages" for California unemployment tax purposes of any payment made, or benefit furnished to, or for the benefit of an employee under Code Section 105(b), including 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.

## Next Steps for Employers and Plan Administrators

Employers and plan administrators should take action now in the following ways:

- Employers and plan administrators subject to California state tax should take steps to ensure that their reporting and payroll systems comply with the changes made under AB 36, including any appropriate retroactive correction for the 2010 tax year.
- Employers and plan administrators should consider circulating employee communications regarding the impact of AB 36.
- Employers and plan administrators should continue to monitor California and other state laws for further tax reform related to health coverage for adult children under age 27. For instance, Vermont (H. 436) and Hawaii (H.B. 1089) are both currently in the process of approving legislation that would conform their tax laws relating to health coverage for adult children under age 27 to federal tax laws.

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