



## **Employers Beware on Definition of Dependent in Iowa**

**IMPORTANT TAX  
IMPLICATIONS OF  
IOWA'S EXPANSION  
OF DEPENDENT  
HEALTH INSURANCE  
COVERAGE**

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# **IMPORTANT TAX IMPLICATIONS OF IOWA'S EXPANSION OF DEPENDENT HEALTH INSURANCE COVERAGE**

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During the 2008 legislative session, the Iowa General Assembly passed a law requiring that group health plans in the State of Iowa expand their definition of dependents covered under the terms of the plan to include an unmarried child who is a resident of the State of Iowa and:

- has not reached the age of 25; or
- remains a full-time student (regardless of age).

The health plan must cover the child for the remainder of the plan year during which he/she was eligible. For example, if the plan year runs from January 1- December 31 and the child turns 25 on January 5, 2009, he would be eligible to continue on the plan through December 31, 2009.

The definition of "dependent" utilized by the Internal Revenue Service has not changed. Therefore, many individuals that must be added to health plan coverage at the request of the employee may not be considered a "dependent" by the IRS. If they are not considered a "dependent" under the IRS' definition, the cost of their health insurance can not be pre-taxed through an employer's cafeteria plan by the employee. Additionally, there are tax consequences to the employee if the employer pays any amount toward the dependent coverage. Below is a more detailed summary of this issue.

Under the Internal Revenue Code, health insurance premiums paid by or on behalf of an employee are excludable from the employee's gross income to the extent they cover only the employee, the employee's spouse and dependents. The Internal Revenue Code defines a "dependent" to include a child who meets the following criteria:

- bears a relationship to the taxpayer;
- has the same principal place of abode as the taxpayer for more than one-half of the taxable year;
- has not attained the age of 19 or 24 if the child is a student, as of the close of the calendar year; and
- has not provided over one-half of their own support for the calendar year.

Children who are permanently and totally disabled are treated as having met the above criteria and are considered dependents.

Because Iowa's definition of dependent is much broader than the IRS' definition, some employers will find that they are being asked to add children to their group health plan who do not meet the IRS' definition of dependent. When these children are added to the group health plan there will be tax consequences to the employee and implications to the employer's cafeteria plan and income reporting obligations. (For purposes of this summary, children who do not meet the definition of "dependent" in the Internal Revenue Code are being referred to as "non-tax dependents.")

When an employee pays coverage with after-tax dollars for non-tax dependents, the coverage is not taxable to the employee, provided the employee pays at least the fair market value of the coverage. If an employer subsidizes the premium resulting in the employee paying less than fair market value for the coverage, the difference between the amount paid by the employee and the fair market value of the coverage is taxable to the employee and should be included as income to the employee in their W-2. Even when there is no employer subsidy, if the amount paid by the employee with after-tax dollars is less than the fair market value of the coverage, the difference will be taxable to the employee.

If an employer pays for the entire cost of coverage and a non-tax dependent is on the plan, the value of the health coverage is includible in the employee's income. The employer will need to include the value of the non-tax dependent's health coverage on the employee's W-2.

An employee can not pre-tax any amounts paid for a non-tax dependent's health plan coverage. Doing so could disqualify the cafeteria plan and the employer and all plan participants could lose their tax benefits.

The IRS has not provided any guidance as to how to determine the value of health coverage for purposes of imputing income to employees who elect coverage for an individual who does not meet the IRS' definition of dependent. The most cautious approach is to use the plan's COBRA premium (not including the 2% administrative fee) for individual coverage. Another approach would be to determine the value based on the incremental cost of adding coverage for the individual. For example, if the monthly premium for employee plus spouse is \$500.00 and the monthly premium for employee plus spouse and children is \$750.00, the amount attributed to the non-tax dependent would be \$250.00. Employers should be cautious in using this approach as it does not always result in the fair market value of the coverage. For instance, if more than one child is on the plan there is arguably no additional cost for adding the non-tax dependent. Additionally, in some cases the increment may be very small. Therefore, the safest approach is to use the COBRA premium for individual coverage.

In addition, employees can not be reimbursed under health flexible spending accounts for expenses attributable to non-tax dependents.

For assistance in addressing this issue, contact Susan Freed at (515) 246-7891.