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### States extend age of children entitled to dependent health coverage

One strategy many states are using to address the problem of the uninsured is extending the age of children eligible for dependent coverage under insured group health and HMO plans. Some states are also applying this coverage requirement to stand-alone dental and vision plans, as well as to insurance policies and contracts issued in another state that cover state residents. For employers, these extension mandates raise several issues related to benefit cost and taxation, compliance, notice, and COBRA. This *Update* explores those issues.

#### State laws extend dependent eligibility for health or HMO coverage

Group health plans commonly offer coverage for employees, their spouses and children. Traditionally, employers could limit dependent coverage to unmarried children under a certain age – such as 19 years, or 23 years for full-time students. In recent years, many states have enacted so-called limiting-age laws or mandates that specify and usually extend age limits for dependent coverage under an insured health plan. (See sidebar on page 2.)

**Applicability.** State limiting-age laws apply to insured medical plans issued within the state, including employer-sponsored insured group plans. However, none of these mandates applies to *self-insured* medical plans governed by ERISA. Most of the laws do apply to HMOs, and many cover stand-alone insured dental and vision plans. Some also extend to policies and contracts issued outside the state – a concept commonly referred to as “extraterritoriality.”

**Extraterritoriality.** State insurance laws with extraterritorial provisions apply to policies or health plan contracts issued elsewhere if they cover individuals who live or work in the state. These complex laws vary by state and may include rules that extend mandates

- to any policy, wherever issued, to the extent it covers state residents, or
- to policies if a majority of covered employees work in the state.

States with extended dependent coverage provisions

- Alabama
- California
- Delaware
- Florida
- Georgia
- Illinois
- Indiana
- Iowa
- Kentucky
- Louisiana
- Maine
- Massachusetts
- Michigan
- Minnesota
- Mississippi
- Montana
- Nebraska
- Nevada
- New Hampshire
- New Jersey
- New Mexico
- New York
- North Carolina
- North Dakota
- Ohio
- Oklahoma
- Oregon
- Pennsylvania
- Rhode Island
- Tennessee
- Texas
- Vermont
- Virginia
- Washington
- West Virginia
- Wisconsin
- Wyoming

Not all state limiting-age laws contain the same provisions, but most generally follow one of the following three approaches:

- Extended dependent coverage becomes part of the plan's terms without an affirmative election by employees.
- Insurers must allow covered employees the chance to elect continued coverage for their eligible dependents.
- Insured health plans must extend coverage only for full-time students on a medical or military leave of absence that would otherwise cause loss of coverage.

Issues for employers

Employers providing insured coverage for their employees can face a variety of issues related to limiting-age laws.

Cost. Although states can require extended dependent eligibility under insured plans and HMOs, employers aren't legally required to pay the cost of extended coverage. All or part of the additional cost can be passed on to the covered employee.

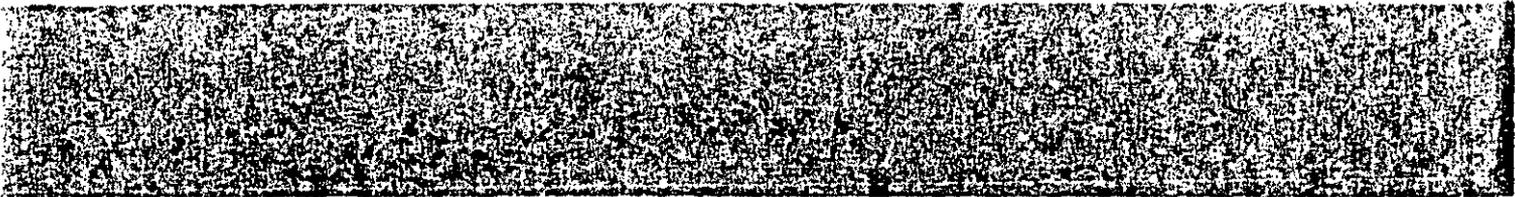
Exclusion of benefits. Some dependents eligible for extended coverage under state mandates don't qualify for tax-free health benefits under the federal tax code. In such cases, the employer must tax the employee for the full value of the dependent's coverage by imputing income, having the employee pay the full coverage cost on an after-tax basis, or using a combination of these approaches. (For a useful checklist to help determine which dependents can have tax-free health coverage, see [Which dependents can have tax-free health coverage?](#), Oct. 25, 2006.)

Compliance with state laws. Generally, insurers and HMOs are responsible for conforming their policies and contracts to applicable state laws and communicating extended dependent eligibility information. But all employers with both insured and self-insured coverage will need to carefully communicate any differences in eligibility rules to their employees.

COBRA. In those states where extended dependent coverage is an optional election for employees rather than a requirement for the insured plan, employees' dependents must also be given the option of electing COBRA coverage. This is because the dependent child will lose coverage under the plan's standard age limit, and that loss of coverage is a COBRA qualifying event.

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### **For more information**

For additional information, please contact your Mercer consultant.

*This Update is for information only and does not constitute legal advice; consult with legal and tax advisers before applying this information to your situation.*

### **Conclusion**

While it is generally up to carriers to comply with the various state mandates, employers with insured plans and HMOs should be aware of the laws and how they may affect plan administration, taxation and communication. Employers with self-insured ERISA plans don't need to comply with the mandates but may need to answer inquiries from employees who have heard of the laws elsewhere. A general understanding of issues that may arise can help in both situations.

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# Update

October 25, 2006

## Which dependents can have tax-free health coverage?

### Summary

Employers can provide tax-free health coverage to employees' dependents only if the dependents meet certain tax code rules. The Working Families Tax Relief Act changed those rules, creating uncertainty about which dependents can have employer-provided coverage on a tax-free basis. This Update lays out a process to help employees answer that question.

### Tax-free coverage for children, other family members

Employer-provided health care coverage for employees, spouses, and certain dependents is exempt from federal income and employment taxes. These individuals usually can receive tax-free medical expense reimbursements as well.

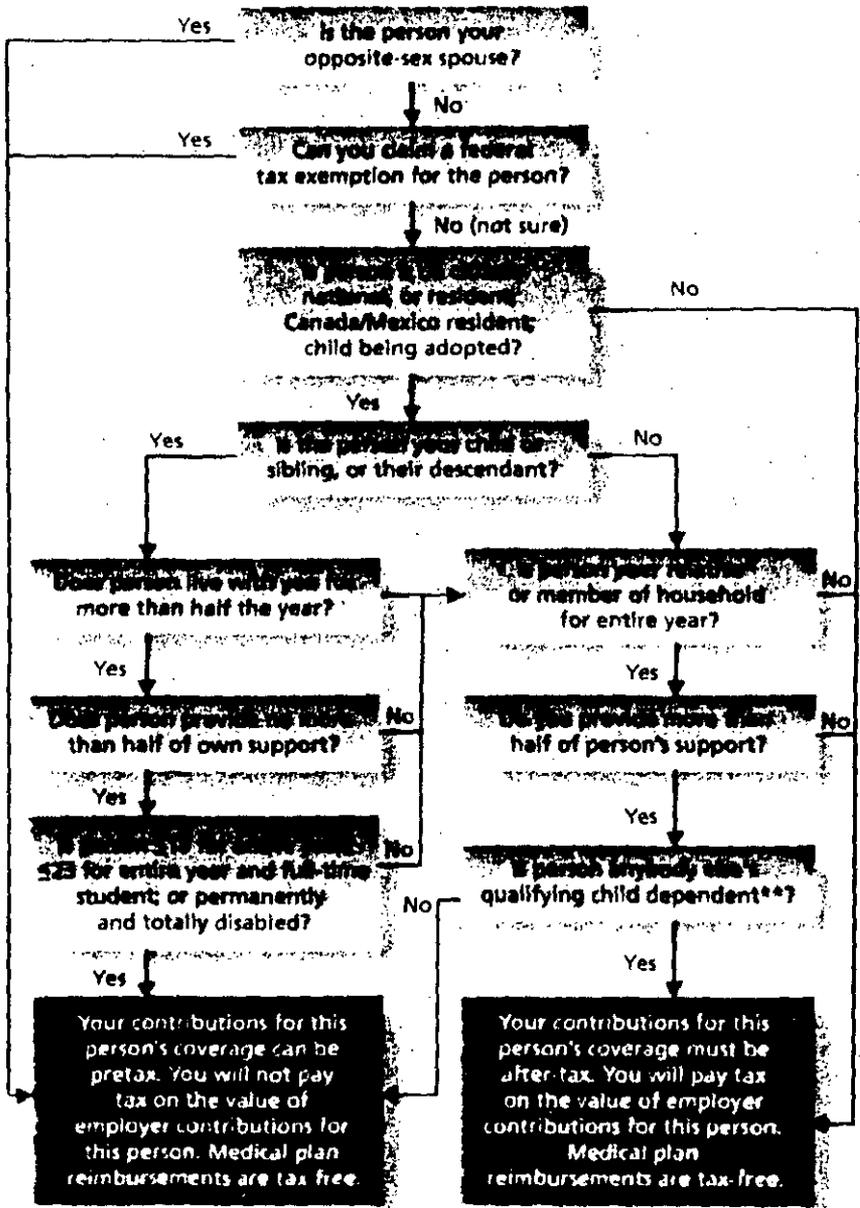
### Who's a dependent?

Many health plans use section 152 of the tax code to define who is a dependent, but the Working Families Tax Relief Act (WFTRA) shifted age, income, and residency requirements to section 152. The changes drove employers to see if their plan documents' dependent definitions needed revisions - and confused participants about which dependents could receive tax-free coverage.

### A helpful tool

The decision tree and checklist in this Update can help employees determine whether your health plan's coverage for family members is subject to federal taxes - though your plan documents still determine who is eligible for coverage. The checklist clarifies the decision tree by elaborating details related to its questions.

### Which dependents get tax-free health coverage?



\* Relative: your children (including by birth, adoption, foster care, stepchildren) and their descendants; your parents and their ancestors; your stepparents; your siblings, step siblings, nieces, and nephews; your aunts and uncles; and your parents, children, and siblings-in-law

\*\*Qualifying child dependent: not married; not anyone else's dependent; a US citizen, resident, or national, or resident of Canada/Mexico; or child being adopted by US citizen who is member of the household; your child, sibling, step-sibling, or one of their descendants; for the entire calendar year; is age 18 or under, or age 21 or under and a full-time student, or is permanently and totally disabled at any time during the year (regardless of age); lives with you for more than half the year; and doesn't provide more than half of own support for the year.

**Definitions**

*Qualifying child dependent*  
**A qualifying child dependent meets all the following requirements:**

- Is unmarried
- Is not anyone else's dependent
- Is either:
  - A. a US citizen, national, or resident; or
  - B. a resident of Canada or Mexico; or
  - C. a child being adopted by a US citizen or national who shares that individual's home as a member of the household.
- Is your child or descendant of that child; your sibling, step-sibling, or one of their descendants
- For the entire calendar year, is age 18 or under, or age 23 or under and a full-time student; or is permanently and totally disabled at any time during the year (regardless of age)
- Lives with you for more than half the year
- Doesn't provide more than half his or her own support for the year

**Checklist for tax-free employer health plan benefits**

This checklist will help determine if your spouse, domestic partner, or other dependents can be covered by your employer's group health plan on a tax-free basis. Your plan's eligibility provisions will determine if these individuals are eligible for coverage at all; the checklist merely determines the taxation of that coverage.

This checklist applies only to the federal tax treatment of employer-provided health benefits. It does not address state taxation of these benefits.

**Caution:** The checklist doesn't apply to your children if:

- you are divorced, legally separated, or living apart from the other parent during the last six months of the calendar year, or
- they can be claimed as "qualifying child" dependents (see definitions in sidebar) by two or more people.

If your children fall into either of these categories, talk to your tax advisor to determine whether their health benefits can be tax-free.

**Spouses**

If the person you're covering is:

- └ Your opposite-sex spouse, coverage is tax-free and contributions can be pre-tax
- └ Your same-sex spouse, go to Test 1 below to see if coverage is tax-free

**Test 1** (Use this test if the person you're covering is a dependent, domestic partner, or same-sex spouse)

- └ If you can claim an exemption on your federal taxes for this person, then the coverage is tax-free and your contributions can be pre-tax. [Not sure if you can claim an exemption for this person? See IRS Publications 501 and 17]
- └ If you can't claim an exemption for this person or aren't sure if you can claim an exemption, go to Test 2 below.

**Definitions**

*Full-time student*

**A full-time student must be enrolled for five months in the calendar year at an educational institution that has a full-time faculty and must satisfy the school's full-time requirements**

*Relative*

**The following individuals qualify as relatives:**

- **Your children and their descendants. The term children includes your children by birth or adoption (including placement for adoption), your foster children, and your stepchildren**
- **Your parents and their ancestors (grandparents, etc.)**
- **Your stepmother and stepfather**
- **Your siblings, step-siblings, nieces, and nephews**
- **Your aunts and uncles**
- **Your parents-in-law, children-in-law, and siblings-in-law**

**Test 2** (Use this test if the person you're covering is a dependent, domestic partner, or same-sex spouse and can't satisfy Test 1)

Check any of the following boxes that apply:

- ┐ This person is either:
  - A. your child (by birth or adoption), stepchild, or foster child; or
  - B. your sibling, step-sibling; or
  - C. a descendant of someone listed in A or B
- ┐ This person lives with you for more than half the year
- ┐ This person is either:
  - A. a US citizen, national, or resident; or
  - B. a resident of Canada or Mexico; or
  - C. a child being adopted by a US citizen or national who shares that individual's home as a member of the household
- ┐ This person doesn't provide more than half his own support for the year
- ┐ This person is either:
  - A. age 18 or younger for the entire calendar year; or
  - B. age 23 or younger and a full-time student (see definitions in sidebar) for the entire calendar year; or
  - C. permanently and totally disabled at any time during the calendar year (regardless of age)

If you checked **all** the boxes, then coverage is tax-free and your contributions can be pre-tax. If not, go to Test 3.

**Test 3** (Use this test if the person you're covering is a dependent, domestic partner, or same-sex spouse and can't satisfy Tests 1 or 2)

Check any of the following boxes that apply:

- ┐ You provide more than half this person's support during the calendar year
- ┐ This person is either:
  - A. a US citizen, national, or resident; or
  - B. a resident of Canada or Mexico; or
  - C. a child being adopted by a US citizen or national who shares that individual's home as a member of the household
- ┐ This person can't be claimed as anyone's "qualifying child" dependent
- ┐ This person is either:
  - A. your relative (see definitions in sidebar), or
  - B. unrelated to you but lives with you for the entire calendar year as a member of your household and the relationship isn't in violation of local law

Attachment # 3  
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Health & Benefits