



# BENEFIT *Advisor*

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## In This Issue

*The recently enacted Working Families Tax Relief Act of 2004 (WFTRA) modifies the definition of eligible tax dependent; however, these WFTRA changes to the definition of dependent apply only to specific sections of the Internal Revenue Code. This Advisor discusses the changes and the potential impact on your benefit plans.*

*We welcome your comments and suggestions regarding this issue of our technical bulletin. For more information on this Benefit Advisor, please contact your Account Manager or visit the McGrawWentworth web site at [www.mcgrawwentworth.com](http://www.mcgrawwentworth.com).*

## Special Alert:

## “IRS Definition of Dependent”

Effective January 1, 2005, the Working Families Tax Relief Act redefined the requirements of an eligible tax dependent. The change directly affects Section 152 of the Internal Revenue Code.

The new Section 152 dependent requirements are causing a great deal of confusion on how these changes could potentially affect employee benefit plans.

Many sections of the Internal Revenue Code refer to Section 152 to define eligible dependent. By making changes to Section 152, the IRS has affected many different areas of how employee benefit plans operate. The intention of the change was to create a more uniform definition of dependent throughout the Internal Revenue Code.

The most pressing impact on employers will be on their dependent care flexible spending accounts. For employees who use these accounts to pay for daycare expenses for dependent parents, their parent may no longer be considered an eligible dependent.

This change also may impact the tax favored nature of employer-sponsored health plans for specific dependents. Since the IRS did not intend this change to impact the tax-favored status of employer-sponsored health plans, most organizations are not making any

changes to their administrative procedures at this time. Organizations are expecting the IRS to issue guidance to maintain the status quo of the tax favored status of benefits and

employer contributions to health plans.

It is important to understand the potential impact of these changes and to notify your dependent care

participants of the new definitions. From a health plan standpoint, the consequences seem unintended and most organizations are not acting on the potential impact of these changes. Hopefully, the IRS will issue guidance to maintain the current requirements for receiving tax favored benefits and premium contributions.



### Dependent Definitions

The revised Section 152 defines two types of eligible tax dependents, a qualifying child or a qualifying relative. A qualifying tax dependent must meet the following requirements of a qualifying child or a qualifying relative.

#### Qualifying Child

- **Relationship:** The child must be the taxpayer's son, daughter, step child, sibling or step

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sibling. A legally adopted child or a child lawfully placed with the taxpayer for adoption is treated as a taxpayer's child. A foster child legally placed with the taxpayer is also treated as the taxpayer's child.

- **Residency:** The child must live at home with the taxpayer for more than half of the taxable year. Temporary absences because of special circumstances, including illness, education, business, vacation or military service, do not prevent the child from qualifying.
- **Age:** In general, the child must be under age 19 (or under age 24 if a full-time student) as of the end of the calendar year. However, the age limit varies depending on the tax benefit. For example, for the dependent care tax credit or benefits paid under a dependent care flexible spending account, the child must be under age 13.

There is a special rule for disabled children. In the case of an individual who is permanently and totally disabled as defined in Section 22(e)(3) at any time during the calendar year, the age limits will be waived.

- **Support:** The child must not have provided more than half of his or her support for the taxable year.

There are special provisions in WFTRA that are intended to address divorce situations. This provision says that the child will be deemed the qualifying child or relative of the non-custodial parent:

- If there is a court order or divorce decree or maintenance/separation agreement saying that either the non-custodial parent is entitled to take the deduction for the child *or*
- The custodial parent declares in writing that he/she won't claim the child as a deduction on his/her taxes.



There are also special rules that apply if more than one individual is able to claim the child as a dependent. If two or more taxpayers claim a qualifying child, WFTRA has provided "tie-breaking" rules:

- Between a parent and another individual:
  - The parent may claim the child.
- Between two non-parents:
  - The individual with the highest Adjusted Gross Income for the tax year may claim the child.

- Between two parents who do not file a joint tax return:

- The parent with whom the child lives the longest during the year may claim the child, or if the child resided with both parents for the same period of time during the year, the parent with the highest Adjusted Gross Income for the tax year may claim the child.

If a child does not meet all the requirements of a qualifying child, he or she may still qualify as a relative.

#### **Qualifying Relative**

- **Relationship or Residency:** The dependent must be the taxpayer's child or descendant of a child, sibling or step sibling, parent or ancestor, step parent, aunt, uncle, niece or nephew. The dependent can also be a brother or sister in-law, a son or daughter in-law, or a mother or father in-law.

A qualifying relative also includes an individual (other than an individual who at any time during the taxable year was a spouse) who has the same principal place of abode as the taxpayer and is a member of the taxpayer's household. The relationship between the individual and the taxpayer may not violate state or federal law.

There is a question whether the residency requirement applies to dependents who meet the

## NOTABLE THOUGHT

**EDUCATE A MAN AND YOU EDUCATE AN INDIVIDUAL -  
EDUCATE A WOMAN AND YOU EDUCATE A FAMILY.**

**AGNES CRIPPS**

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relationship requirement. It is simply not clear if an individual in a relationship as defined above must also reside with the taxpayer.

- **Income Limits:** The dependent's gross income must not exceed the exemption amount (estimated to be \$3,200 for 2005). Special rules apply to the income of a handicapped dependent. If a qualifying relative is permanently and totally disabled as defined in Section 22(e)(3), income attributable to service performed at a sheltered workshop is not counted toward the income limit, if:
  - The availability of medical care at such a workshop is the principal reason for individual's presence there.
  - The income arises solely from the activities at a workshop which are incident to such medical care.
- **Support:** The qualifying relative must have received over half of his or her support from the taxpayer for the calendar year.

These are the new requirements listed under Section 152. However, other areas of the tax code and technical clarifications issued by the IRS will change some aspects of these definitions depending on the benefit in question. We will discuss how many aspects of your benefit plans may be affected by this change.



### How Could This Change Affect Your Organization's Benefit Plans?

The changes in the Section 152 definition of dependents directly affect some plans and have caused some complicated problems. Your organization should review the following key plans and provisions:

- Dependent Care Flexible Spending Accounts
- Health plans
  - Eligibility provisions
  - Tax consequence of benefits and premiums paid by plans
- Health Savings Accounts

### Dependent Care Flexible Spending Accounts

To determine how the Section 152 changes directly affect your dependent care flexible spending account:

1. **Review your summary plan description.** Decide whether you need to change your definition of an eligible dependent under the plan. If your eligibility provision refers to Section 152 directly, no change may be necessary. However, if your summary plan description's definition of a dependent is different from the new requirements, you will need to amend your plan document.

The rules for who can qualify for dependent care benefits are as follows:

- a. A dependent of the taxpayer who is under the age of 13 and with respect to whom the taxpayer is entitled to a deduction under section 151(c) (requirements are similar to new requirements) *or*
- b. A dependent of the taxpayer who is physically or mentally incapable of caring for him/herself *or*
- c. The spouse of the taxpayer, if he/she is physically or mentally incapable of caring for him/herself.

These are independent requirements, therefore a disabled child who is over age 13, but who still qualifies as a dependent under the new requirements, will be a "qualifying individual" for purposes of dependent care.

It is important to understand that some of your employees may be using the dependent care account to pay for elder care expenses for a dependent parent. The dependent must be incapable of self-care but must also meet the requirements of qualifying relative. It is important to understand, the income requirements for a qualifying relative are new for 2005. It is quite conceivable that an employee who set aside money in a dependent care account to pay for a dependent parent's elder care expenses may no longer claim those expenses because the parent's income could disqualify the parent from being considered a "qualifying relative". Social security income is considered income for purposes of this section.

**2. Notify your dependent care FSA participants about this tax code change.** Explain that this change is not a plan design change, but rather a tax code change that may affect whether or not they will be eligible to receive a tax-favored benefit. If your plan operates on the calendar year basis, your organization should allow employees to modify their 2005 election if this change affects them.

If your plan does not operate on the calendar year, make the change in the SPD effective January 1, 2005 and notify your participants. For individuals that may no longer use dependent account funds for a qualifying relative, the Treasury Department has informally indicated that you can treat this as a mid-year family status change and allow changes to the participant's election.

If your plan document simply refers to Section 152 to define *eligible dependent*, an amendment may not be required. However, your organization should still notify participants of this change and allow amended elections.



## Health Plans

The effect of WFTRA on employer-sponsored health plans is complex. The passage of WFTRA has created a conflict between tax law and federal or state law as it pertains to whom must be considered a covered dependent under a health plan.

This is an important distinction to understand:

- Tax law defines dependents who may receive tax-favored benefits from an employer-sponsored health plan and who are eligible to receive tax-favored employer contributions for the health plan coverage.
- The federal law, OBRA required states pass laws to prohibit insurers and self-funded plans from **denying** coverage to a child because:
  - The child was born out of wedlock.
  - The child was not declared as a dependent on the plan participant's tax return.
  - The child does not reside with the plan participant or the child resides outside the service area of the plan.

Your health plan eligibility cannot mirror the requirements of Section 152 while still complying with federal and state law. Your organization should review your summary plan description to make sure the eligibility section does not defer to Section 152 as the definition for an eligible dependent under your plan.

Most plans comply with the OBRA requirements and therefore there is the opportunity for a plan to cover a dependent that may not be eligible to receive tax-favored benefits or tax-favored employer contributions for plan coverage, according to the Internal Revenue Code. Generally when this situation applies, the employer is required to impute income for the fair market value of the cov-

erage provided and the employer is not permitted to make tax favored contributions for coverage.

It appears the IRS did not intend this to be the consequence of the changes dictated by WFTRA. In particular, if taken literally, many employers would be required to impute income on children over 18 if not a full time student (over 24 if a full-time student), if coverage is provided under the health plan. Many employers' eligibility criteria allow dependent children to be covered until a child turns 19 or 25 if a full-time student.

In order to remedy this alarming consequence, the IRS issued additional guidance that basically states for the purpose of tax favored benefits or employer contributions for health plan coverage, the income requirements for a "qualifying relative" will not apply. This guidance does alleviate a major problem health plan sponsors faced. In effect, most children who did not meet the age requirements of a "qualifying child" could meet the requirements of a "qualifying relative" if the income limitation of \$3,200 was not applied.

However, this additional guidance did not alleviate all issues related to the new dependent requirements from a health plan standpoint. For example, in Qualified Medical Child Support Order situations, a state requires a child to be added to an employer-sponsored plan and that child may not be a tax dependent of the parent being forced to provide coverage.

From an administrative standpoint, this requirement would be almost impossible for employers to track, and equally difficult for the IRS to monitor. The Department of Labor

is investigating this situation and most employers are taking a "wait and see" approach before taking action for these situations. Hopefully, the IRS will issue some guidance that will assist employers in meeting the requirements of state law without having to significantly impact certain plan participants' income.

### Health Savings Accounts

Although not many employers are offering Health Savings Accounts along with a High Deductible Health Plan, these changes may affect what can be considered a qualifying expense under these accounts.

These accounts permit an employee to take tax-favored disbursements for any qualifying expense of any dependent qualifying under Section 152. Therefore, your employees need to ensure their dependents meet the Section 152 definition and not simply your health plan's criteria in determining if an expense is tax-favored disbursement under an HSA.

### Conclusion

The Working Families Tax Relief Act tax code changes have left many of us confused about the impact on our plans. The impact will be relatively minor for most individuals, but you should review your plan documents to make sure any references to Section 152 are correct. Also, your organization should analyze the effect on your dependent care accounts immediately.



## NOTABLE THOUGHT

**WHERE YOU'RE FROM ONLY MATTERS IN RELATION TO WHERE YOU ARE.**

**MALCOLM FORBES**

Employers should act on their dependent care accounts today. Make sure your employees are notified of these changes and have the opportunity to amend their elections if their ability to benefit from the plan is affected. In regard to your group health plan, it is important to understand the potential impact of this law on your plan, but it is be-

lieved the IRS will issue additional guidance which hopefully will alleviate many of the potential problems the new definitions are creating.

Take the time to review all your benefits and investigate the potential impact on your plan. The act could affect fringe benefits (meal and lodging plans) or retirement plans (hardship withdrawals or emergency distributions) as well.

The IRS did not intend all the consequences this new act is having on benefit plans sponsored by employers. While no official guidance has been issued to change the provisions in the tax law to match the provisions required by Federal law, the IRS is aware this issue exists. Many leaders in the benefit industry are offering the IRS opinions in this matter. The general thought is that employers should take a "wait and see" attitude toward handling these differences. There is a good chance

the IRS will issue additional guidance in 2005.

If the discrepancy in tax dependent and group health plan dependent is maintained, it will have a significant impact on how an employer administers the dependent verification for their plans. The necessary documents needed to confirm a dependent's tax eligible status are generally considered quite personal; however, employers will need these documents to determine whether imputed income will be necessary, in instances where a dependent may be covered by a plan but not be an eligible tax dependent of the employee.

If you have any questions, please contact your McGraw Wentworth Account Manager. **MW**

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