



# SPECIAL Alert

## In This Issue

*In this third McGraw Wentworth Special Alert for 2006, we will discuss technical corrections made to Working Families Tax Relief Act of 2004 (WFTRA). WFTRA modified the definition of eligible tax dependent that applied to specific sections of the Internal Revenue Code. The changes of the definition of dependent affected certain aspects of employer-sponsored benefit plans.*

*The technical corrections address the definition of dependent as it relates to Section 125 Dependent Care Accounts and also the definition of eligible dependent for Health Savings Accounts or HSAs.*

*We welcome your comments and suggestions regarding this issue of our Special Alert. For more information on this article, please contact your Account Manager or visit the McGraw Wentworth web site at [www.mcgrawwentworth.com](http://www.mcgrawwentworth.com).*

## “IRS Definition of Dependent Technical Corrections to WFTRA”

The Working Families Tax Relief Act redefined the requirements of an eligible tax dependent for several sections of the Internal Revenue Code effective January 1, 2005. The change directly affected Section 152 of the Internal Revenue Code.

The IRS intended the change to create a more uniform definition of dependent throughout the Internal Revenue Code. Instead, the change created a great deal of confusion on how various plans should define an eligible tax dependent. Many sections of the Internal Revenue Code refer to Section 152 to define eligible dependent. By making changes to Section 152, the IRS affected many different areas of how employee benefit plans operate.

The technical corrections were included in the recently passed Gulf Opportunity Zone Act of 2005. This Act amended the tax code to address many issues created by the recent hurricane destruction in our country. However, the final section of the regulation issued technical corrections for several Acts, including WFTRA. The corrections addressed:

- Definition of dependent for Dependent Care Flexible Spending Accounts

- Changing the definition of dependent as it relates to Health Savings Accounts

In this issue, we will:



- Recap the definition of dependent under Section 152 as amended by WFTRA.

- Discuss the technical corrections

made to the Dependent Care Accounts and Health Savings Accounts.

- Review the areas your organization may need to address based on the corrections.

The new provisions are viewed as technical corrections, not necessarily amendments. Therefore, these corrections are effective January 1, 2005 (the original effective date of WFTRA).

### 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 either a qualifying child or a qualifying relative.

**Qualifying Child:**

- **Relationship:** The child must be the taxpayer's son, daughter, stepchild, sibling or stepsibling. 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 and situations where two individuals may be able to claim a child as a tax dependent.

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 related to the taxpayer, as a child or descendant of a child, sibling or stepsibling, parent, step parent, 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.

- **Income Limits:** The dependent's gross income must not exceed the exemption amount (\$3,200 for 2005; \$3,300 for 2006). 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 the individual's presence there.
  - The income arises solely from the activities at such a workshop which are incidental 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 current definitions of eligible tax dependent according to Section 152.

There has been one clarification issued to date. The IRS issued a technical correction shortly after WFTRA was enacted. The definition of dependent child in many health plans was more generous than the WFTRA qualifying child definition. Many parents would not have been entitled to have their contributions for health plan coverage on dependent children, who did not meet the age requirements, taken on a tax-favored basis. It would have meant,

**NOTABLE THOUGHTS**

**HOME IS NOT WHERE YOU LIVE BUT WHERE THEY UNDERSTAND YOU.**

**CHRISTIAN MORGENSTERN (1871-1914)**

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additional premium charged to cover these dependents could not be paid pre-tax and employers would need to impute income to the employee for covering the non-qualified tax dependent. The IRS certainly did not intend this to be the case.

In order to remedy this alarming consequence, the IRS issued additional guidance that basically states for the purpose of tax-favored health plan benefits or employer contributions for health plan coverage, the income requirements for a qualifying relative will not apply. This guidance did 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 (or \$3,300 for 2006) was not applied.

### Dependent Care Flexible Spending Accounts

The new dependent definitions of WFTRA in many cases impacted an employee's ability to use Dependent Care Flexible Spending Account funds for elder care. The addition of the income requirement disqualified the tax dependent status of many parents that live with their children. Social security income benefits are considered income for the purposes of meeting the qualifying relative requirements.

The new technical corrections allow individuals to disregard the income requirement for Dependent Care Flexible Spending Accounts. This means if a dependent meets all the requirements of a qualifying relative with the exception of the income requirement, an individual can use a dependent care spending account to pay for any dependent

day care needed by the individual. This does not change the age limit of 13 for any eligible dependent children for the Dependent Care Account. However, FSA funds can be used to pay elder care expenses for a dependent parent if the care is medically necessary.

In most cases, this "correction" will have minimal impact on your plan. However, you should review the following information to make sure it remains correct:

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 corrected definitions, you will need to amend your plan document.

For the plan to allow elder care expenses, the dependent must be incapable of self-care but must also meet the requirements of a qualifying relative with the exception of the income requirement.

2. **Notify your Dependent Care FSA participants about this tax code change.** Notify your participants that the income requirement for a qualifying relative has been lifted and they may claim elder care expenses on a dependent parent providing the requirements of the qualifying relative are met.



### Health Savings Accounts

The technical correction issued for dependents covered by group health plans did not encompass Section 223 of the tax code. Section 223 was created to address the tax implications of HSAs. Therefore, for an expense to be withdrawn on a tax-favored basis from an HSA for a qualified dependent, the dependent would

have to meet the requirements of a qualifying child or a qualifying relative.

Since HSAs are designed to work with health plans, a child could be considered tax-favored from the standpoint of the health plan, but an individual may not have the ability to have the child's expenses withdrawn from the HSA on a tax-favored basis. The clarification simply lifts the income requirement on a qualifying relative as it relates to tax-favored expenses withdrawn from an HSA.

Just like it worked for group health plans, this means a child that may not meet the qualifying child requirements, most likely would meet the qualifying relative requirements without applying the income limitations. It makes sense to have individuals that can be covered on a tax-favored basis by the medical plan also have the ability to withdraw expenses on a tax-favored basis from an HSA.

### Conclusion

These two technical corrections do clear up areas where the new definitions of tax dependents under WFTRA may have had negative im-

pact for some employees. From an action step standpoint, employers should review two areas:

- **Section 125 Plan Document:**

Make sure your definition of dependent either refers directly to Section 152 for defining a dependent or your plan is amended to account for these changes. Make sure the document does not specifically reference the income requirement in relation to a qualifying relative for the purposes of elder or disabled dependent care. In addition, you should review your organization's informal communication to make sure it is accurate as well.

- **HSAs:** If your organization offers a high deductible health plan with HSAs, review your communication materials in relation to the HSAs. HSAs are typically not considered



ERISA plans. Most likely, your organization is not required to distribute a summary plan description. However, your organization undoubtedly delivered communication materials discussing eligible expenses. If you have defined eligible dependent expenses by referencing Section 152, there will be no need to amend your documents. If you provide a more detailed description, you should remove the income

requirement for qualifying relatives.

These technical corrections are welcomed by organizations and should make administering tax-favored benefits a bit easier.

The technical corrections did not address some of the tricky issues relating to the tax-favored status of certain dependents; for example, Qualified Medical Child Support Orders that compel an employer to cover a dependent child. However, if the child does not meet the re-

quirements of a qualifying child or a qualifying relative, the coverage cannot be provided on a tax-favored basis. WFTRA may be amended in the future to address the areas that remain unclear.

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

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