

Working Families Tax Relief Act of 2004

Effective 1/1/05

This federal law now makes taxable some types of benefits that were previously tax-exempt. Other types of benefits will be considered now unavailable.

Under current IRS rules (Internal Revenue Code Section 152), a dependent is one who is a US citizen or national or a resident of the US (or any country contiguous to the US); receives over half of his/her support from the employee participant in the benefit plan and is either a relative of the employee or lives with the employee for the entire year.

Under the new rules, a dependent must be a “qualifying child” or “qualifying relative”.

Qualifying Child

A “qualifying child” is a natural child, step child, adopted child, child placed with the employee for legal adoption or placed as a foster child by judgment, decree or court order. (There are special rules for children of divorced or separated parents where there are multiple support orders.) A “qualifying child” can include an employees children, brothers, sisters, stepbrothers, stepsisters and their descendents who do not provide over one-half of their own support for the calendar year (not considering any scholarship payments) IF they are under age 19 as of the close of the calendar year (under age 24 for full-time students in approved educational institutions) or are permanently or totally disabled.

If a child can be a “qualifying child” for more than one person, the child will be the “qualifying child” of the parent over a non-parent OR the parent with whom the child resides for the longest period during the year. If both employees are non-parents or parents who reside with the child for equal duration during the year, the child will be the “qualifying child of the employee with the highest gross income.

Qualifying Relative

A “qualifying relative” is one who is not a “qualifying child” and who receives over half of his or her support for the calendar year from the employee and is a parent, grandparent, step parent, child, grandchild, sibling, stepsibling, aunt, uncle, niece, nephew or an employee’s spouse’s parents siblings or children. The individual must also share a principle residence with the employee and be a member of the employee’s household for the entire calendar year.

If the employee contributes more than 10% of a relative’s support and there is no other person providing more than half of the relative’s support, the employee is considered to be providing more than half of the relative’s support of every other person who contributes over 10% of the relative’s support files a written declaration that he/she will not claim the relative as a dependent.

IMPACT ON BENEFIT PLANS

Health Benefit Plans

The most notable change is the change in the age maximum of dependent child. Most health benefit plans cover dependent children to end of the year in which they turn 19 (or

24 if full-time students). The new definition of dependent ends at the end of the year in which the child turns 19 (or 23 if a full-time student).

This normally would have meant that the insurance premiums paid for health plan coverage for a dependent child from age 18 to 19 (or age 23 to 24 for full-time students) could be considered taxable income since the child is not considered a dependent under the revised tax code. However, the IRS issued a statement that it will not apply a tax to such premiums despite the language of the Act. IRS Notice 2004-79 may be used until the law is revised. Notice 2005-79 states that “an employee may exclude from gross income the value of employer-provided coverage for an individual who meets the definition of a qualifying relative except that the individual’s gross income equals or exceeds the exemption amount.”

Employers should NOT include language in the benefit plan which describes the definition of dependent as subject to 152 of the Tax Code. Doing so would make the premium payment taxable.

Flexible Spending Accounts

Flexible Spending Accounts (FSAs) often define “dependent” by referencing IRS Code Section 152. Should your plan contain such language, you should amend the plan document to permit nontaxable reimbursements to employees for medical expenses incurred by children who don’t meet the Act’s definition of “dependent.”

Dependent Care Assistance Programs

If an employee provides dependent care assistance to a dependent who is not the employee’s child under the age of 13, that dependent must be:

1. Unable to care for him or herself;
2. Reside with the employee for a least half of the year; and
3. Not have an income in excess of \$3,100 for the year (excluding scholarship income.)

Employer plans that allow for dependent care assistance for elderly relatives would be most impacted by this tax code change. Examine the plan document language and enrollment materials for any needed changes. Employers with a current open enrollment for plan year 2005 may permit employees to make election changes prior to 2005 to address contributions for dependent care assistance that will no longer be considered tax deductible.

Other Plans

1. For cafeteria plan non-discrimination testing the above definition of dependent is used.
2. Payments for long-term care service provided will not be considered a payment for medical care if the service is provided by a persons’ unlicensed relative.
3. A qualified tuition program account can be rolled over or the beneficiary designation can be changed without a tax consequence if the new beneficiary is the prior beneficiary’s relative.

4. 401(k) plans that permit hardship withdrawals for medical and educational expenses for a dependent will require that the applicable dependent make less than \$3,100 per year. The IRS is considering allowing a broader category of dependent than is stated in the new tax code.
5. A QDRO can pay benefits to alternate payees if the dependent makes less than \$3,100 per year.