

Benefits

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New Rules Defining Dependents Will Impact Many Employee Benefits

By Steven J. Friedman and Michelle Pretlow

Congress recently passed the Working Families Tax Relief Act of 2004 ("WFTRA"). This new law amended the definition of dependent found in Section 152 of the Internal Revenue Code. The law takes effect for tax years beginning on or after January 1, 2005. Although the law intended to coordinate the definition of dependent for purposes of 1) the dependency exemption, 2) the child credit, 3) the earned income credit, 4) the dependent care credit and 5) the head of household filing status, it also affects the definition used for employee benefit plans. This change will impact not only who employees can cover tax-free as dependents under certain employee benefit plans (such as health savings accounts and dependent care assistance programs) but will also impact an employee's ability to obtain hardship distributions on behalf of dependents from 401(k) and 403(b) plans and other emergency distributions from non-qualified deferred compensation plans. The IRS is expected to issue additional regulations to clarify certain aspects of this issue and its implications on employee benefit plans.

Who is a dependent now?

A dependent under the current definition includes those who: 1) are children, parents, siblings or anyone else who for the taxable year lives in an individual's home and is a member of that individual's household; and 2) for whom an

individual provides more than 50% of the dependent's support for the year.

This expansive definition may include adult children who are still living at home and working part-time, and certain non-spouse domestic partners.

Who is a dependent after January 1, 2005?

Beginning January 1, 2005, a new definition of "dependent" will apply. Under the new standard, a dependent must either be a "qualifying child" or a "qualifying relative." A qualifying child includes someone who:

1. is a child, grandchild, sibling or step-sibling, niece or nephew of an individual;
2. lives with the individual for more than half of the year;
3. does not provide more than one-half of his or her own support for the year; and
4. has not reached age 19 by the end of the calendar year or is a student who has not reached age 24 by the end of the calendar year; however, if a person is permanently and totally disabled at anytime during the year, then there is no age requirement.

A qualifying relative includes someone who:

1. is a child, grandchild, sibling or step-sibling, parent or step-parent, aunt, uncle, first cousin, in-law or someone

who is a member of the individual's household and lives in their principal place of abode;

2. has gross income less than a defined amount (\$3,200 for 2005);
3. has more than one-half of their support provided for by the individual; and
4. is not a qualifying child of the individual or of any other individual for the calendar year and is not married and filing a joint income tax return.

The differences between the current definition and the new definition of dependent are obvious. Under the current definition, there are no limits on the age of the dependent or on the dependent's income. Therefore, an employee may currently be able to claim a 25 year old student with a summer job as a dependent. However, under the new definition if that student earns more than \$3,200 during the summer then he or she may no longer qualify as a dependent. Please note the definition also includes rules relating to what happens when two or more taxpayers claim a dependent.

How are health benefits affected?

The definition of dependent is referenced in many other sections of the Internal Revenue Code, including the sections that allow employees to receive health coverage from their employer without including it in their income. However, IRS Notice 2004-79 addressed WFTRA's application to an employer's health plan and made it clear that although there is some ambiguity with respect to current statutory and regulatory language, under the majority of health plans (including health flexible spending accounts) the definition of dependent will continue to be based on current law and will not change under WFTRA. The IRS is expected to issue regulations which remove all ambiguities in this area. Employers may rely upon Notice 2004-79 until regulations are issued.

The new WFTRA dependent definition will, however, apply to health savings accounts and dependent care assistance programs for tax years beginning on or after January 1, 2005.

How are retirement benefits affected?

The change in the definition of dependent will affect hardship distributions from 401(k) and 403(b) plans because hardship distributions under these plans may be made for a dependent's medical or educational expenses. Therefore, the implementation of WFTRA will limit these types of hardship distributions to only "qualified children" or "qualified relatives" of participants.

Similarly, governmental and tax exempt 457 plans and non-qualified deferred compensation plans will have to limit the definition of dependent used for purposes of providing unforeseeable emergency distribution from these plans.

What is WFTRA's impact on employers?

The definition of dependent is important to employers because it serves as an outer limit as to who employers can cover under many of their plans in a tax-favored manner. Employers are not required to permit employees to cover every permissible type of dependent. However, an employer that allows tax-favored coverage to be extended to those who are no longer dependents could face the prospect of IRS sanctions. Therefore, the definition of who is included as a covered dependent in a benefits plan should be reviewed by the sponsoring employer.

What should employers do now?

- Review health plan documents and summary plan descriptions. Because health plans are not affected by WFTRA, if the plan's definition of dependent refers to IRC Section 152 of the Internal Revenue Code (which is the definition changed by WFTRA), then the language may need to be revised in light of Notice 2004-79.
- Employers with health savings accounts or dependent care accounts must review the definition of dependent used in those documents to be certain that it conforms to the new rules.

- Review and revise employee communications to explain the new dependent definitions and their applicability (or non-applicability) to different types of plans.
- Review procedures for certifying that an individual is actually a dependent of the employee for benefits purposes.
- Review 401(k), 403(b), 457 and any non-qualified deferred compensation plan documents, summary plan descriptions, other employee communication and forms to ensure compliance with new definitions.

Congress and the IRS are continuing to explore the implications of WFTRA. We can expect further guidance and possibly new legislation.

For further assistance, please consult one of our attorneys in the Employee Benefits Practice Group.

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