Employee Benefits Alert

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Taxation of Benefits for Domestic Partners

Over the past few years more and more employers have revised their benefit plans to add benefits for the domestic partners of their employees. Many employees (and even some employers) mistakenly assume that, because domestic partners are being treated like spouses under the employer's plan, the benefit taxation issues are the same as those impacting legal spouses. However, that is typically not the case. Just because the benefits would have been excludable from the employee's income if they were provided to a spouse does not mean that they will be excludable if the benefits are provided to a domestic partner.

Exclusions from taxable compensation for benefits provided by an employer are embodied in the Internal Revenue Code. Those requirements provide that, to be excludable, the benefits have to be provided to an employee, the employee's spouse, or dependents. For federal tax purposes, domestic partners are not included in the definition of a "spouse" and therefore tax benefits at the federal level do not exist for domestic partners (except in rare instances where the domestic partner might qualify as the employee's dependent). Therefore (unless the domestic partner is the employee's dependent), the domestic partner benefits must be included in the employee's taxable income.

State and Local Tax Jurisdictions

In addition to the federal tax issues, other tax rules will apply, depending on the specific tax jurisdiction. For example, several years ago California amended its state tax laws to permit employers to provide benefits to domestic partners of their employees on a tax-excludable basis (as federal tax law would treat benefits provided to the marital spouse of an employee). However, those benefits are still only excluded from state income taxes; all federal tax obligations still apply to the value of those benefits. In addition, the California statute imposes specific requirements for establishing a domestic partner relationship. Other states have already implemented or are now considering implementation of tax rules modeled after the California tax law.

What about Dependent Status?

In 2004, provisions of the *Working Families Tax Relief Act of 2004* (WFTRA) altered the Internal Revenue Code Section 152 definition of "dependent." Congress envisioned a specific definition governing the concept of who can qualify as a dependent for federal tax purposes. Introducing a new standard definition for "dependent" status was expected to (theoretically) promote greater consistency throughout the Internal Revenue Code. The Section 152 definition is used for, among other things, the federal dependency exemption and the child care tax credit. In a nutshell, WFTRA requires that a dependent must either be a "qualifying child" or a "qualifying relative."

Despite this push for uniformity, WFTRA also included a provision that modified the dependent definition for purposes of tax-free health benefits. (Later legislation extended these modifications to tax-free health plan premiums.) Applying those modifications to the WFTRA definitions results in the following definitions of an employee's "qualifying child" and "qualifying relative" for health plan purposes.

A person is an employee's "qualifying child" for a year if the following four requirements are met: (1) the child is the employee's child, sibling or step-sibling, or is a descendant of any of these relatives; (2) the child has the same principal abode as the employee for more than one-half of the year; (3) at the end of the year, the child is less than 19 years old (24, if a student) or is permanently disabled; and (4) the child does not provide more than one-half of his or her own support for the year.

A person is an employee's "qualifying relative" if the following three requirements are met: (1) the individual is a relative by either blood or marriage, *or has the same principal abode as the employee and is a member of the employee's household for the tax year;* (2) the employee provides over one-half of the individual's support for the year; and (3) the individual is not anyone's "qualifying child" as defined above. This definition of "qualifying relative" may

encompass not only opposite-sex but also same-sex domestic partners.

If an individual is eligible for benefits under a plan but is not a "dependent" under Code Section 152, the employer of the participant will be required to impute income to the participant for coverage elected for the non-qualifying dependent.

Regardless of whether or not a domestic partner meets the definition of a "dependent," an employer does not have to exclude domestic partner benefits from its plan. In fact, it can offer the benefits — but must track the value of the benefit to the extent such coverage represents additional compensation to the employee. In other words, the value of the domestic partner's benefits, to the extent paid by the employer, must be included in the taxable income of the employee.

In light of the "dependent" definition changes under WFTRA, plan sponsors should review all plan documents for benefits that continue to use the Section 152 definition of "dependent." Additionally, sponsors should review and amend, as necessary, any documentation reflecting the definition of "dependent" for domestic partner purposes.

What about the tax result for children of the domestic partner?

Children of domestic partners present an additional challenge for plan sponsors. Unless these children are adopted (or are otherwise characterized as dependents of the employee), they are, typically, unlikely to satisfy the requirements for "dependent" status. Therefore, the employee would not be entitled to tax-favored treatment under the federal tax code, and plan sponsors would be obligated to calculate the value of coverage received by these children and impute that value as taxable income to the employee for tax purposes, as well.

Valuation Issues

Plan sponsors will likely face tough issues regarding the method of valuing the coverage for the determination of how much income to impute. Perhaps the employer has a rate structure where the addition of a domestic partner or additional child does not change the cost (perhaps because the employee is already paying the family rate since his or her own biological children are covered under the plan). How does the employer determine the "cost" of adding that additional person? And on a related note, is it appropriate to separate out and impute the value of coverage for the domestic partner's children?

The IRS has not provided much formal guidance in this area, but the best answer appears to be that the IRS will approve any "reasonable" steps the employer takes to segregate family members who are entitled to receive tax-favored coverage from those outside the parameters for such coverage. Some employers separate out the domestic partner rate (usually based on the single COBRA rate minus the two percent administrative fee) and use that as a yardstick to measure the value of imputed coverage. Similarly, the plan may create a domestic partner "family" rate based on a reasonable correlation to the COBRA family rate to impute and track the value of coverage for children of domestic partners. Other solutions might also be appropriate depending on the individual factual circumstances associated with a particular group. As long as the solution is reasonable, it is expected that the IRS will respect the calculation. The IRS has indicated that it is NOT reasonable to use zero as the imputed income just because the additional cost to the plan is zero. In fact, the IRS has repeatedly stated that health coverage carries an intrinsic value which must be included in the employee's income. It is hoped that the IRS will address health coverage valuation issues with detailed guidance in the future, but there are no indications that anything definitive is currently in the works.

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