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Imputed Income Issues for Health and Welfare Benefits

One of the more complicated compliance issues for sponsors of health and welfare plans is whether welfare benefits are taxable to employees (i.e. with respect to group-term life insurance in certain amounts or benefits provided to non-dependent domestic partners or other individuals who do not qualify as tax dependents of the employee). The imputed income of certain fringe benefits must be added to the W-2 income of certain employees and the employee must pay federal, state and FICA taxes as applicable on the value of the benefits. To avoid misunderstandings, employers should be sure they and their employees grasp the rules of imputed income.

What is Imputed Income? Imputed income is the tax accountants' term for a value that is considered part of a person's income (typically in the form of an employer paid benefit) though the individual doesn't receive this value in cash form. This type of income is often received in the form of a non-cash benefit. It's important to note that some types of non-cash benefits may not be considered taxable imputed income. For example, a person may receive group-term life insurance coverage that is tax free up to a certain amount. If the group-term life insurance passes the tax-free threshold, however, the excess amount may be considered taxable imputed income.

Group-Term Life Insurance. Perhaps the most common fringe benefit that must be added to income is the cost of company-paid group-term life insurance (GTLI).

- **For Coverage Above $50,000.** Imputing income is required based on an employee's GTLI coverage over $50,000. For example, if an employer provides GTLI at two times salary, an employee making $75,000 will owe tax on the premiums for $100,000 of coverage (two times $75,000 less the $50,000 limit equals $100,000). To assist employers in calculating tax withholding on GTLI premiums, the IRS publishes a table of the calculations of the cost of GTLI protection based on age. The cost of $1,000 of GTLI for someone under 30 is $.06/month. The cost per $1,000 of coverage for a person age 55 is $.43/month. The imputed income tax on GTLI is generally not a significant amount, but it does increase with age and income.
- **For Discriminatory Coverage.** If GTLI discriminates in favor of key employees (usually by limiting eligibility to certain owners and officers or by offering those individuals broader coverage), additional imputing requirements apply. The employer is required to impute income to these individuals on their entire coverage amount – not just amounts exceeding $50,000.
- **For Dependent Life Insurance.** The cost of employer-provided term life insurance on the

lives of an employee’s dependents must be imputed to the employee unless the benefit provided is $2,000 or less. If the $2,000 limit is exceeded, all dependent life insurance, including the first $2,000, is taxable.

Medical Coverage for Non-Tax Dependents. According to the IRS, taxable income includes income from any source. This would typically include employer health benefits, however, health benefits provided to an employee, his/her spouse and his/her dependents are normally tax-free as they are specifically excluded from being treated as taxable income. When an employer makes health coverage available to an employee’s domestic partner, or the employee’s older child or other covered individual who is not a dependent under federal rules, the value of that health coverage must be treated as taxable income to the employee for federal income tax purposes. Because this income is not paid in cash, it is referred to as “imputed income.” The general rule is that the fair market value of the health coverage is to be treated as taxable income to the employee.

- **Domestic Partner Coverage.** The extension of health benefits to domestic partners is problematic because a domestic partner is not a “spouse.” Although some states recognize same-sex marriages, federal law does not treat a same-sex couple as spouses for any purposes including the operation of the federal income tax rules. If a covered domestic partner is not considered a "tax dependent" under federal law, the employer must include the fair market value of the health insurance benefits provided to the domestic partner in the employee’s gross income. This is known as "imputed income" and it will likely affect the employee’s taxable income and increase the employee’s tax liability.
- **Adult Children.** The extension of health coverage to older children or to other covered individuals who are not tax dependents becomes problematic because there is a very specific definition in which children are treated as “dependents” for federal tax purposes. The general rule is if an adult child is enrolled in the health plan and is not the employee’s tax dependent for income tax purposes, the fair market value (“imputed income”) of the coverage will be taxed like other income. However, these federal income tax rules were revised in connection with the enactment of the health care reform. Federal health care reform requires health plans to provide coverage for adult children until they reach age 26 (for plan years beginning on and after September 23, 2010). For these purposes, a child includes an employee's child, stepchild, legally adopted child, child lawfully placed with the employee for legal adoption, and an eligible foster child. Effective as of March 30, 2010, for federal income tax purposes, imputed income tax or withholding rules do not apply to health coverage provided to any adult child up to the time the child is age 26 for the full tax year. Keep in mind that some states extend coverage beyond the federal age limit (NJ to age 31), which will require that an employer impute income for federal tax purposes beyond the year that the child turns age 26.
- **State Income Tax Implications.** Though the IRS relaxed the federal tax standards for reporting the value of adult dependent health coverage (as explained above), employers may still have to report for state income taxes in those states that do not currently conform to federal tax rules. If the state income tax law is not amended to conform to the federal changes, then, in general, the employer should be withholding taxes on the value of the coverage for the adult child who is not otherwise eligible for favorable tax treatment and sending it to the state. (We understand that NJ and PA do not currently conform to federal tax rules and employers may have to report for state income taxes). The employer may need to report different amounts of income for federal and state income tax purposes. State legislatures often act to conform their state tax laws to federal tax law and apply this

change retroactively to the date federal income tax law changed. It is hoped this will be the case on the expansion of coverage to adult children up to age 26, but employers may wish to check with their counsel on the status of the tax law for the states in which they have employees. Multistate employers may want to consult with their tax advisers and payroll vendors to ensure appropriate wage withholding and reporting.

- **How is Imputed Income Calculated?** The amount of "imputed income" can be difficult to determine as the IRS has not provided employers with specific guidance. Many believe a reasonable estimate of the fair market value is the COBRA rate for single coverage under the plan. For this purpose, any 2% administrative fees that may be added to the premium under the COBRA rules would be disregarded.

Employers should be cognizant of tax implications of benefits offered and review their plans and enrollment records to determine who is eligible for tax-free benefits, both on the state and federal level. Employers and administrators that are not aware of imputed income situations when such situations first arise may find that they have to impute income for prior open years. Care must be taken to adjust employee W-2s to account for "imputed income" as needed and to pay the correct amounts of withholding taxes. When a dependent doesn't qualify for tax-free benefits, employers must tax employees for the value of a dependent's coverage by imputing income to the extent the employee is not paying the full cost on an after-tax basis. To ensure proper reporting and withholding, employers may want to establish a process for identifying who is or is not a tax dependent.

Employers should check with their Human Resources office to ensure compliance with these requirements. For a complete list of Legislative Updates issued by Conner Strong, visit our online Resource Center. If you have questions, please contact your Conner Strong account representative toll-free at 1-877-861-3220.

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