To: **All Participating Employers in the WESTERN HEALTHCARE INSURANCE TRUST**

From: **Board of Trustees, Western Healthcare Insurance Trust**

Date: **December 27, 2008**

ADVISORY: IRS HEIGHTENED ENFORCEMENT MODE ON TAXATION OF CERTAIN DEPENDENT PREMIUMS

A. Expansion of Health Coverage for Dependents Creates Tax Issue

1. Washington State Definition of Dependent. The IRS is currently in a heightened enforcement mode related to insurance coverage for dependents. This appears to be prompted by the enactment of insurance laws in several states, including Washington, which expands the traditional definition of "dependent," e.g., to require medical coverage for all children under age 25.

2. Difference from IRS Definition of Dependent. As you know, the Western Healthcare Insurance Trust ("WHIT") provides several different healthcare plans to its participating employers and their employees, which offer coverage to an employee's dependent children. In the past, we used the IRS definition of "dependent," which generally covered children until age 23 if enrolled full time in school. However, the new Washington State insurance statute, RCW Section 48.44.215 (effective 1/1/09), requires insurers in this state to offer medical coverage to an employee's unmarried children up to the child's 25th birthday, regardless of whether they are in school. Therefore, WHIT will now offer coverage to all participating employees' unmarried children up to their 25th birthday on dental and vision plans.

3. Only IRS-dependents Receive Tax-Favored Treatment. Unfortunately, the new state statute presents an issue of taxation under the federal Internal Revenue Code (the "Code"). The Code provides that payments for health insurance – although considered a form of wages to the employee -- will be exempted from taxable income if paid for health coverage on certain carefully defined persons, namely employees, their spouses and "dependents," as defined in the Code. (So, for example, an employee could not decide to buy coverage for his brother, and get this tax-favored treatment.) Section 152 of the Internal Revenue Code limits the definition of a "dependent" to the following groups of children:

1) under the age of 19;
2) age 19-23 only if enrolled full-time in school;
3) disabled children of any age.

What this means is that only these children (which we shall call "IRS-dependents") can receive tax-favored health coverage. In other words, premiums that an employer pays for health coverage for these categories of children will not be considered taxable income to the employee who is their parent.

On the other hand, employer premiums paid for health coverage for the following categories of children (which we shall call "non-IRS dependents") will not receive favorable tax treatment; instead such amounts will count as taxable income to the employee, and need to be reported as such:

1) Children age 19-23 who are not in school full-time: and
2) Children age 24, regardless of their enrollment in school.

In other words, the IRS considers that the premiums paid on those children who meet the state definition, but not the federal definition of a dependent, to be a form of "wages" that has not received tax-favored treatment by the Code, and therefore will be taxable income to the employee.

B. Compliance with Federal Tax Code for Non-IRS Dependents.

In order to comply with the Internal Revenue Code and avoid penalties, WHIT recommends treating premiums to the Trust for non-IRS dependents as taxable income to the employee.

1. Employer premiums. The employer will have the obligation to withhold taxes on the employer premiums for coverage for the non-IRS dependents (i.e., children age 24, regardless of student status; and children age 19-23 who are not enrolled in full-time school).

2. Employee premiums. Premiums that are paid by the employee may be paid with pre-tax or post-tax dollars, depending on whether the employer has a cafeteria plan[1]. Because each participating employer in WHIT may be handling employee premiums differently, we cannot recommend how to treat these premiums. However, in light of the heightened interest by the IRS in matters of dependent insurance premiums, we recommend that you look critically at the issue and consult your tax advisor.

As for any premiums that you determine are taxable income to the employee, there are **several strategies for calculating the taxable amount of the premium to be reported as taxable income**. Please see Section B3 below for some ideas that might be acceptable to the IRS. WHIT is not qualified to give tax advice to participating employers, and we offer the following only as suggestions to consider and to review with your tax advisor.

[1] A cafeteria plan allows an employee to, in effect, convert post-tax salary to a pre-tax premium for health coverage. The cafeteria plan should not be used to pay for premiums for the non-IRS dependents because they cannot receive tax-favored treatment.

3. <u>Value of Premiums on Non-IRS Dependents.</u> The most challenging part of reporting this taxable income to the IRS is determining the taxable amount of the premium that is attributed to coverage of the non-IRS dependent. (A substantial portion of the premium will still be tax-favored, as it will provide coverage for the employee and spouse and IRS-dependents.) Your employer and/or employee premiums generally are based on a <u>composite rate</u> that includes the premium for several family members, including the employee, spouse, and children. The composite rate premium for a family may cover both IRS-dependents and non-IRS dependents. *So the issue is determining how much of that composite rate premium is for the non-IRS dependent*. WHIT advisors have heard of the following approaches, but again we urge you to check with your tax advisor.

The taxable portion of the composite rate could be calculated in one of the following ways. Each of these strategies may have advantages and disadvantages that could be explored with your tax advisor before implementing a policy.

1) the "child(ren) rate" that WHIT generally charges for dependents could be used as the taxable amount, regardless of the number of children covered under the composite rate;

2) all employees enrolling a non-IRS dependent child could be required to pay for that child's premium with post-tax employee premiums by salary deduction, thus making the premium nontaxable (since it was already taxed in the salary).

This is not meant as an exhaustive list of your options. These are merely suggested strategies. If you have any questions about the "child(ren) rate" contact the Trust Consultants, Karni Adamson or Cricket Morgan, at DiMartino Associates, Inc. (800) 488-8277.

C. Summary of IRS-Dependent Premiums (That Remain Non-Taxable)

To recap, several categories of dependent premiums remain nontaxable as follows:

1) Premiums paid with post-tax dollars;

2) Premiums for children who qualify as IRS-dependents, including children age 19 to 23 who are enrolled in full-time school;

3) Premiums for disabled children of any age, who qualify as IRS-dependents under the Code.

Employers paying premiums on children in any of these three categories would not have additional taxable income to report on the employee's W-2. However, you should have a process for verifying the qualification of dependents as IRS-dependents under categories (2) and (3) above, i.e., verification of student status or disabled status.

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The signed contracts between the Western Healthcare Insurance Trust and the insurance carriers and the "Trust Agreement governing the Washington Hospitals Insurance Trust" are the formal plan documents governing the Trust. In the event of a conflict between the contents of this communication and the formal plan documents, the formal plan documents will prevail. You may contact the Trust Office at Zenith Administrators, Inc., 201 Queen Anne Avenue N., Suite 100, Seattle, WA 98109, (206) 281-1585, to request a copy of the formal plan documents.