COMPLIANCE ALERT

Considerations for Domestic Partner Coverage in Employee Benefits

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Quick Facts

- Many employers offer benefits to domestic partners and their children despite the absence of federal laws requiring such coverage.
- Domestic partner benefits are subject to specific taxation rules under the Internal Revenue Code (IRC).
- An employee covering a domestic partner or domestic partners' child that does not qualify as a tax dependent will have imputed income in the amount of the fair market value (FMV) of coverage subject to income tax withholding.
- Employers should pay close attention to domestic partner rules that effect mid-year changes under IRC Section 125 and Consolidated Omnibus Budget Reconciliation Act (COBRA) coverage.

Background

While opposite-sex and same-sex marriages are permitted nationwide, today's workforce presents a wide variety of relationship arrangements for which a domestic partner benefit offering provides more flexibility. In addition, while most employers are not required to offer benefits to domestic partners, doing so may provide some additional protection against claims of discrimination based on gender. For employers who do offer coverage to domestic partners, and maybe to their children as well, it is important to ensure the administration and taxation are handled in a compliant manner.

Eligibility

Federal, State and Local Requirements

Under federal law, employers are not required to offer coverage to domestic partners. However, there are a handful of states, as well as several counties and cities that do require plan eligibility to include registered domestic partners (i.e., those who are formally registered as domestic partners in accordance with state or local laws). Fully insured plans issued in such states must at least include registered domestic partners as eligible dependents. The carrier will likely only offer plans including such coverage. Self-funded plans that are subject to the Employer Retirement Income Security Act (ERISA) could choose not to include domestic partners due to ERISA preemption.

NOTE: Employers with government contract workers or city contracts may also be required to offer coverage to domestic partners in certain localities.

Eligibility Rules

For employers who are required to, or who choose to, include domestic partners in the plan eligibility rules, there is some flexibility in defining who is eligible. There is no standard definition for "domestic partner" which varies from state to state and from employer to employer. As mentioned above, some plans will be required to include at least those domestic partners who are formally registered. In

addition, the plan could include those individuals who are not formally registered, but who meet requirements such as:

- Age requirement (e.g., 18+)
- Currently living and have lived at the same address for a specified time period
- Joint finances or shared ownership of real or personal property
- Not in another marriage or domestic partnership

The eligibility rules could also include the children of the domestic partner.

Verification of Eligibility

Employers are not required to obtain an attestation or any additional documentation to prove a domestic partner's status, especially if the employer does not require anything for spouses who are permitted to enroll. However, it is possible to require verification of meeting certain requirements or to require evidence of the relationship. Proof of meeting the plan eligibility requirements, or a formal registration certificate, is easiest to collect administratively, but employers might also require documentation demonstrating things such as a common address or shared finances.

Taxation

Many benefits can be offered on a tax-favored basis to employees and to the employee's spouse and tax dependents, but if benefits are offered to those who do not qualify as the employee's spouse or tax dependent, then the coverage may need to be offered on a taxable basis. If a domestic partner, or a child of the domestic partner, does not qualify as an IRC §105(b) dependent of the employee, the employer must treat the FMV of the coverage provided to the domestic partner or child as taxable income to the employee. This is true not only for medical coverage, but also for other benefits that are generally provided on a tax-favored basis (e.g., dental, vision).

Definition of a Tax Dependent

To be a federal tax dependent under IRC §105(b), the individual must be a "qualifying relative" or a "qualifying child" of the employee as defined by the IRC. To be a qualifying relative, a domestic partner must meet all the following requirements:

- Reside at the same address as the employee and be a member of the employee's household;
- Receive over half of his or her support from the employee;
- Not be anyone's qualifying child; and
- Be a citizen or national of the U.S., or a resident of the U.S. or a country contiguous to the U.S.

Some employers also offer coverage to the children of a domestic partner who are not dependent children of the employee. To be the employee's IRC §105(b) dependent, the domestic partner's child would have to be a qualifying relative of the employee. However, one of the requirements for being a qualifying relative is that an individual must not be a qualifying child of any other taxpayer. A domestic partner's child will probably be a qualifying child of the domestic partner, and therefore cannot be the employee's qualifying relative.

Generally, employers will not know whether a domestic partner or child qualifies as a tax dependent of the employee. The employer may want to adopt a default rule that assumes the domestic partner or child is not a tax dependent unless the employee notifies the employer otherwise. Plan sponsors should communicate this assumption in benefit communications and then provide an opportunity for employees to submit an affidavit that a domestic partner or their children qualify as an IRC §105(b)

tax dependent when applicable. The Internal Revenue Service (IRS) has approved the use of employee certifications for verifying tax dependent status.

How to Tax Domestic Partner Benefits

When health coverage is provided to a domestic partner (or to his or her child) who is not the employee's tax dependent, the employer must impute the FMV of the coverage as taxable income to the employee. The employee will have imputed income reported on Form W-2 equal to the FMV of the domestic partner's (or child's) coverage, and this amount will be subject to income tax withholding and employment taxes. A domestic partner (or child) must remain a dependent for the entire tax year. If a domestic partner ceases to qualify as a dependent during the tax year, the employer is required to include the value of employer-provided domestic partner coverage provided since the beginning of the tax year in the employee's taxable income.

The IRS has not provided any official guidance about determining the value of health coverage, so employers have some flexibility for determining FMV.

- One approach commonly used by employers is to use the plan's COBRA premium for self-only (individual) coverage, not including the 2% COBRA administration fee. When coverage is added for more than one individual (e.g., a domestic partner and his or her child), the COBRA premium for that number of individuals could be used.
- Another method used by some employers is to determine the value based on the incremental cost of adding coverage for the individual. For example, if the monthly plan cost for single coverage is $450 and the cost for Employee plus one coverage is $700, the FMV of the domestic partner's coverage would be $250 ($700 − $450).

In some cases, such as when the employee already carries family coverage, the cost of adding coverage for an individual may be $0.00. The IRS has made it clear that the coverage still has value and that an appropriate FMV must be included in the employee's income, even if there is no additional premium due.

The mechanics of imputing taxable income will depend on how the coverage is paid for by the employer and the employee.

- If the employer covers the full premium for the domestic partner's coverage (or for his or her child), then the FMV of the health coverage must be included in the employee's income.
- If the employer and the employer share in the cost of the monthly premium, it can be handled one of two ways:

    1. Handle employee contributions for the domestic partner coverage on an after-tax basis and impute the FMV minus the employee's after-tax contributions; or
    2. Handle employee contributions for the domestic partner coverage on a pre-tax basis and then impute the full FMV.

Some employers impute income only once a year, adding all the imputed income for the domestic partner coverage to the taxable income reported on the employee's W-2 at year's end. Others report the imputed income incrementally throughout the year as the domestic partner coverage is provided. The latter approach allows the employer to calculate and withhold taxes on the imputed income throughout the year and avoid a potential tax surprise for employees when they file their taxes.

Other Benefit Considerations

Health FSA, HRA, and HSA Reimbursement

Health flexible spending accounts (FSAs) and health reimbursement arrangements (HRAs) are generally only available to reimburse qualifying medical expenses of the employee, employee's spouse, the employee's child who has not yet reached age 27, and employee's tax dependents. Therefore, expenses incurred by a domestic partner or the domestic partner's child who is not a tax dependent of the employee cannot be reimbursed on a tax-favored basis. There is informal guidance from the **IRS in Private Letter Ruling 201415011** indicating that an HRA may reimburse qualifying medical expenses for domestic partners, but only if the reimbursement is imputed as taxable income to the employee (assuming the domestic partner is NOT the employee's tax dependent).

Similarly, health savings account (HSA) funds may only be used to reimburse qualifying medical expenses of an HSA account holder and account holder's spouse and tax dependents on a tax-favored basis. Therefore, the expenses of domestic partners or their children are generally not reimbursable by the employee's HSA, unless the employee is willing to pay the taxes and penalties applicable to ineligible withdrawals. The domestic partner, if enrolled in a high deductible health plan (HDHP) and is otherwise HSA-eligible, could open and contribute to his or her own HSA. In addition, the contribution limit that applies to married spouses with family HDHP coverage would not apply, so the domestic partner and the employee could each contribute up to the family HDHP maximum for the year if enrolled in family HDHP coverage.

Cafeteria Plan Election Change Rules

Domestic partners who are not permitted to participate in benefits on a tax-favored basis are not subject to IRC §125 election change rules and have more flexibility to add, drop, increase or decrease coverage throughout the year, unless the employer or carrier implements rules restricting mid-year changes.

HIPAA Special Enrollment Rights

The following events trigger Health Insurance Privacy and Accountability Act (HIPAA) special enrollment rights, requiring the group health plan to allow mid-year enrollment if it is requested by the employee due to:

- Loss of coverage;
- Acquisition of a dependent through marriage, birth or adoption; and
- Becoming eligible for a children's health insurance program (CHIP) or Medicaid subsidy.

A domestic partner (or child) who loses eligibility for other coverage, or becomes eligible for a Medicaid or CHIP subsidy, triggers a HIPAA special enrollment right for the domestic partner or child. However, newly forming a domestic partnership is not equal to entering into a legal marriage and does not trigger a HIPAA special enrollment right. Plans that choose to extend coverage to domestic partners could choose to allow mid-year enrollment upon a newly formed domestic partnership so long as the carrier agrees.

COBRA & State Continuation Rights

Under federal COBRA, only covered employees, spouses, and dependent children may be COBRA qualified beneficiaries. A domestic partner does not qualify as a spouse or as a dependent child of the employee. Consequently, a covered domestic partner will not be a qualified beneficiary and will not have independent COBRA election rights. However, if the employee and domestic partner are both enrolled in the employer's group health plan(s), the domestic partner should be offered COBRA if the

employee is offered COBRA (e.g., following a termination of employment or reduction in hours). If COBRA is elected for the employee and domestic partner, the domestic partner may continue coverage so long as the employee remains enrolled since the domestic partner does not have independent COBRA rights.

For fully insured plans subject to state continuation requirements, in states which recognize domestic partnerships, the plan may be required to offer continuation coverage to domestic partners in some cases (e.g., under CalCOBRA).

Summary

Any employer that offers health and welfare benefits to eligible domestic partners and their dependents should carefully consider the different tax rules and other laws applicable to the benefits available to such individuals, and how they differ from the laws applicable to spouses and other federal tax dependents. Additional consideration should be given to varying state laws and local ordinances that may impose requirements on employers offering certain benefits in the state or locality.

EPIC Employee Benefits Compliance Services

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