Domestic Partner Benefits and Imputed Income

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Domestic Partner Benefits
The legalization of same-sex marriage nationwide has made it easier for employers to administer the tax impact of health benefits provided to same-sex spouses of employees. Federal tax treatment of benefits applies equally to legally married same-sex and to opposite-sex couples. However, some employers continue to provide employer sponsored benefits to domestic partners who are not legally married. Employers must generally treat the value of employer-provided domestic partner benefits as taxable income to the employee.

Background
Employers who choose to offer domestic partner benefits must first define who is eligible for the coverage. ERISA does not define the term "domestic partner," and the definition varies from state to state and from employer to employer. Some elements commonly used to define a domestic partner for plan eligibility purposes include each partner being a minimum age; neither partner being legally married to or in a domestic partnership with anyone else; and the partners having lived together for a specified amount of time and being financially interdependent. Some employers also require evidence of the relationship, such as a driver's license listing a common address or evidence of common ownership of real property, joint bank accounts, or credit accounts.

When Can a Domestic Partner Qualify as a Dependent?
Unless a domestic partner qualifies as a Code §105(b) dependent of the employee, the employer must treat the fair market value (FMV) of the health coverage extended to the domestic partner as taxable income to the employee. In general, when a domestic partner is an employee's Code §105(b) dependent, the domestic partner's health coverage and benefits will be tax-free to the employee and the domestic partner.

To be a federal tax dependent under Code §105(b), a domestic partner must be a "qualifying relative" or a "qualifying child" of the employee as defined by the Code. It is rare for a domestic partner to be a qualifying child of the employee. 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
- 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 children of a domestic partner who are not dependent children of the employee. To be the employee's Code §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.

Many plan sponsors also require the employee to provide an affidavit that indicates whether a domestic partner qualifies as a Code §105(b) tax dependent and that requires the employee to notify the employer of any changes. The IRS has approved an employer's use of employee certifications as part of an administrative process for verifying dependent status.

Taxable Domestic Partner Benefits
When health coverage is provided to a domestic partner (or to his or her child) who is not the employee's Code §105(b) tax dependent depends on how coverage is paid for (pre-tax or after tax).

- When an employee pays with after-tax dollars for coverage of a domestic partner (or child), the coverage will not be taxable to the employee as long as the employee pays at least the FMV of the coverage.
- If an employer pays for the domestic partner's (or child's) health coverage, then the FMV of the health coverage must be included in the employee's income.

    - The employee will have imputed income reported on Form W-2 equal to the FMV of the domestic partner's (or child's) coverage.
    - This amount will also be subject to income tax withholding and employment taxes.
- Cafeteria plan rules allow non-Code §105(b) tax-dependent health coverage to be offered as a taxable benefit. When such coverage is offered, the employee must be treated as receiving cash compensation equal to the full FMV of such benefits. An employee cannot pay for domestic partner (or child) coverage on a pre-tax basis under a cafeteria plan.
- 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.

Determining the Value of Health Coverage Provided
When employers provide health coverage to domestic partners (or children) who are not Code §105(b) tax dependents, the employer must impute income to the employee equal to the FMV of the coverage (less any after-tax payments by the employee). Unfortunately, the IRS has not provided any official guidance about determining the value of health coverage.

One approach commonly used by employers is to use the plan's COBRA-applicable premium for self-only (individual) coverage when coverage is added for a domestic partner (not including the 2% COBRA administration fee added to COBRA premiums). 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 $250 and the cost for employee+1 is $450, the FMV of the domestic partner's coverage would be $200 ($450 − $250).

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 actually no additional premium due.

Regardless of which approach is used, any amount that the employee pays on an after-tax basis would be subtracted from the FMV to determine the amount to include in the employee's taxable income.

Other Benefits
Other important benefits issues are raised when coverage is offered to domestic partners (or children) who are not Code §105(b) tax dependents.

- Employees cannot have claims incurred by a domestic partner reimbursed though a Section 125 health flexible spending account (HFSA).
- Under COBRA, only covered employees, spouses, and dependent children may be qualified beneficiaries. A domestic partner will not qualify as a spouse or be considered a dependent child of the employee. Consequently, a covered domestic partner will not be a qualified beneficiary and will have no independent COBRA election rights.
- Employees cannot use HSA funds on a tax-free basis to pay for medical claims incurred by a domestic partner. However, HSA contribution limits are determined by the level of High Deductible Health Plan (HDHP) coverage carried by the employee. So if the employee has family HDHP coverage resulting from coverage provided to a domestic partner, the employee may make HSA contributions based on the family maximum contribution limit set by the IRS.

Summary
Some analysts predicted that fewer employers would offer domestic partner benefits after same-sex marriage was legalized, but this has not turned out to be the case. Domestic partner benefits are still offered by many employers, so the proper administration and tax treatment of benefits remains as important as ever.