Tax Issues with Providing Benefits to Domestic Partners, Including 50 State Tax Table

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Background

In general (and with exceptions noted below), Domestic Partners will not receive tax favored employer sponsored group health plan benefits under federal or state law. This means that Domestic Partners will have the Fair Market Value (FMV) of coverage imputed as income under federal and state law (exceptions noted below). Note that the term Domestic Partner can refer to registered Domestic Partners recognized by state law and confirmed by registration with the state, as well as Domestic Partners that are simply recognized in an employer's plan eligibility provisions and usually confirmed by employee affidavit. Same sex spouses are now legally recognized under federal and state law and are different from Domestic Partners.

A Domestic Partner, state recognized or not, may qualify as a federal tax dependent, specifically a "qualifying relative," under Code § 152 as modified by § 105(b). A Domestic Partner who qualifies as an employee's Code §152/105(b) tax dependent should complete a verifying affidavit and will not have the FMV of coverage imputed as income under federal or state law. Although imputing income under Federal law is otherwise required, there is no need to impute income under state law in states with no personal income tax or that only tax interest or dividend income. Some states also converted certain existing Domestic Partnerships to marriages and no longer register new Domestic Partnerships or Civil Unions. Domestic Partnerships that were converted to marriages will not require imputed income under federal or state law but any unrecognized partnerships that were not converted to marriages will generally require that the FMV of group health plan benefits be imputed as income.

A "Qualifying Relative"

The following requirements for a covered dependent must be met for the tax year for a Domestic Partner to qualify as an employee's Qualifying Relative and Code §152/105(b) tax dependent:

(1) have the same principal place of abode as the employee and be a member of the employee's household (must not violate local law);

(2) receive over half of his or her support from the employee;

(3) not be anyone's "Qualifying Child"; and

(4) be a citizen or national of the U.S., a resident of the U.S., or a country contiguous to the U.S.

Any individual that satisfies these "Qualifying Relative" criteria will not have the FMV of coverage imputed as income under federal or state law.

The children of Domestic Partners (who are not otherwise children of the employee) are entitled to receive tax-free health coverage only if they qualify as Code § 152/105(b) tax dependents as a qualifying relative or as stepchildren under state law. Since one of the conditions of the qualifying relative test is that a qualifying relative cannot be the qualifying child of any other taxpayer, the child

of a domestic partner will frequently fail to satisfy the qualifying relative test because they are generally the qualifying child of the Domestic Partner. Nonetheless, if an employee is a stepparent of his or her domestic partner's child as recognized by the laws of the state in which the partners reside, then the employee will also be the child's stepparent for federal income tax purposes and there will not be imputed income under federal or state law (e.g. children of CA Registered Domestic Partners are stepchildren).

"Common Law" Marriage

Several states recognize common-law marriages (marriage without a formal ceremony). These states include Colorado, Iowa, Kansas, Montana, New Hampshire, South Carolina, Texas, and Utah. Common-Law Marriage (National Conference of State Legislatures. Courts in certain other jurisdictions (e.g., Alabama, Oklahoma, Rhode Island, and the District of Columbia) have also recognized common-law marriages, even though there is no clear statutory right in those states. (Alabama no longer recognizes common-law marriages beginning after 2016). The specific requirements to establish a common-law marriage vary by jurisdiction, but tend to include basic elements regarding long-term commitment and monogamous relationships. Many of these states actually require a formal registration and will issue a certificate (e.g. Texas and Utah).

For benefit plan eligibility and tax purposes plan sponsors need to have proof of validity of the common law marriage. If a couple misrepresent their marital status (to avoid imputed income) they are committing tax fraud and the employer is failing to pay its required payroll taxes. Because of the significance of these tax issues employees claiming a common law marriage should present a state certificate or registration or a federal tax filing showing either married filing jointly or married filing separately. The federal tax code recognizes valid common law marriages so with the proper documentation (or attestation) there is not imputed income.

Imputing Income

When an employee's coverage of a Domestic Partner requires imputed income under federal and/or state law, determining the FMV of that coverage can be complicated. IRS has not sanctioned a specific method to determine the FMV of coverage for purposes of imputing income. The following three ways to determine the FMV of group health plan benefits for purposes of imputing income are most commonly used:

(1) COBRA Rate – The COBRA rate for employee-only coverage.

(2) Incremental Cost – The additional cost of adding an individual to the coverage (e.g. the difference in cost between employee-only coverage and employee + 1 coverage, etc.). The incremental cost can never be zero. An insured plan with no incremental cost could use the employee only rate as well.

(3) Actuarial Value – The value is determined by an actuary based on actual plan costs, demographics, and trend.

Although the source of the contribution (e.g., employer-paid or employee-paid) is generally irrelevant to the tax analysis, any amount the employee contributes toward the domestic partner's coverage on

a post-tax basis should be subtracted from the fair market value amount imputed as income. Note that an employee can pay for Domestic Partner coverage through the cafeteria plan on a pre-tax basis, but in that situation the entire FMV is imputed (without subtracting post tax payments).

The annual fair market value of coverage for a domestic partner is $4,000 (does not include the cost of coverage for the employee).

- Employee contribution for domestic partner coverage is $1,000
- Employer contribution for domestic partner coverage is $3,000 ($4,000-$1,000)

Option 1 - Employee pays $1,000 post-tax. $3,000 employer contribution is included on W-2 as gross income.

OR

Option 2 - Employee pays $1,000 pre-tax. $4,000 total cost of coverage is included on W-2 as gross income.

Employees should understand that they will have additional federal taxes owed or withheld to correspond with this additional imputed income. Federal income tax brackets vary (most commonly between 15-30%) and Federal Insurance Contributions Act (FICA) tax rates also vary slightly (generally 7.65%). Employees, however, should expect to pay ~20-35% of the imputed income amount in federal taxes, or $800-$1,400 based on the example above in which the annual fair market value of domestic partner coverage is $4,000. Importantly, more or less may be withheld or due based on an employee's W4 withholding elections. Employers that gross up employees' wages to account for these additional taxes should work with their tax advisor on issues surrounding "pyramiding" of wages. Additional state taxes and imputed income issues under state law are described in detail below.

Summary Table

State	Impute Income	DP Recognition and/or State Tax Provisions
1. Alabama	Yes	No Recognition
2. Alaska	No	No Income tax or Interest/Dividends Only
3. Arizona	Yes	No Recognition
4. Arkansas	Yes	No Recognition
5. California	No	Registered Only (RDP coverage mandate)
6. Colorado	Yes	Mirrors Federal Tax Code
7. Connecticut	No	Converted to Marriage (impute for any remaining DPs)
8. Delaware	No	Converted to Marriage (impute for any remaining DPs)
9. District of Columbia	No	Registered Only
10. Florida	No	No Income tax or Interest/Dividends Only
11. Georgia	Yes	No Recognition
12. Hawaii	No	Registered Only
13. Idaho	Yes	No Recognition
14. Illinois	No	Certified Civil Unions Only
15. Indiana	Yes	No Recognition
16. Iowa	Yes	No Recognition
17. Kansas	Yes	No Recognition
18. Kentucky	Yes	No Recognition
19. Louisiana	Yes	No Recognition
20. Maine	Yes	Mirrors Federal Tax Code
21. Maryland	Yes	Mirrors Federal Tax Code
22. Massachusetts	Yes	No Recognition
23. Michigan	Yes	No Recognition
24. Minnesota	Yes	No Recognition
25. Mississippi	Yes	No Recognition
26. Missouri	Yes	No Recognition
27. Montana	Yes	No Recognition
28. Nebraska	Yes	No Recognition
29. Nevada	No	No Income tax or Interest/Dividends Only
30. New Hampshire	No	Converted to Marriage / No Income tax or Interest/Dividends Only
31. New Jersey	No	Registered Only

32. New Mexico	Yes	Mirrors Federal Tax Code
33. New York	Yes	No Recognition
34. North Carolina	Yes	No Recognition
35. North Dakota	Yes	No Recognition
36. Ohio	Yes	No Recognition
37. Oklahoma	Yes	No Recognition
38. Oregon	No	Registered Only
39. Pennsylvania	No	No Recognition
40. Rhode Island	No	Converted to Marriage (impute for any remaining DPs)
41. South Carolina	Yes	No Recognition
42. South Dakota	No	No Income tax or Interest/Dividends Only
43. Tennessee	No	No Income tax or Interest/Dividends Only
44. Texas	No	No Income tax or Interest/Dividends Only
45. Utah	Yes	No Recognition
46. Vermont	No	Converted to Marriage (impute for any remaining DPs)
47. Virginia	Yes	No Recognition
48. Washington	No	No Income tax or Interest/Dividends Only
49. West Virginia	Yes	No Recognition
50. Wisconsin	Yes	Limited Recognition Not Impacting Tax Status
51. Wyoming	No	No Income tax or Interest/Dividends Only

Caution: State tax laws are complicated and subject to frequent change. The information provided may not reflect the most current state guidance. This information should be used only as a starting point together with advice from an experienced state tax law advisor.

Compliance Alert is presented by the Compliance Practice Group of Alliant Employee Benefits