

ALERT: Change in “Dependent” Definition

Health, 401(k) and Cafeteria Plans: Plan amendments may be needed to avoid any unexpected changes to the definition of dependent.

Working Families Tax Relief Act of 2004

Effective January 1, 2005, the definition of “dependent” under Internal Revenue Code (“Code”) section 152 will be limited:

- Qualifying Child. A dependent child must be under age 19 (or disabled, or a student under age 24), and must meet residency and support requirements.
- Qualifying Relative. Alternatively, a dependent individual who is not a qualifying child must satisfy a **new** gross income limitation of \$3,100, in addition to support and relationship requirements.

The Act did not intend to change the definition of dependent for employee benefit plans¹, and both Congress and Treasury are working to provide legal “escape clauses” to exempt benefit plans from these changes. *Still, your plan documents may need to be updated to incorporate these escape clauses – they are not automatic.* This is because the escape clauses relate to Code sections 21, 105, 106, 129 and 401(k) – not to section 152 itself.

If You Do Nothing

If you do nothing, your health, 401(k) and cafeteria plans will become subject to the new restrictions *if they define dependent by reference to Code section 152.*

This may expose you to operational noncompliance and potential reporting penalties. This is because certain individuals who previously qualified as dependents (such as domestic partners, aging parents, and most children over age 19) will cease to qualify for 2005 if they earn more than \$3,100.

As a result, your health plans may be noncompliant for extending coverage to these individuals and for failing to report health benefits as income. Your 401(k) plan will be noncompliant if it issues a hardship withdrawal to pay for medical expenses for these individuals. Similarly, a DCAP risks noncompliance if it reimburses expenses for the care of an aging parent with earnings over \$3,100.

¹ The stated purpose of P.L. 108-311 was to increase conformity among the child tax credit, dependency exemption, dependent care credit, earned income credit, and head of household filing status.

If You Want Plan Operations To Remain Unchanged

If you want to preserve existing plan operations unchanged, your health plans should be reviewed and possibly tweaked to incorporate the “escape clauses” that Congress and Treasury have already adopted. *Ideally, these changes should be made before 2005.*

Similar escape clauses are expected for 401(k) plans as well, although the timing is less urgent in this case.

It is unclear whether technical corrections will materialize for dependent care assistance programs. To prepare for the worst, we advise ensuring that the ‘change in status’ rules in your cafeteria plan allow a participant to discontinue contributions mid-year when such a dependent reaches the income limit.² This would enable a participant to cease contributions if a dependent becomes ineligible part-way through the year.

² This election change is permissible as a change in status event under existing Treasury Regulation section 1.125-4(c)(2)(iv).