

POTENTIAL TAX IMPLICATIONS OF PROVIDING DOMESTIC PARTNER BENEFITS

There are certain potential tax implications to both the employee and the employer, of which all parties should be aware before domestic partner benefits are offered. Most of these implications are discussed in Section 152 of the Internal Revenue Code. Some of the major points shall be summarized here.

Internal Revenue Code Section 152(a) defines a “dependent” for federal tax purposes. This definition generally requires a blood relationship (including adoption) or a marital relationship, as well as a support test. In most situations, a domestic partner will not meet the Code requirements for the definition of a “dependent”. In fact, a domestic partner will only meet the Code definition of a “dependent” if all of the following requirements are met:

1. the taxpayer (in this case, the employee) provides over 50% of the domestic partner’s support;
2. the domestic partner’s principal place of abode is that of the taxpayer/employee, and the domestic partner is a member of the taxpayer/employee’s “household”; and
3. the relationship of the taxpayer/employee and the domestic partner does not violate state or local law. Under the Internal Revenue Code Section 152 (b)(5), if the relationship violates state or local law, the domestic partner cannot be considered to be a member of the employee’s household, and therefore cannot be considered to be a dependent.

If a domestic partner does not meet the above requirements, and therefore does not meet the IRS requirements to be considered a tax-qualified dependent, then any domestic partner benefits provided by the employer will be considered taxable benefits to the employee. If the employer pays any portion of the premium (for health and/or dental insurance) for the domestic partner’s coverage, the amount which the employer pays for that coverage is includible in the employee’s income under Internal Revenue Code Section 61. So, for example, if the employer pays 50% of the cost of dependent coverage for an employee’s domestic partner, that amount paid by the employer must be included in the employee’s income.

In addition, any such amounts includible in the employee’s income due to coverage of a domestic partner constitute wages under Section 3401(a) of the Internal Revenue Code, and are subject to income tax withholding, as well as FICA and FUTA taxes. This means that any employer that provides domestic partner benefits must put in place a procedural arrangement to ensure that W-2 tax forms are prepared for those employees who elect domestic partner coverage. These W-2 tax forms must include the value of the imputed income arising out of the domestic partner benefits. The employer must also be sure to make the necessary withholding and payroll tax payments.

Another issue which must be addressed by employers offering domestic partner coverage concerns payment of premiums by employees under a cafeteria plan or other pre-tax arrangement. If the employee pays all or any portion of the cost for domestic partner coverage, that portion of the premium must be paid on an after-tax basis, unless the domestic partner meets the dependent definition in Code Section 152. In a Private Letter Ruling issued by the IRS in 1995 (IRS Private Letter Ruling 9603011, October 18, 1995), the IRS ruled that, if a domestic partner is neither a spouse or dependent (as defined earlier in this memo), then:

1. premiums paid by the employer for domestic partner coverage must be included in the employee's income, as already described; and
2. the employee cannot pay any part of the premium for the domestic partner's coverage on a pre-tax basis. Thus, even if the employer has a plan in place for employees to pay their portion of health and/or dental insurance premiums on a pre-tax basis, employees would not be able to pay for domestic partner premiums pre-tax. Any contribution which the employee makes toward the cost of coverage for his/her domestic partner must be made on an after-tax basis.

Because of all the potential tax implications and complications arising from the offering of domestic partner coverage, the Health Trust strongly recommends that any employer group offering such coverage consult with its payroll administrator, tax consultant and/or attorney, and (if applicable) cafeteria plan administrator.

THIS DISCLOSURE IS NOT INTENDED TO CONSTITUTE TAX ADVICE, BUT RATHER IS INTENDED TO HIGHLIGHT SOME OF THE COMPLEX TAX AND ADMINISTRATIVE ISSUES ARISING OUT OF DOMESTIC PARTNER BENEFIT COVERAGE. EMPLOYERS ARE ENCOURAGED TO CONSULT THEIR OWN ACCOUNTANTS FOR SPECIFIC TAX ADVICE.