

Employers Still Struggle to Determine Imputed Income for Domestic Partner Benefits

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The federal tax code excludes from employees' taxable income amounts an employer pays for medical care provided to the employee and an employee's spouse and dependents. Generally, however, it is very difficult for a domestic partner to qualify as a tax code dependent. As a result, the employee is taxed on the fair market value (FMV) of the health care coverage extended to the employee's non-dependent domestic partner (See ¶372 of the *Handbook*). If the domestic partner's children are also covered (and do not qualify as the employee's dependents), the employee will be taxed on the FMV of that coverage. The imputed income resulting from domestic partner coverage provided is deemed to be wages reported on an employee's Form W-2. The employer must withhold for federal Social Security (FICA), unemployment (FUTA), Medicare and income taxes on the value of those benefits.

Calculating Fair Market Value of Coverage

There is only limited IRS guidance (mainly contained in private letter rulings (PLRs); see Box 2), on how to determine FMV of domestic partner benefits. When the IRS issues guidance, it is clear what is *not* included in an FMV determination. The FMV of coverage does not depend on usage of the coverage or benefit claims actually paid. For example, if an employee's domestic partner incurs large expenses for cancer treatment or heart surgery, the FMV of the coverage would be no higher than if the partner merely receives regular medical checkups. Similarly, the cost incurred by the employer is not determinative of FMV. If, for example, an employee already has family coverage so that there is no additional cost to the employer to add the domestic partner and/or the partner's children to the employee's coverage, the employer must still impute income to the employee for such coverage.

The FMV of coverage is determined based on the amount an individual would have to pay for the particular coverage in an arm's-length transaction. The most common way to determine that amount is the difference between the cost of employee-plus-one and employee-only coverage, after deducting any portion of the cost the employees paid. There are two options for performing this calculation (see Box 1).

The IRS has not specifically indicated its opinion on the most appropriate method for determining FMV, but it has not rejected these approaches in several PLRs.

Alternatively, some employers use a plan's individual COBRA premiums (less the administration fee) to determine FMV as the IRS has not objected to the use of COBRA rates as a proxy for FMV in previous PLRs. This approach generally leads to a larger amount of imputed income for an employee.

We recommend that employers seek advice from their legal counsel when determining FMV.

Box 1

Calculating Fair Market Value of Coverage

- 1) The difference between the amount the employer would contribute for the employee alone and the amount the employer would contribute for coverage of an employee and a spouse or family (as applicable). When the particular coverage provided to the individual is group medical insurance coverage, PLRs provide that the amount includible in the employee's gross income can be the FMV of the group medical coverage. Employers can, therefore, impute income for domestic partner benefits coverage using group rates as opposed to, for example, the higher COBRA individual rate.
- 2) The difference between the actuarial value of insurance for a single person and insurance for a couple or family. This method involves actuarial calculations and is more expensive to complete than the first. It is possible that this actuarial method will result in a more accurate value of coverage and a lower amount of imputed income for the employee.

Box 2

Private Letter Rulings Relevant to Domestic Partner Benefits

- PLRs 19985011, 9717018, 199231062 and 199034048: Once the FMV of coverage has been included in an employee's income, neither the employee nor the domestic partner will be taxed on any benefits paid on behalf of the domestic partner.
- PLRs 199111018 and 199109060: FMV of group medical coverage can be used regardless of whether the employee is also covering a spouse or dependent.
- PLR 200108010: When domestic partner coverage is valued in accordance with actuarially determined individual or family COBRA rates, excess of the FMV of the domestic partner's coverage (including any "gross-up") minus the amount paid by the employee for such coverage, is includible in the employee's income.
- PLR 200339001: An employee's same-gender domestic partner may qualify as a dependent although not qualifying as a spouse.

A Note about PLRs: Private letter rulings do not have the force and effect of law, nor do they constitute official IRS guidance. Nonetheless, employers should be aware of the view the IRS expresses in PLRs since they suggest how the IRS interprets the law with regard to a specific situation and how the IRS may apply the law in similar scenarios.

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