

# Issues to Consider in Providing a Tax Gross-Up for Employees Covering Same-Sex Spouses and Partners under the Employer's Medical, Dental, and Vision Plans

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Recent announcements from several large corporations and law firms may signal a new trend in employers adopting the cutting-edge practice of providing tax gross-ups for employees covering a same-sex spouse or partner under the employer's medical, dental or vision plans. Under such an arrangement, an employer agrees to relieve some or all of the additional federal and state income and payroll tax burden that an employee will incur due to the fact that the employee's spouse or partner covered under the employer's medical, dental or vision plans is of the same sex. The taxation of domestic partner benefits, as well as the mechanics of providing a tax gross-up, are described below.

Employers generally have great latitude to structure and implement benefit policies for same-sex spouses and partners in any manner they choose, though the benefits they do offer are governed by a series of federal laws and regulations. The most common benefit offered by employers to their employees' same-sex spouses and partners is coverage under the company's medical, dental and vision plans. Employees who opt to enroll a same-sex spouse or partner in these benefits typically pay a "married" or "employee plus 1" premium to cover the same-sex spouse or partner in the same way that an employee with an opposite-sex spouse would pay for spousal coverage.

## *Federal and State Taxation*

Employers that extend these benefits to employees' same-sex spouses and partners need to be aware of the corresponding tax implications of doing so. While federal law excludes amounts that an employer pays towards medical, dental or vision coverage for an employee and the employee's spouse and dependents from the employee's taxable income, employers that provide these same benefits to employees' same-sex spouses or partners are required to impute the fair market value of the benefits as income to the employee that is subject to federal income tax, unless the same-sex spouse or partner otherwise qualifies as the employee's tax code dependent. Same-sex spouses and partners often will not qualify as an employee's dependent due to the narrow definition of dependent under the federal tax code. In addition, unlike premiums for opposite-sex spouses, the cost of a non-dependent same-sex spouse or partner's medical, dental or vision coverage cannot be paid on a pre-tax basis under a so-called "cafeteria plan" and instead can only be paid by the employee with after-tax premiums. The employee also cannot seek reimbursement for the cost of the coverage from a health reimbursement arrangement or flexible spending account. Even in states where same-sex marriage has been legalized, same-sex spouses and partners cannot qualify as an employee's spouse for federal income tax purposes.

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since the federal Defense of Marriage Act (DOMA), Pub. L. 104-199, limits the definition of "spouse" to a person of the opposite sex regardless of how "spouse" is defined for purposes of state law.

States have taken conflicting approaches to the treatment of employer-provided benefits for same-sex spouses and partners for state income tax purposes. The majority of states have chosen to follow the federal law approach by enacting their own versions of the federal DOMA as either a state constitutional amendment or as a state statute that limits the definitions of "marriage" and "spouse" to opposite-sex couples for all purposes of state law. These states impute the fair market value of employer-provided medical, dental and vision coverage for an employee's same-sex spouse or partner as income subject to state income taxation in the same manner as required by federal law. A handful of states have attempted to address this differing treatment by adopting specific provisions taxing employer-provided medical, dental or vision coverage for same-sex spouses and partners in the same way as coverage for opposite-sex spouses.

#### *Calculating "Fair Market Value"*

In calculating the amount of income that must be imputed to an employee for purposes of federal income taxation of employer-provided benefits for a same-sex spouse or partner, the Internal Revenue Service (IRS) requires the "fair market value" of these benefits be included as taxable income. The fair market value is defined under Income Tax Regulations as "the amount that an individual would have to pay for the particular benefit in an arm's length transaction." This means that the amount of income that must be imputed is not the amount that the employee contributes to such benefits for his or her same-sex spouse or partner or the subjective value of such benefits to the employee or his or her same-sex spouse or partner. Rather, the taxable amount that is imputed as income to the employee is determined based on the amount that the employee would have to pay to purchase the benefit coverage for his or her

same-sex spouse or partner separate from employment.

The IRS has indicated that the fair market value of benefits for an employee's same-sex spouse or partner must be imputed as income to the employee even if the cost of coverage does not otherwise increase for the employee. One common situation in which this can occur is when an employee is enrolled for family coverage for the employee and his or her children and the employee can enroll a same-sex spouse or partner under the family coverage without incurring an increase in the applicable premiums. Even though benefit coverage for the employee's same-sex spouse or partner is provided at no additional cost to the employee, the IRS nevertheless requires the fair market value of the coverage to be imputed as taxable income to the employee.

Although the IRS has not prescribed a set means by which the fair market value of such benefits is to be calculated, the IRS has indicated its approval of several means. These means can be used even in situations where benefit coverage for an employee's same-sex spouse or partner is provided at no additional cost to the employee as described above. The most common way to calculate the fair market value of the benefits is to compare the difference between the costs of providing employee-only coverage and employee-plus-one coverage, after deducting any portion of the cost that is paid by the employee. This amount can be calculated as the difference in what the employer pays to provide coverage for a single employee compared to what the employer pays to provide coverage for an employee and a spouse. Although this result is based on a group health plan rate and would be less than the amount the employee would pay for such coverage separate from employment, the IRS has approved the use of the group health plan rate as a means for calculating the fair market value of the benefit. Alternatively, many employers also calculate the fair market value of the benefit based on the individual COBRA premium rate that otherwise applies to such benefits (less the 2 percent COBRA administration fee). Use of the

COBRA premium rate generally leads to a larger amount of imputed income for the employee.

Employers are required to report income that is imputed as a result of medical, dental and vision benefits provided to an employee's same-sex spouse or partner on the employee's annual Form W-2. In addition, employers are required to withhold federal payroll taxes from the imputed amount, including federal income, Social Security (FICA), Medicare and employment (FUTA) taxes.

### *Providing Gross-Ups*

Because employees covering a same-sex spouse or partner are taxed on the value of employer-provided coverage and must pay premiums on an after-tax basis, they end up paying significantly more for coverage than an employee covering an opposite-sex spouse. Employers that recognize this disparity and want to provide equal benefits for all employees can do so by grossing up the income of the employee covering a same-sex spouse or partner by the approximate amount that the employee must pay in taxes for the partner's coverage. Employers that provide such gross-ups should keep in mind that employees must also pay tax on the gross-up itself. Therefore, some employers structure the amount of the gross-up to include both the amount of the tax that the employee would pay for the partner's coverage and the amount of the tax that the employee would pay on the gross-up itself. Other decision points for an employer contemplating a gross-up include the following:

- What tax rate should be used to calculate the gross-up? Alternatives include a "one size fits all" approach where a standard tax rate is presumed to apply to all employees who receive the gross-up or requesting tax information from employees such that an individually designed rate can be used.
- Should the gross-up be for federal income taxes only? Or should the gross-

up also include state income taxes and payroll taxes? Should the gross-up also try to account for the fact that the employees pay for coverage of same-sex partners on an after-tax basis and are not able to take advantage of pre-tax payment of premiums under a cafeteria plan?

- How often should the gross-up occur? Alternatives include grossing-up employees periodically on each paycheck or waiting until the end of the year to provide a gross-up. If the latter approach is used, the employer will need to consider whether it will provide a partial gross-up to employees who terminate employment or die during the year.
- Should the gross-up be for same-sex and opposite-sex domestic partners, or should it be limited to same-sex partners on the theory that opposite-sex partners can marry in all 50 states and have their marriage recognized by the federal government?
- Should the gross-up also account for coverage of a domestic partner's children who are covered under the plan but are not dependents of the employee?

Each of these decisions will require careful consideration by an employer, as well as discussions with the employer's payroll and tax departments to understand and coordinate the administrative issues arising from providing a tax gross-up.

### *Conclusion*

The taxation of employer-provided benefits for same-sex spouses and partners is complex and can often be the focus of questions from employees. Employers need to ensure their payroll systems are structured to reflect the differing tax treatment of these benefits under federal and state laws, particularly as state tax laws become more complex as additional states legalize same-sex marriage and

other forms of same-sex unions. Although providing tax gross-ups to equalize the costs for employer-provided medical, dental and vision benefits for all employees is still a cutting-edge practice, more employers are considering this benefit in recognition of the unequal taxation of benefits provided to employees' same-sex spouses and partners.

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