

The Unintended Consequence of Providing Employee Benefits for Domestic Partners

18

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Legislation has recently been reintroduced in both the House and Senate that would allow employers to provide health insurance for domestic partners (and other nonspouse beneficiaries) without adversely affecting the employee for income tax purposes. Until legislation is passed, domestic partner benefits could, however, be considered imputed income to your employees.

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Employers are always looking for innovative ways to recruit and retain employees to maintain a competitive edge. Historically, one of those tools has been to provide health benefits to employees and their families. Employers have found that the definition of family has expanded over time and some employers have tried to accommodate that expansion. One example is that employers are increasingly offering domestic partner benefits to their employees.

The Human Rights Campaign Foundation has reported that employers offering domestic partner benefits have “steadily increased over the last decade, with 49 percent of the Fortune 500 largest corporations offering domestic partner health benefits as of March 1, 2006.” [See Domestic Partner Benefits Employer Trends and Benefits Equivalency for the GLBT Family, by Samir Luther, workplace project manager (<http://www.brc.org>).]

For a list of employers that provide domestic partner benefits and additional information on employee benefits for domestic partners, see www.brc.org/workplace/dpbsearch.

For employers that offer domestic partner benefits, the taxation of domestic partner benefits is problematic. Employers must navigate through complex income tax rules and withholding requirements when providing domestic partner benefits. This issue is particularly important for multistate employers that want to establish a nationwide policy of providing domestic partner benefits. Although the tax issues are difficult for single-state employers, they are compounded for multistate companies that want to use a single, company-wide policy.

Treating Domestic Partner Benefits for Federal Income Tax Purposes

Generally, employee benefits are taxed to the employee under Internal Revenue Code (“Code”) Section 61(a)(1), unless excluded under the Code. The Code excludes employer contributions of health insurance premiums for an employee or the employee’s spouse or legal dependents. Section 106 of the Code provides that “gross income of an employee does not include employer-provided coverage under an accident or health plan.” Furthermore, Treasury Regulations Section 1.106-1 provides that:

The gross income of an employee does not include contributions which his employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred

by him, his spouse, or his dependents, as defined in section 152.

The payment of health insurance premiums by an employer for an employee or the employee's spouse is therefore not subject to federal income tax.

Although the Code does not define "spouse," Section 3 of the Defense of Marriage Act, (P.L. 104-199) (DOMA) provides that:

in determining the meaning of any Act of Congress, or of any ruling, regulation or interpretation of the various administrative bureaus or agencies of the United States, the word "marriage" means only a legal union between one man and one woman as husband and wife, and the word "spouse" refers only to a person of the opposite sex who is a husband or a wife.

In determining who is considered a spouse, the IRS has stated that "unless the State recognizes common law marriages, a [domestic partner] cannot qualify as an employee's spouse for purposes of Sections 105 and 106 of the Code." [PLR 9109060] Thus, the IRS defers to state law in determining the marital status of individuals. [Rev. Rul. 58-66] As a result of DOMA and the interpretation of the IRS, for states that recognize common law marriage, some opposite-sex domestic partners could satisfy the definition of spouse.

Some states require that in order to establish a common law marriage, the man and woman must register with the county (for example in Texas), agree to be married, cohabit, and represent to others that they are married. Currently, only ten states (Alabama, Colorado, Kansas, Rhode Island, South Carolina, Iowa, Montana, Oklahoma, Pennsylvania, and Texas) and the District of Columbia recognize common-law marriages within their state or district.

For same-sex domestic partners and for opposite-sex domestic partners who do not reside in states that recognize common law marriages, the only way to qualify for the income tax exclusion is to have the domestic partner satisfy the definition of a dependent under Section 152 of the Code.

Section 152 of the Code defines a dependent to mean a "qualifying child" or a "qualifying relative." In order to satisfy the requirements for a qualifying relative, a domestic partner must:

1. Have a relationship with the taxpayer that is not void by local law;
2. Have gross income that is less than the exemption amount provided by Section 151(d);
3. Receive at least one-half of his or her support from the employee; and
4. Not be a qualifying child.

One of the biggest causes of concern and confusion in the definition of qualifying relative is in determining whether or not the relationship is "void by local law." As a result, the law of each state must be reviewed to determine whether a domestic partnership could be considered void by local law.

One approach to this requirement is to look to antisodomy laws, which could be construed to mean that domestic partner relationships are void as against public policy. This argument may not have merit, but it is worth considering its potential impact on the provision of benefits to domestic partners. Although many states have repealed their antisodomy laws, states such as Florida and Virginia still have these types of laws in effect.

On June 26, 2003, the US Supreme Court in *Lawrence v. Texas* [539 U.S. 558] struck down Section 21.06 of the Texas Penal Code, which criminalized "deviate sexual intercourse with another individual of the same sex." The US Supreme Court held that state laws prohibiting sodomy were unconstitutional, arguing that any government interest in consensual sex between adults, either homosexual or heterosexual, infringed upon the right to liberty protected by the Due Process clause of the Fourteenth Amendment. Thus, even if antisodomy laws were considered relevant to whether domestic partnerships are void as against public policy, the US Supreme Court has found that they are unconstitutional.

If a domestic partner is able to satisfy the definition of a qualifying relative, then the employer is not required to include as imputed income the value of the health insurance to the employee and the employee is not subject to the withholding requirements for that value. For domestic partners who satisfy the definition of a qualifying relative under the Code, employers will want to require the employee to provide an affidavit certifying that his or her domestic partner satisfies that definition. Furthermore, employers may want to request that the domestic partnership be registered if the applicable state law provides for such registration. Lastly, the employer may also want to advise employees to have an attorney review the affidavit, as it could create certain rights and obligations between the employee and the domestic partner. For example, an affidavit could serve to create an employment

relationship, other than an at-will employment relationship, if not narrowly drafted to address issues solely related to the domestic partner satisfying the definition of qualifying relative under the Code.

If the domestic partner is not able to satisfy the definition of dependent under Section 152 of the Code, the amount of difference between the fair market value of the coverage for the domestic partner and the amount paid by the employee for that coverage is includible in the employee's gross income. Withholding requirements also apply. [PLR 200108010 and PLR 200339001] If the employee contributes towards the health insurance premium for the domestic partner, such payroll withholding must be made on an after-tax basis. [*Id.*] As a result, employers and their payroll administrators must be aware of and must comply with these requirements.

Treating Domestic Partner Benefits for State Income Tax Purposes

Many states conform to the provisions of the Code in determining whether employer contributions towards health insurance premiums for domestic partners are taxable to the employee. As a result, if health insurance premiums paid for domestic partners are included as income under the Code, they are also included as income under state tax laws.

Other jurisdictions like California and Washington, DC, exclude employer contributions toward health insurance premiums for domestic partners from personal income tax, but they are the exception. Furthermore, some other states do not impose tax (such as Florida, Nevada, and Texas).

For states that tax personal income and do not expressly exclude employer contributions toward health insurance premiums for domestic partners, employers must make sure that the domestic partner either satisfies the definition of a dependent under Section 152 of the Code or include as income to the employee the fair market value of the health insurance provided to the domestic partner.

The Future of Domestic Partner Benefits

Providing domestic partner benefits is a growing trend for attracting and retaining capable employees. The increasing popularity of domestic partner benefits

is evidenced by two bills that were recently introduced in Congress. On March 29, 2007, Representative McDermott (D-WA) introduced The Tax Equity for Health Benefits Equity Act (H.R. 1820); on June 7, 2007, Senator Smith (R-OR) introduced the Senate version, The Tax Equity for Domestic Partner and Health Plan Beneficiaries Act (S. 1556), which would exclude health coverage benefits from federal income tax for domestic partners. The stated purpose of the act is:

To amend the Internal Revenue Code of 1986 to extend the exclusion from gross income for employer-provided health coverage for employees' spouses and dependent children to coverage provided to other eligible designated beneficiaries of employees.

Among other things, the legislation would allow the value of employer-provided health insurance for a domestic partner or other nondependent, nonspouse beneficiary to be excludible from the income of the employee if that person is an eligible beneficiary under the plan. The legislation would also allow employers to choose the manner in which employees can prove domestic partner status.

Lastly, the legislation keeps in mind small business owners. The legislation would allow a self-employed person to deduct the cost of health insurance for domestic partners or other nonspouse, nondependent beneficiaries of self-employed individuals (*e.g.*, small business owners).

This bill is in the early stages of the legislative process. It has been referred to the Senate Finance committee and may undergo significant changes in markup sessions. Until it becomes law, though, employers need to make sure that they are administering domestic partner benefits consistent with existing tax laws and withholding requirements.

Conclusion

The advantages of providing domestic partner benefits can be significant. Employers that are interested in providing these benefits should work with experienced counsel and their payroll administrators to ensure that the tax issues are handled properly and employees are given adequate information. ■