W-2 Reporting for Health Benefits (For Same-Sex Couples and Other Employees)

02.09.2012 | By Douglas W. Schwartz

Welcome employers to 2012 – and with it new Form W-2 reporting requirements for the cost of employee group health insurance coverage and other health benefits. These requirements were added by the Patient Protection and Affordable Care Act back in March 2010 and are now effective for W-2 Forms for 2012 (due to be submitted to the employees by January 31, 2013 and then filed with government) and for later years. Such reporting is for informational purposes only; does not affect the employer's tax liability; and does not tax what are otherwise tax-free health benefits to the employee and family members.

The IRS has done us the favor of explaining, in Q&A format, how employers are to handle this new reporting in Notice 2012-9 (January 3, 2012) amending its previous notice on this subject (Notice 2011-28 (April 18, 2011)) and adding some new provisions.

The IRS notices do not address, but do shed some light on, another compliance issue that has plagued California employers in particular: reporting health benefits for an employee with a same-sex spouse or registered domestic partner. In general, health benefits for the employee's same-sex spouse or partner are not taxable on the employee's California Form 540 return, but *are* taxable on the employee's federal Form 1040 return. That disparate tax treatment will not change – at least for the time being – even with the Ninth Circuit's February 7 decision in *Perry v. San Francisco* overturning California Proposition 8's ban on same-sex marriage.

Reporting Under the New Health Care Reform Law

Notice 2012-9 is very detailed, but here are some highlights:

Employers covered. Any employer providing tax-free health benefits, such as group health coverage, to employees is potentially subject to the new reporting requirements, including (but not limited to) federal,

state and local government entities, and churches and other religious organizations. However, an employer is excused from the reporting requirement for any calendar year if the employer was not required to file 250 or more W-2 forms for the preceding calendar year.

Where reported. The cost of health coverage is reported in Box 12 of the Form W-2, using the code "DD."

Successor employers. If an individual who transfers to a new employer that qualifies as a "successor employer" under tax law (as is usually the case in the acquisition of a continuing business, by purchase or otherwise), the successor may report the entire amount for the employee for the year so long as the successor follows special IRS procedures for doing so. Otherwise, both the predecessor and successor employers must report the aggregate reportable cost of coverage each provided.

Cost to be reported. The fact that the new reporting requirements apply to an employer providing tax-free health benefits does not mean that only the tax-free portion is to be reported. The reportable cost includes both the portion of the cost paid by the employer and the portion of the cost paid by the employee (regardless of whether the employee paid for that cost through pre-tax or after-tax contributions). The reportable cost will also include any portion of the cost of coverage under an employer-sponsored group health plan that is includible in the employee's gross income (for example, the cost of coverage for a person other than an employee, the spouse of the employee, a dependent of the employee, or a child of the employee who has not attained age 27 by the end of the taxable year).

Certain costs excluded. Notice 2012-9 provides a laundry list of health benefit costs that are *not* required to be reported, such as contributions to an Archer MSA; contributions to a Health Savings Account; salary reduction elections to a health Flexible Spending Arrangement (unless offered through a cafeteria plan, in which case special rules apply); cost of coverage under a multi-employer plan; cost of coverage under a Health Reimbursement Arrangement; and costs of most dental and vision plans. The actual guidelines are quite technical for what benefits need not be reported and what kinds of arrangements qualify for the exclusion.

Calculating the cost of coverage. Notice 2012-9 provides for three different methods under which the employer can calculate the cost of health coverage: pegging the cost according to the actual cost of comparable coverage under COBRA; the premium charged by the group insurer for coverage (the "premium charged method"); or the employer's good-faith determination of the cost for comparable COBRA coverage (but only if the employer subsidizes the cost of COBRA coverage or in certain other narrow circumstances). Most employers will probably use the premium charged method as that method will tend to be the simplest to apply and result in the lowest reportable cost.

Same-Sex Spouses and Registered Domestic Partners

The IRS notice addresses only reporting of health coverage costs under the health care reform law. However, its sanctioning of the three different methods for calculating the cost of coverage provides some insight on how employers can similarly report the taxable value of coverage for a same-sex spouse or registered domestic partner of an employee (especially given that the IRS in *private* guidance to taxpayers has sanctioned these same methods for reporting the taxable value in similar situations).

Registered domestic partners and same-sex spouses in California. This issue is a thorny one for California employers because California treats a taxpayer's same-sex spouse or registered domestic partner as a

"spouse" for tax purposes, meaning that group health insurance coverage and many other health benefits for the spouse or partner are non-taxable for California purposes (the same treatment as for an opposite-sex spouse). Registered domestic partners and same-sex spouses are also subject to California's community property laws just like opposite-sex spouses. Becoming "**registered domestic partners**" is relatively straightforward: a couple in a same-sex relationship files a registration with the California Secretary of State. The status of same-sex *marriages* in California is in flux because of the highly-publicized battle between state-wide propositions on the one hand that have banned same-sex marriage in California, and California Supreme Court and federal district court decisions on the other hand that have struck down those propositions as unconstitutional (the most recent being the Ninth Circuit's February 7 decision in *Perry v. San Francisco*). Essentially, same-sex couple marriages performed in California on or after June 16, 2008 (the effective date of the state Supreme Court's overturning the statutory ban on same-sex marriages) and before November 5, 2008 (the day after passage of Proposition 8 which amended the state *constitution* to ban same-sex marriage) will be treated as valid marriages for California purposes; and California will also recognize same-sex marriages lawfully performed outside California (though it does not use the word "marriage" to describe these unions). Same-sex marriages are still on hold in California notwithstanding the Ninth Circuit's decision in *Perry*, pending appeal of that decision to the full Ninth Circuit and, after that, probably to the US Supreme Court.

Federal Defense of Marriage Act. However, the IRS cannot (even if it wanted to) extend the same California treatment for federal tax purposes because of the federal Defense of Marriage Act ("**DOMA**"), meaning that coverage for the same-sex spouse or registered domestic partner will be taxable "imputed income" to the employee for federal purposes. The IRS so confirmed in guidance issued in September 2011 ("Questions and Answers for Registered Domestic Partners in Community Property States and Same-Sex Spouses in California"), where it addressed many of the other difficult federal tax issues facing same-sex married couples and registered domestic partners under DOMA. (DOMA has been found unconstitutional by federal courts outside California, and we can anticipate that this issue will ultimately need to be resolved by the US Supreme Court.)

Because the health benefits are imputed taxable income for federal purposes, the employer must take special care to report the same as additional taxable compensation on the employee's W-2 as well as on the employer's Form 941 payroll tax returns. The employer must also take the additional imputed compensation into account in computing withholding from the employee's wages for income tax purposes and for Social Security and Medicare taxes under the Federal Insurance Contributions Act ("**FICA**"), and also in paying the employer's share of FICA taxes.

"Dependents." Up to the time that the IRS issued this guidance, an employee would often try to keep the health benefits to the same-sex spouse or registered domestic partner non-taxable by treating the spouse or partner as a "dependent." One unpleasant surprise in the IRS guidance is that this approach may not work even if the employee is the sole breadwinner. (The IRS so concludes because of the peculiar ways in which California's community property laws apply to same-sex married couples or registered domestic partners.) The guidance provides that, in order for the same-sex spouse or registered domestic partner to be a "dependent" of the employee, the employee must use some of his or her separate property funds (*e.g.*, gifts, inheritances, and/or funds earned before the marriage or start of the registered domestic partnership, as opposed to earnings during the marriage or registered domestic partnership) to support his or her spouse or partner.

(**NB** – We are only addressing whether the spouse or partner can be claimed as a "dependent" for health coverage purposes, *not* for purposes of claiming that person as an additional exemption on the Form 1040 tax return.)

Children. The guidance does confirm that the natural-born or adopted child of the employee can qualify as a dependent provided that the other tests for being a "dependent" are met (*e.g.*, the child must live with the employee for more than half the year and cannot have turned age 27 by the end of the year). If both persons in a same-sex marriage or registered domestic partnership can treat a child as a dependent, then either member (but not both) may treat the child as a dependent.

Advice for employers

Start the groundwork NOW for W-2 reporting. Although W-2s for 2012 are not due until the end of January 2013, employers should start getting ready *now* for the new W-2 reporting by talking to their HR departments (or outside payroll services) and being sure that the ball will be passed smoothly through every step of the process – from gathering the correct information, to getting it in the proper places on the W-2, to getting the W-2s in the employees' and government's hands. It is a mistake to wait until the last minute because the last minute is when mistakes are made. Penalties for not complying are steep – $200 for any "bad" W-2, up to a maximum of $3 million.

Gather information from all employees, including those in same-sex relationships. Unless DOMA is repealed or ruled unconstitutional, it remains a part of federal law (including tax law) and the IRS is bound by it. California employers who have employees in same-sex relationships will need to solicit the necessary information from them to determine whether they can claim their spouses or registered domestic partners, and any child in the relationship, as "dependents" for federal tax purposes. While there are no firm guidelines on how to do this, as a rule of thumb the inquiry should be no more intrusive than the employer's protocols for *any* employee. This area is obviously sensitive.

Report health benefits for same-sex couples correctly. If the employee is not claiming that a same-sex spouse, registered domestic partner, or child is a "dependent," then the reporting on the W-2 for health benefits to that person should be as follows:

- The *entire* cost of the health benefits, including both the non-taxable portion and the "imputed income" portion, should be reported in Box 12 with code "DD."
- The taxable portion of the health benefits under federal law (*i.e.*, the coverage for any child and/or same-sex spouse. or registered domestic partner who cannot be treated as a "dependent" of the employee) should be reported along with other salary in Box 1 ("Wages, tips, other compensation").
- The taxable portion of the health benefits for federal law purposes can be "backed out" from the employee's other compensation and the reduced amount reported in Box 16 ("State wages, tips, etc.") for California purposes.
- The employee would then include the full amount from Box 1 of the Form W-2 on his or her federal Form 1040 return, but only the reduced amount from Box 16 of the Form W-2 on his or her California Form 540 return. The employee will also need to prepare and attach to his or her California 540 return a separate reconciliation schedule (called a "CA SSMC Adjustments Worksheet") explaining why the federal taxable portion of the health benefits was backed out for California purposes.

How Nossaman Can Help

Attorneys in Nossaman's Employment and Corporate Practice Groups can help you with any questions you

may have about the new W-2 reporting requirements for health benefits in general and the federal reporting for health benefits for same-sex spouses or partners in particular, and in developing a program to solicit the necessary information from your employees in a manner that complies with employment laws and is also sensitive to the emotions involved.

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including attachments), unless expressly stated otherwise, is not intended or written to be used, and cannot be used, for the purpose of (I) avoiding tax-related penalties under the Internal Revenue Code or (II) promoting, marketing or recommending to another party any tax related matter(s) addressed herein.