



Electronic Dispatch

Employee Benefits Law Action Memo

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AS A RESULT OF RECENT LEGISLATION CHANGING THE DEFINITION OF DEPENDENT, EMPLOYERS MAY NEED TO REVISE THE DEFINITION OF DEPENDENT IN CERTAIN OF THEIR EMPLOYEE BENEFIT PLANS

The Working Families Tax Relief Act of 2004 significantly changes the definition of dependent in the Internal Revenue Code ("Code"), effective for taxable years beginning after December 31, 2004. Certain types of employee benefit plans directly or indirectly use the Code definition of dependent, and the statutory change in that definition could alter which individuals are eligible for plan benefits and which individuals satisfy the requirements for receiving such benefits on a tax-favored basis. In order to assess any possible impact the new Code definition of dependent could have, employers should: (1) identify which of their employee benefit plans or policies use a definition of dependent that takes into account the Code definition of dependent; and (2) decide, with respect to each such plan or policy, whether the definition of dependent should be modified.

What Changes Have Been Made In the Code's Definition of Dependent?

Effective for taxable years beginning after December 31, 2004, an individual must be either a "qualifying child" or a "qualifying relative" in order to satisfy the Code's definition of dependent. A "qualifying child" generally means, with respect to a taxpayer, an individual who satisfies each of the following tests:

- Relationship Test – the individual must be (1) a child of the taxpayer or a descendant of such a child, or (2) a brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of any such relative (certain children placed for adoption and certain foster children also will be covered);
- Residency Test – the individual must have the same principal place of abode as the taxpayer for more than one-half of the applicable taxable year (the legislative history indicates that temporary absences due to special circumstances, including absences due to illness, education, business, vacation, or military service, will not be treated as absences);
- Age Test – the individual must be (1) under the age of 19 (or under the age of 24, in the case of a full-time student) as of the close of the applicable calendar year, or (2) permanently and totally disabled (within the meaning of Section 22(e)(3) of the Code) at any time during the applicable calendar year, in which case no age limit will apply to such disabled individual during such year; and
- Support Test – the individual must not have provided over one-half of his or her own support for the applicable calendar year.

A "qualifying relative" generally means, with respect to a taxpayer, an individual who satisfies each of the following tests:

- Relationship Test – the individual must be (1) a child or a descendant of a child of the taxpayer, (2) a brother, sister, stepbrother, or stepsister of the taxpayer, (3) the father or mother, or an ancestor of either, of the taxpayer, (4) a stepfather or stepmother of the taxpayer, (5) a son or daughter of a brother or sister of the taxpayer, (6) a brother



or sister of the father or mother of the taxpayer, (7) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the taxpayer, or (8) an individual (other than an individual who at any time during the taxable year was the spouse of the taxpayer) who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household;

- Gross Income Test – the individual's gross income for the applicable calendar year must be less than the personal exemption amount in Section 151(d) of the Code (which is \$3,200 for 2005);
- Support Test – the individual must receive over one-half of his or her support from the taxpayer for the applicable calendar year; and
- Non-Qualifying Child Test – the individual must not be a qualifying child of the taxpayer or of any other taxpayer for the applicable taxable year.

The Code's definition of dependent also has certain other requirements that could apply when implementing the qualifying child and qualifying relative definitions. If a child does not satisfy the qualifying child definition, the child still might be able to be a dependent under the Code if the child satisfies the qualifying relative definition.

The Code's new definition of dependent differs from the current Code definition of dependent in several important respects. The new qualifying child definition imposes an age test and a residency test that is not present in the current Code definition of dependent. The new qualifying relative definition imposes an income test that also is not present in the current Code definition of dependent. These new tests could cause certain individuals who now satisfy the Code's definition of dependent to lose their dependent status under the Code in 2005 (e.g., a child who does not satisfy the age test in the qualifying child definition, and who also does not satisfy the income test in the qualifying relative definition).

What Steps Should Employers Take To Address the Employee Benefit Issues Raised By the Code's New Definition of Dependent?

Steps employers should take to address the employee benefit issues raised by the Code's new definition of dependent include the following:

- Identify Which Employee Benefit Plans and Policies Provide Benefits To Dependents – An employer should review all of its employee benefit plans and policies to determine which provide benefits to dependents, and the definition of dependent that is used in each such plan or policy.
- The Definition of Dependent Used In Each Applicable Employee Benefit Plan or Policy Should Be Reviewed To Determine If It is Based, Directly or Indirectly, On the Code Definition of Dependent – An employer should review the definition of dependent that is used in each of its applicable employee benefit plans and policies to determine whether the definition takes into account the Code definition of dependent. This determination will be easy if the definition of dependent in the plan or policy directly references the Code definition of dependent. If the definition of dependent in a plan or policy does not reference the Code definition of dependent, an analysis will need to be made to see if the benefits in that plan or policy may only be provided on a tax-favored basis to dependents who satisfy, among other things, the Code's definition of dependent. Examples of benefits that can only be provided to a dependent on a tax-favored basis if the dependent satisfies the Code's definition of dependent (as well as certain other Code requirements that may apply with respect to each such benefit) include (1) eligible dependent care expenses for a qualifying dependent in a dependent care assistance plan, (2) eligible hardship distributions for a qualifying dependent in a 401(k) plan or a 403(b) tax-sheltered annuity plan, (3) qualified medical expenses for an eligible dependent in a health savings account, and (4) eligible emergency distributions for qualifying dependents in nonqualified deferred compensation plans. Tax-favored benefits under a health plan (including, but not limited to, a medical plan, a prescription drug plan, and a dental plan) for a dependent also are based on

the Code's definition of dependent, but statutory and regulatory relief will make it much easier for such benefits to comply with the new Code definition of dependent (e.g., that relief will, among other things, allow employers to disregard the gross income test when determining whether an individual satisfies the requirements for being a qualifying relative).

- An Analysis Should Be Made Whether the Definition of Dependent In An Employee Benefit Plan or Policy Needs To Be Modified – If the definition of dependent in an employee benefit plan or policy is based on the Code definition of dependent (e.g., because benefits under that plan may only be provided on a tax-favored basis to dependents who satisfy the Code's definition of dependent), that definition should be reviewed to ensure that it satisfies the new Code definition of dependent.

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