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Update

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State and federal laws pose challenge in offering domestic partner benefits

Summary

Whether called domestic partnerships, civil unions, reciprocal beneficiaries or same-sex marriages, nontraditional same- and opposite-sex relationships present benefit challenges for employers. Understanding what state and federal laws require and how they interact is critical, whether benefits are offered voluntarily or to satisfy state laws. Using the term "domestic partner" to refer to these relationships, this *Update* looks at federal and state law conflicts and tax issues for these benefits.

Federal and state laws differ on domestic partnership

Recognizing committed relationships outside traditional marriage can raise a number of confusing issues about rights, benefits, interaction between state and federal laws, taxes, and even what to call these relationships. Conflicts between federal and state laws on domestic partnerships and same-sex marriages can leave employers uncertain about how to offer benefits.

Federal law. The 1996 federal Defense of Marriage Act (DOMA) defines "marriage" for all federal purposes as the union of one man and one woman. Federal laws don't recognize same-sex marriages, provide domestic partnership status or recognize partnerships established under state laws.

State and local laws. Many states don't recognize domestic partnerships or same-sex marriages. Other states, counties and municipalities provide domestic partner registries and give partners certain legal rights. In some states, all employers that purchase insured coverage for their employees must offer benefits to domestic partners on par with those for spouses; in certain other jurisdictions, only employers – whether insured or self-insured – that contract with the particular governmental entity must do so.

Federal rules govern federal benefits. When domestic partners receive benefits usually regulated by federal law, the employee is treated as an unmarried individual. For example, if an employer's group health plan offers

Required or voluntary benefits?

Some employers provide only the domestic partner benefits required by a particular state or local law. Self-insured plans subject to ERISA and some church plans don't have to comply with benefit mandates but still must comply with any state family leave or other laws that may apply to domestic partners.

Other employers offer domestic partner benefits to demonstrate a commitment to diversity or to attract and retain talent. Some recognize both same- and opposite-sex partners for benefits, while others limit domestic partner benefits to same-sex couples because they can't choose to marry and receive spousal benefits.

Employers voluntarily offering domestic partner benefits can impose certain requirements – such as age limits, cohabitation, reciprocal expectations of support and unmarried status for each partner – and require employees to sign an affidavit or other written document attesting that the domestic partnership meets the employer's standards.

If state or local laws require domestic partner benefits, employers with insured plans and all governmental plans must ensure that their voluntary benefit offerings match or exceed the mandates.

domestic partner benefits, the law doesn't require offering an employee's domestic partner COBRA continuation coverage after the relationship ends, because federal law only recognizes opposite-sex married couples as spouses. Similarly, domestic partners are not required to be COBRA-qualified beneficiaries – unlike a spouse who loses coverage due to divorce. Many employers voluntarily extend to domestic partners some type of continuation option similar or identical to COBRA coverage.

State laws mirroring federal laws may create obligations. State-recognized domestic partners often have rights under state law comparable to the protections granted opposite-sex married couples under federal laws, such as mandated family leave (FMLA), health continuation coverage (COBRA), and special health insurance enrollment and other portability rights (HIPAA). So, even though plans governed solely by federal law don't have to treat domestic partners as spouses, insured plans may be required or permitted to offer benefits to same-sex couples under state law. While ERISA pre-emption means that most state mandates regarding domestic partner benefits don't apply to self-insured plans, the federal FMLA doesn't pre-empt more generous state family leave benefits.

> *Example.* John and Alan are state-registered domestic partners and are enrolled in Alan's employer's insured health plan governed by Oregon laws. They terminate the domestic partnership, causing John to lose eligibility under the plan. Because John isn't Alan's spouse, he doesn't need to be offered COBRA coverage under federal law. However, Oregon requires insurers to offer health continuation coverage to registered domestic partners on the same terms available to spouses, so John must be offered continuation coverage to satisfy state law.

> *Example.* Assume the same facts as above, but John and Alan live in a state that doesn't require continued health coverage to domestic partners, and the employer's contract with the insurer doesn't provide for continuation. Unless the employer wishes to offer COBRA-like coverage, Alan's employer should avoid any statement that might lead Alan or John to believe that John will have a right to continued coverage under the group contract, because the insurer could decline to pay his medical expenses, leaving the employer to self-insure them.

Federal tax rules' impact on domestic partner benefits

Some states treat domestic partners as spouses for state income tax purposes, so employees receiving health plan coverage for their domestic partners through an employer plan don't pay state tax on the coverage. But that's not the case for federal income tax purposes – unless the partner can qualify as a federal tax dependent for health plan purposes.

General rule for taxing employer health benefits. Employer-paid contributions for health coverage for employees, spouses and tax dependents are not taxable to employees, nor are plan payments for medical expenses. If someone other than the employee, spouse or tax dependent – for example, the employee's roommate – receives health coverage, the employer's contributions are taxable to the employee and treated as a taxable fringe benefit paid by the employer to the employee.

How do employees with domestic partners fare? Because federal law only recognizes opposite-sex spouses and doesn't grant domestic partners special legal status, employees with domestic partners (including same-sex spouses) don't automatically qualify for favorable federal tax treatment of employer-paid coverage. While domestic partners can't qualify as spouses, some may qualify as employees' tax dependents for health plan purposes, making employer coverage exempt from federal income tax.

Domestic partners as tax dependents. Employees with domestic partners, including same-sex spouses, can get federal tax-free employer health benefits in two ways: (i) the partner qualifies as the employee's tax dependent for health plan purposes or (ii) the employee claims a federal tax exemption for the partner.

Health plan tax dependent. Partners can qualify as an employee's tax dependent for health plan purposes if the relationship doesn't violate local law, and the partner meets these conditions:

- Is a member of the employee's household for the entire calendar year
- Gets more than half of his or her support from the employee
- Can't be claimed as anyone else's qualifying child dependent
- Is a US resident, citizen or national; or a resident of Canada or Mexico

Federal tax exemption. To be claimed as a federal tax exemption, a partner must meet the health plan tax dependent test and have income no greater than the current exemption amount for single taxpayers ($3,400 for the 2007 tax year). The most common way partners qualify for tax-free benefits is as a health plan tax dependent, but employees that can claim a federal tax exemption for their partners may also receive benefits tax-free.

Bottom line. A domestic partner (or domestic partner's child) who satisfies either test is treated the same as any other federal tax dependent when it comes to employer-provided health benefits – the employee can make pretax contributions toward the cost of coverage, and employer contributions toward coverage are tax-free to the employee. Plan payments for a partner's medical expenses are tax-free for federal income tax purposes.

Benefit design considerations

Before implementing domestic partner coverage, employers need to consider the answers to questions such as:

- Which state laws apply?
- What benefits will be offered?
- What contribution will the employer make toward costs?
- What eligibility criteria will be used?
- How should plan language be changed?
- Do plan provisions accord with insurance and stop-loss contracts?
- How will tax dependent status be tracked? What forms and procedures need to be put in place?
- How will the fair market value of the coverage be calculated?
- How will employees with nondependent partners and children be taxed? Must any employees be taxed differently for state and federal purposes?
- How will coverage and tax information be communicated?
- How will programs be kept up to date?

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Fair market value. If a domestic partner doesn't satisfy either tax-dependent test described above, then the employer will have to tax the employee on the benefits provided. Federal rules require employees to pay tax on the fair market value (FMV) of the fringe benefit (in this situation, the partner's health coverage). Fair market value is what the employee would have had to pay for the coverage. The IRS has interpreted this to mean the cost of group medical coverage, *not* the cost of a comparable individual insurance policy in the marketplace.

Approaches. Employers have adopted several approaches for deciding the FMV of domestic partner coverage, such as using an employee-only rate, or the difference between the two-party and the single rate. After determining the FMV of the taxable coverage, the employer must adopt procedures for income and employment tax reporting and withholding. This can be done using after-tax deductions, imputed income or a combination of these. Amounts may differ for state and federal purposes.

Conclusion

Whether offered because of state or local legal requirements, or as a recruiting and retention tool, domestic partner benefits are becoming more common among employers. Before adding domestic partner benefits to their benefit offerings, employers must take care to understand and resolve conflicts between state and federal laws, and provide proper accounting and tax treatment.

Authors

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