

HEALTH INSURANCE TAXATION ISSUES POST-DIVORCE



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Introduction: Health Insurance as a Fringe Benefit

According to IRS Publication 15-Bⁱ a fringe benefit “is a form of pay for the performance of services.” Any fringe benefit an employer provides “is taxable and must be included in the recipient's pay unless the law specifically excludes it.”

Employer provided health insurance is considered a fringe benefit by the IRS, and is specifically excluded from taxation in many circumstances.ⁱⁱ In many cases the employer will cover much or most of the cost, and if the individual is an “eligible individual” then these expenses are tax deductible for the employer and are not taxable income to the employee.ⁱⁱⁱ In addition, the “eligible” employee pays the remainder out of pre-tax salary deductions.^{iv}

The employee is also responsible for paying costs that are not covered by health insurance, sometimes on a tax advantaged basis, for instance with a Health Savings Account or a Flexible Spending Account. Employer contributions to these accounts may also be non-taxable.^v There are also tax credits available in some instances.

However, in some instances the recipient of the health benefits may not be an “eligible individual” and in that case these federal tax benefits may not be available to that individual.^{vi} This is the case with ex-spouses. We will explore this extra taxation issue for ex-spouses below, and provide some other options to avoid or minimize these taxation issues. Throughout, unless specified otherwise, the term “employee” will refer to the party in the divorce who is covered by an employer's health insurance plan, and “ex-spouse” will refer to the party in the divorce that may lose coverage due to the divorce.

I. Health Insurance Benefits Post-Divorce:

When a person divorces, he/she may lose the insurance coverage he/she had with their employed ex-spouse. He/she also may lose some of the tax advantages, and may gain others, while some remain unchanged. In addition, the solution of continuing health insurance coverage under the employed ex-spouse's policy or through COBRA is often a short term fix. Thus, a non employed divorcing spouse needs to plan for both the short term and long term.

There are three possible avenues for a non employed ex-spouse to continue health insurance coverage:

A. Option 1: Trying to Maintain the Status Quo

In this option, the non employed ex-spouse continues to be covered under the employee's health insurance.

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Whether or not a non employed ex-spouse can stay on the other party's health insurance after the divorce will depend on the type of plan and whether the court order requires it. If the original health insurance carrier's employer participates in a self-insured plan (usually only the case with very large employers), then the plan is covered by Federal law and not State law, in which case the employer can ignore the Massachusetts law requiring coverage of ex-spouses. This means that if the carrier's employer has a self-insured plan then no matter what the Court order states the non employed ex-spouse will likely be terminated from the health insurance upon the divorce.^{vii} In addition the non employed ex-spouse will be eligible for COBRA, which is discussed below.

If, however, the carrier's plan is not a self-insured plan then the non employed ex-spouse will be eligible to continue coverage so long as he/she pays attention to the second factor, which is whether or not the Judgment of Divorce includes language requiring coverage. It is very important to consult with an attorney regarding the proper language to include in a Divorce Agreement to ensure that the non employed ex-spouse will be eligible to continue to health insurance, if their spouse's employer allows for that option.

For more information on how to maintain or find health insurance after a divorce, check out the brochure prepared and distributed by the Massachusetts Attorney General's Office and Health Law Advocates entitled [Staying Healthy: A Guide to Keeping Health Insurance After Divorce](#).^{viii}

i. What is the Cost of Option 1?

There are two costs of staying on an employed ex-spouse's insurance. The first is the actual cost of the plan. If the plan participant would qualify for a lower cost plan, for instance if the plan participant is single with no children, then the "additional cost" to cover the non employed ex-spouse must be paid by either the plan participant or his/her ex-spouse. Usually the ex-spouse seeking this coverage will pay the "additional cost" but this must be defined in a court order or agreement.

In addition, the IRS defines excludable fringe benefit costs to include only costs for spouses and other dependents.^{ix} Ex-spouse coverage is not excludable and is therefore a taxable benefit.^x Although often overlooked by employers, many have started to treat these ongoing benefits to non employed ex-spouses as taxable income to the employee.

When there is no "additional cost" between the "single with children" and "single with children and spouse" options, most employers will not try to apportion a taxable benefit for the non employed ex-spouse. In the past this has not been clearly addressed by the IRS, leaving it up to the employer to try to apportion a cost for the non employed ex-spouse and indicate that said portion is not excludable, and therefore a taxable benefit. Under the Affordable Care Act, The IRS will require reporting by the employer of the cost of coverage of employer sponsored health plans.^{xi} That may facilitate the apportionment of the cost of health coverage for divorced spouse.

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In the more clear cases, where there is an “additional cost” between the “single with children” and “single with children and spouse” options, employers should be attributing that additional cost as a taxable benefit. This taxable benefit includes the portion paid by the employer, and also the previously non-taxable “additional cost” paid by the employee. Although, not all employers have been enforcing this issue, more employers are now recognizing that the correct tax treatment is for them to indicate that this “additional cost” attributable to the non employed ex-spouse is a taxable fringe benefit.

Unlike the “additional cost”, which will be an obvious amount, the additional taxation cost will not be known exactly until the employee’s taxes are complete in the following year. This is because the cost of the taxable benefit will depend on other factors, including the tax bracket and deductions available to that employee. How does the non employed ex-spouse then reimburse the employee for this additional cost?

The simplest way to transfer the cost to the non employed ex-spouse receiving the benefit of continued coverage is to treat it like an alimony payment. It is then deductible to the employee as alimony expense, and includible in the non employed ex-spouse’s income. For instance, for an employee, a benefit to the non employed ex-spouse of \$100 would result in taxable income. After deducting it as alimony, the employee effectively doesn’t pay tax on that income, but the non employed ex-spouse will when he/she reports the benefit as alimony income. This results in the person actually receiving the benefit, the non employed ex-spouse, paying tax on that non-excludible fringe benefit.

In this example, the non employed ex-spouse gets a health insurance benefit worth \$100 that is taxable income. At a marginal income tax rate of 25%, the benefit cost becomes \$125. It is important that the non employed ex-spouse is aware that he or she needs to declare the income and pay income tax on that benefit. To the extent that it and other health expenses will total more than 10% of Adjustable Gross Income, it may be partially deductible on Schedule A, if total deductions exceed the standard deduction.

This is the most common sense approach because it does not require any complicated reimbursement calculation. Also, in many cases the non employed ex-spouse receiving the health insurance benefit will be the lower earning spouse, in which case his/her taxation on this benefit will be lower than the employee's.

Just to further complicate the issue, the Commonwealth taxes health insurance differently than the Federal Government, by allowing the deduction of health insurance costs from State taxable income.^{xii} While this does not eliminate the negative impact of federal taxation, it certainly helps mitigate it. Because of these complicated calculations, it may be helpful to consult with a Certified Divorce Financial Analyst and a lawyer if you are unsure of what your best option is before signing any Agreements.

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B. Option 2: COBRA Coverage

If the health insurance carrier's plan is self-insured then the ex-spouse will not be able to continue coverage after the divorce, but he/she will still qualify for COBRA coverage.

i. What is the Cost of Option 2?

In option 2, the non employed ex-spouse opts for COBRA coverage. COBRA provides the identical benefit that the non employed ex-spouse had when married at a slightly higher cost (up to 102% of the full premium). The difference is that he/she now has to pay for that entire cost instead of having part of it paid by the employer.

If the cost of COBRA is paid by one spouse for the benefit of the other, then it can be included as alimony, and thus can be deducted from the income of the alimony payor, as in option 1. In that case, the payee needs to pay taxes on the income that pays for the coverage. As in option 1, health care insurance coverage is partially deductible to the extent that the cost is greater than 10% of his/her Adjusted Gross Income. A person in the situation described is likely to have a low AGI. Assuming \$50,000 of AGI, health costs above \$5,000 are tax deductible. The cost of health insurance above \$5,000 may be deducted on schedule A, subject to total deductions exceeding the standard deduction. In a case like this, it is often possible to calculate the need or loss of benefits due to divorce, and to devise a cost sharing compromise with the alimony payor.

Obviously this is only a short-term solution because eventually COBRA coverage will run out, after 18 or 36 months depending on the case, and the ex-spouse will then need to obtain his/her own insurance. If his/her own insurance is a current option, it may be more economical than COBRA and this temporary fix can then be avoided.

C. Option 3: Ex-Spouse Obtains Their Own Insurance

In some instances, the costs involved in Option 1 or Option 2 may exceed the amount that it would cost for the non employed ex-spouse to simply obtain his/her own insurance. Usually if health insurance is available through his/her own employer this is the case. If the non employed ex-spouse does not have health insurance available through his/her employer, there may still be benefits to obtaining private insurance, either because it is a lower cost, or the coverage is more appropriate for the circumstance. The non employed ex-spouse may qualify for low cost or no cost insurance through Massachusetts Health Connector.^{xiii} The advantage is that getting his/her own insurance may remove some of the uncertainties with the previous two alternatives which are generally short term by nature. Eventually, most divorcing spouses losing their insurance coverage will want to consider this option.

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i. What is the Cost of Option 3?

The cost of the insurance will vary depending on the ex-spouse's employer or eligibility under various private or state plans. If the plan is through the ex-spouse's own employer, then the fringe benefit status would exist and the benefit is non-taxable.^{xiv} If health insurance is obtained separately, the tax treatment would be similar to COBRA coverage under Option 2. In either case, the cost of health insurance could be covered by alimony if so negotiated.

In addition, some lower income divorced spouses may qualify for the tax credits that will be available starting in 2014 under the Affordable Care Act.^{xv} People with small businesses may also qualify for tax credits.^{xvi} In either case the rules for deductions and tax credits will affect different people in different ways. Consultation with a financial analyst is encouraged to ensure that the full costs of post-divorce life are understood and planned for.

Conclusion: Short-Term vs. Long-Term Solutions

Clients often focus on the short term issue of health insurance, which are obviously important and have to do with expediency, costs and taxes. Equally important, if not more, are the long term financial planning issues. In the long term, maintaining coverage under an ex-spouse's employer policy is usually a temporary situation and can be affected by either party's remarriage. The same is true for COBRA which has built-in time limitations. To the extent possible, divorces should include longer term planning for health care in order to try to control the uncertainty of costs and coverage. In addition, changes in health care law and their fiscal consequences are continuing to make the calculation of the value of benefits difficult without specialized help from a qualified Certified Divorce Financial Analyst or other professional.

In summary, health insurance is a complex divorce planning issue which involves the analysis of the coverage, the costs, the tax issues, and long term financial issues. Each issue should be addressed in your divorce plan.

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Endnotes

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- i Internal Revenue Service, *Publication 15B Fringe Benefits* (2012), available at http://www.irs.gov/publications/p15b/ar02.html#en_US_2012_publink1000193641.
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- iii *Id.*
- iv *Id.*
- v 26 U.S.C. § 106 (2010), available at <http://www.law.cornell.edu/uscode/text/26/106>.
- vi IRS, *Publication 15B Fringe Benefit*, *supra*.
- vii Office of Attorney General Tom Reilly and Health law Advocates, *Staying Healthy: A Guide to Keeping Health Insurance After Divorce* (November 2002), available at <http://www.healthlawadvocates.org/tools/publications/files/0002.pdf>.
- viii *Id.*
- ix IRS, *Publication 15B Fringe Benefit*, *supra*.
- x *Id.*
- xi *IRS Note 2011-28, 2012-09, 2012-32, 2012-33*
- xii Massachusetts Department of Revenue, *Directive 09-2: Personal Income Tax Treatment of Employer-Provided Health Insurance Coverage for an Employee's Former Spouse* (April 23, 2009), available at <http://www.mass.gov/dor/businesses/help-and-resources/legal-library/directives/directives-by-decade/2000-2009-directives/directive-09-2-personal-income-tax-treatment.html>.
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