

**TECHNICAL CORRECTIONS IN GULF OPPORTUNITY ZONE ACT OF 2005****EXPAND DEFINITION OF DEPENDENT****January 4, 2006**

On December 21, President Bush signed the Gulf Opportunity Zone Act of 2005 (Public Law 109-135). A number of technical corrections to recent tax legislation are included among the act's provisions affording hurricane-related tax relief and incentives. Specifically, section 404 of the act contains technical corrections to the Working Families Tax Relief Act of 2004, which itself made a number of clarifying and corrective changes to the definition of the term "dependent" under the Internal Revenue Code. The definition of "dependent" plays an important role in determining who can be covered in health and welfare plans. As a result of the technical corrections, more individuals will be treated as dependents for HSAs and dependent care plans. Employers may therefore need to revise programming for 2005 Forms W-2 and may also consider running a special enrollment period for dependent care spending accounts.

**Background**

The Working Families Tax Relief Act of 2004 made changes to the definition of "dependent" for purposes of numerous Code sections. Code section 152 now contains rules defining when a dependent is a "qualifying child" or a "qualifying relative" for purposes of, among other things, receiving tax-free medical benefits from an employer's medical plan or HSA, or determining whether a dependent's day care expenses can be reimbursed from a dependent care spending account or are eligible for the dependent care credit.

The result of these changes was to place an age limit on qualifying children and an income limit on qualifying relatives. While some of the affected Code sections specifically waived the income limit (thus returning to rules very similar to the historical definition of "dependent"), this change was not made to the Code provisions applicable to HSAs or dependent care benefits. Further, while the IRS was able to eliminate this problem for employer-provided medical coverage when it issued Notice 2004-79, it did not have the power to revise the HSA or dependent care Code provisions.

**Gulf Opportunity Zone Act Changes**

Now, as a result of the Gulf Opportunity Zone Act, the language of both Code section 21(b)(1) governing dependent care benefits and Code section 223 governing HSAs allows an individual to be treated as a "qualifying relative" (and thus an eligible dependent) without regard to the individual's gross income. Other changes allow an individual to be treated as a "qualifying child" or a "qualifying relative" even if the individual is married and filing a joint return or if the individual claims a dependent on his or her own tax return. One final clarifying change allows a divorced custodial parent to waive his

or her right to claim a child as a dependent. All of these changes are effective as if they were included in the original Working Families Tax Relief Act, which, as a practical matter, means that the liberalized rules are effective as of January 1, 2005. These changes were widely anticipated and even began to appear in IRS forms and publications issued before December 21.

### **Gulf Opportunity Zone Act Challenges**

Now that a broader range of dependents meet the “qualifying child” and “qualifying relative” requirements, employers may need to take several immediate steps.

To the extent that employers anticipated reporting dependent care reimbursements as taxable income to employees (for example, because the individual was not deemed a qualifying relative due to the income limit), employers should immediately revise their Form W-2 programming logic to reflect the extent to which these reimbursements are tax free in 2005. If it is not practical to change the Form W-2 reporting before issuing the 2005 Forms W-2 (which are due no later than January 31, 2006), employers should issue corrected Forms W-2 after informing employees that corrected forms are forthcoming.

Also, to the extent that employers communicated the restrictive dependent definitions during the 2006 open enrollment period and wish to amend their plans to reflect the modified rules going forward, they should consider offering a special open enrollment period during which employees could begin or increase dependent care spending account contributions for newly eligible dependents under the revised definition. Since this enrollment opportunity would be in response to a change in the definition of “dependent,” it does not run afoul of any restriction on mid-year election changes under Code section 125.

Either of the aforementioned actions will require close coordination with an employer’s payroll department and dependent care spending account administrator.

If an employer has already revised plan documents or employee communication materials to address the Working Families Tax Relief Act, these items should be examined to determine if any additional modifications are needed to address the changes under the Gulf Opportunity Zone Act.

Finally, no additional actions should be necessary for HSAs since employees can change HSA contribution amounts at any time and employers are not involved in monitoring or reporting the tax treatment of HSA distributions.

If you would like further information regarding the issues raised in this Morgan Lewis LawFlash, please contact any of the following Morgan Lewis attorneys:

#### **Chicago**

|                  |              |  |
|------------------|--------------|--|
| David Ackerman   | 312.324.1170 | <a href="mailto:dackerman@morganlewis.com">dackerman@morganlewis.com</a> |
| Andy R. Anderson | 312.324.1177 | <a href="mailto:aanderson@morganlewis.com">aanderson@morganlewis.com</a> |
| Brian D. Hector  | 312.324.1160 | <a href="mailto:bhector@morganlewis.com">bhector@morganlewis.com</a>     |

## Dallas

|                 |              |  |
|-----------------|--------------|--|
| Riva T. Johnson | 214.466.4107 | <a href="mailto:riva.johnson@morganlewis.com">riva.johnson@morganlewis.com</a> |
| John A. Kober   | 214.466.4105 | <a href="mailto:jkober@morganlewis.com">jkober@morganlewis.com</a>             |
| Erin Turley     | 214.466.4108 | <a href="mailto:eturley@morganlewis.com">eturley@morganlewis.com</a>           |

## New York

|                   |              |  |
|-------------------|--------------|--|
| Craig A. Bitman   | 212.309.7190 | <a href="mailto:cbitman@morganlewis.com">cbitman@morganlewis.com</a>       |
| Gary S. Rothstein | 212.309.6360 | <a href="mailto:grothstein@morganlewis.com">grothstein@morganlewis.com</a> |

## Philadelphia

|                        |              |  |
|------------------------|--------------|--|
| Robert L. Abramowitz   | 215.963.4811 | <a href="mailto:r Abramowitz@morganlewis.com">rabramowitz@morganlewis.com</a>    |
| Brian J. Dougherty     | 215.963.4833 | <a href="mailto:bdougherty@morganlewis.com">bdougherty@morganlewis.com</a>       |
| I. Lee Falk            | 215.963.5616 | <a href="mailto:ilfalk@morganlewis.com">ilfalk@morganlewis.com</a>               |
| Robert J. Lichtenstein | 215.963.5726 | <a href="mailto:rlichtenstein@morganlewis.com">rlichtenstein@morganlewis.com</a> |
| Vivian S. McCardell    | 215.963.5810 | <a href="mailto:vmccardell@morganlewis.com">vmccardell@morganlewis.com</a>       |
| Joseph E. Ronan, Jr.   | 215.963.5793 | <a href="mailto:jronan@morganlewis.com">jronan@morganlewis.com</a>               |
| Mims Maynard Zabriskie | 215.963.5036 | <a href="mailto:mzabriskie@morganlewis.com">mzabriskie@morganlewis.com</a>       |

## Pittsburgh

|                   |              |  |
|-------------------|--------------|--|
| John G. Ferreira  | 412.560.3350 | <a href="mailto:jferreira@morganlewis.com">jferreira@morganlewis.com</a> |
| R. Randall Tracht | 412.560.3352 | <a href="mailto:rtracht@morganlewis.com">rtracht@morganlewis.com</a>     |

## San Francisco

|                |              |  |
|----------------|--------------|--|
| Mark H. Boxer  | 415.442.1695 | <a href="mailto:mboxer@morganlewis.com">mboxer@morganlewis.com</a>     |
| Eva P. McComas | 415.442.1249 | <a href="mailto:emccomas@morganlewis.com">emccomas@morganlewis.com</a> |

## About Morgan, Lewis & Bockius LLP

Morgan Lewis is a global law firm with more than 1,200 lawyers in 19 offices located in Philadelphia, Washington, D.C., New York, Los Angeles, San Francisco, Miami, Pittsburgh, Princeton, Chicago, Palo Alto, Dallas, Harrisburg, Irvine, Boston, London, Paris, Brussels, Frankfurt and Tokyo. For more information about Morgan Lewis or its practices, please visit us online at [www.morganlewis.com](http://www.morganlewis.com).

This LawFlash is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as imparting legal advice on any specific matter.

© 2006 Morgan, Lewis & Bockius LLP. All Rights Reserved.