



# Advanced Planning Strategies

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Dear Reader,

President Bush's \$2.4 trillion budget proposal contained very few surprises for anyone who's been following tax policy. The budget would reduce the increase to less than one percent for non-defense and non-homeland-security expenditures. The tax proposals place a heavy emphasis on making permanent the 2001 tax relief provisions that are set to expire in 2011. In addition, some relief provisions that expire earlier would be extended. The next question is whether all provisions would be adopted as one package or whether they would be adopted piecemeal. For example, Senator Grassley introduced two bills (S. 2048 and 2050) that would make permanent recent tax incentives for education. The sticking point on any measures would appear to be whether new tax provisions would be required to offset the expenditure in light of the size of the federal deficit.

Although it is probably unlikely that many new provisions will be adopted during the election year, it is important to address and understand the proposals in order to make an informed decision about the candidates for the various offices. The President's budget contains many provisions that were included in last year's budget proposal but not adopted. Many of these involve a change in philosophy for how tax incentives would be used to solve problems. For example, tax-advantaged savings accounts would be created to increase savings for retirement or other reasons. The budget proposes a Retirement Savings Account (RSA) to combine the three different IRAs currently available into one type of account. A Lifetime Savings Account (LSA) would be permitted to save for other purposes, such as health care, emergencies, or education. Significant differences between these and current retirement savings plans are that all individuals with earned income could contribute up to \$5,000 to an RSA. Up to \$5,000 annual contributions would be permitted to an LSA, regardless of the saver's earned income.

Americans spend over \$5,000 per capita annually on health care. The inside report describes a new mechanism for funding health care expenses that may be advantageous to many individuals.

***Knowledge is not power. Only knowledge in use is power.***

## NEW HEALTH SAVINGS ACCOUNTS (HSAs) PROVIDE OPPORTUNITIES

Health Savings Accounts (HSAs) were created by the “Medicare Prescription Drug, Improvement and Modernization Act of 2003” and provide an opportunity for an alternative strategy for funding health care costs. The new strategy provides significant tax advantages and, in return, shifts the burden for monitoring and controlling health care costs to the account owner. HSAs are an extension and expansion of the existing Archer Medical Savings Account (MSA) provisions, which expire after 2003 for new MSAs (existing MSAs are grandfathered).

### WHAT IS AN HSA?

HSAs are IRA-like accounts that provide participants with a tax deduction for contributions and permit tax-free accumulation and distributions to pay for health care expenditures. The requirement for eligibility is that the individual must be covered under a *high-deductible health plan*. The high-deductible plan can be provided by an employer, but HSAs do not have to be linked to a business at all and can be adopted by any individual who qualifies.

A high-deductible health plan is a plan (it can be insured or noninsured) that has (1) an annual deductible of at least \$1,000 for an individual or \$2,000 for a family and (2) an annual out-of-pocket limit (deductibles, co-payments, etc., not including premiums) not exceeding \$5,000 for an individual or \$10,000 for a family.

The individual covered under a high-deductible plan is not eligible if he or she is also covered under a non-high-deductible plan, such as that of a spouse. The individual can be eligible for an HSA even though covered by certain types of “permitted insurance” that don’t have high deductibles; these include coverage for accidents, disability, dental care, vision care, long-term care, workers’ compensation, hospitalization insurance paying a certain sum per day of hospitalization, insurance for a specified disease or illness, and preventive care.

HSA contributions generally must cease after the attainment of age 65 and eligibility for Medicare. An individual who may be claimed as a dependent on another person’s tax return is not eligible for his or her own HSA but can be covered under a family plan.

### CONTRIBUTIONS TO HSAs

The maximum contribution to an HSA is subject to a monthly limit. For coverage during the full year 2004, the maximum monthly limits add up annually to \$2,600 for an individual and \$5,150 for a family. The aggregate annual contribution limit is the *lesser* of (1) the above dollar amount or (2) the high-deductible health insurance plan’s annual deductible. There is a “catch-up” addition of \$500 (for 2004) for individuals aged 55 or older that apparently applies even if it brings the total above the plan’s annual deductible. The catch-up is scheduled to increase by \$100 each year until it reaches \$1,000 in 2009.

Contributions made by an individual are deductible “above the line” (that is, regardless of whether the individual itemizes deductions). Contributions by an employer are deductible by the employer, not taxable to the employee, and not subject to FICA and FUTA taxes (Social Security and federal unemployment).

## **DISTRIBUTIONS FOR HEALTH CARE EXPENSES**

Distributions from the plan are not taxable if participants use the distribution to pay for qualified medical expenses for themselves, their spouses, and dependents. “Qualified medical expense” is defined as any expense eligible for an itemized medical expense deduction under Internal Revenue Code Sec. 213(d), which includes many items not usually provided by health insurance. For example, recent IRS guidance clarified that tax-free distributions can be made for nonprescription drugs (IRS Notice 2004-2, 2004-2 IRB 269). The qualified expenses must be incurred after the HSA is created and must not be covered by medical insurance.

Unlike cafeteria arrangements like flexible spending accounts, HSA plan funds cannot be withdrawn tax free to pay the account owner’s health insurance premiums. However, HSA qualified medical expenses include (1) qualified long-term care insurance premiums, (2) health insurance continuation payments under COBRA, (3) health care while receiving unemployment compensation, and (4) Medicare Part A or B and certain other post-65 payments, including employer-sponsored retiree health insurance premiums.

Distributions that are not for qualified medical expenses are taxable and subject to a 10 percent penalty, which does not apply if the distribution is made after the account beneficiary’s death, disability, or attainment of age 65.

## **FUNDING: THE SAVINGS ELEMENT**

HSA contributions must be held in a tax-exempt plan with a qualified trustee or custodian. Contributions must be in cash, and the fund may not be invested in life insurance contracts. Amounts in the account can accumulate without limit; unused amounts are not forfeited. Also, unused amounts do not reduce the participant’s contribution limit in the future. Any amount that remains in the HSA account when the participant reaches age 65 is treated much like an IRA accumulation thereafter, except that it can be used tax free to pay medical expenses in the future.

## **COVERAGE RULES FOR EMPLOYER PLANS**

If an employer makes a contribution to an employee’s HSA plan, the contributions must be “comparable” for all “comparable participating employees.” It’s not clear yet whether an HSA must cover all employees or whether executives can be favored. In any event, it is possible that very few lower-compensated employees will have the discretionary income to participate.

## **CONCLUSIONS**

HSAs provide employers with a method of saving health insurance costs or an exit strategy for high-cost plans. Self-employed individuals and their families, or those not covered under employer plans, may find HSAs useful as an alternative to conventional health insurance.

HSAs offer tax-saving opportunities to individuals. If an individual is eligible for an HSA and has enough discretionary income to make contributions, it appears that there is little reason not to set up the HSA and make contributions. Excess amounts will accumulate as an unrestricted retirement savings fund.

## RECENT CASES AND RULINGS

### IRS TAKES ACTION TO CURB PURPORTEDLY ABUSIVE ROTH IRAs

The IRS recently issued a notice (IRS Notice 2004-8, 2004-4 IRB) that described what it refers to as an avoidance of the statutory limits on contributions to a Roth IRA. Contributions to a Roth IRA are limited to \$3,000 for 2004 and \$4,000 from 2005 to 2007 by IRC Sec. 408A. "Qualified" distributions from a Roth IRA are not subject to income taxes. In the transactions described by the notice, the taxpayer, the owner of a pre-existing business, creates a Roth IRA that owns or acquires substantially all the shares of a corporation (referred to as a Roth IRA corporation). The notice gives three examples that the IRS views as abusive value-shifting mechanisms designed to circumvent the Roth IRA contribution limits.

One, the Roth IRA corporation acquires property, such as accounts receivable, from the taxpayer's business for less than fair market value. Two, someone other than the Roth IRA makes contributions of property, including intangible property, to the corporation. Three, an arrangement is made between the taxpayer, a related party, or the taxpayer's business and the Roth IRA corporation that has the effect of shifting value to the corporation, comparable to a contribution to the Roth IRA.

The penalties could be severe for this type of arrangement. First, excess contributions to a Roth IRA are subject to a 6 percent excise tax under IRC Sec. 4973. Second, the IRS might reclassify the transfer from the business to the Roth IRA corporation as a payment from the business to the taxpayer, followed by a contribution from the taxpayer to the Roth IRA and then to the Roth IRA corporation. This could result in a taxable dividend to the taxpayer if the original business was a corporation. In addition, the original business, if incorporated, might recognize gain on the transfer of property. Third, the IRS could apply IRC Sec. 482 to allocate income from the Roth IRA corporation. Finally, the transaction could be interpreted as a prohibited transaction between a Roth IRA and a disqualified person.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

*Positioning our clients  
for the future*



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