



Advanced Planning Strategies

Albert E. Gibbons, CLU, ChFC, AEP
President, AEG Financial Services

May 2007

Dear Reader,

There were a couple of major problems with the recent tax filing due date, leaving many taxpayers in difficulty with respect to the April 17 deadline. First, a major e-filing software provider had a system slowdown because of the volume of last-minute filing. The IRS extended the deadline to April 19 at midnight for filers who were unable to meet the original deadline through the servers at Intuit, Inc., the provider of TurboTax and other tax preparation software. In addition, taxpayers affected by the major storm in the northeast on April 16, which caused flooding, widespread power outages, and transportation problems, were given until April 26 to file their returns.

The Senate recently passed a reform of the federal estate tax introduced by Senator Baucus. The estate tax would be moved to 2009 levels. That is, the exemption for estates would be \$3.5 million, with amounts above the threshold subject to a 45 percent tax rate. Other amendments that would have raised the exemption to \$5 million with a rate of 35 percent, along with various other tax cuts or revenue offsets, were rejected. The House has not yet acted on a reform of the estate tax. It's fairly early in this process, and it is possible that the reform will be packaged with other tax provisions before the House and Senate send bills to conference.

Other pieces of tax legislation that will get serious consideration are further extensions to the increased exemptions to the alternative minimum tax as opposed to its immediate repeal or reform. In addition, Congress is likely to take some action to curb gifts to lower-income-tax-bracket family members to take advantage of special capital gains rates. The legislation would prevent the use of the lower rates by dependent children over age 18.

Legislation to license tax return preparers will be seriously considered. The rules might impose a test and periodic license renewals. Presumably CPAs, attorneys, and enrolled agents would be exempt.

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

HEALTH SAVINGS ACCOUNTS— A FAST GROWING HEALTH CARE OPTION

Health Savings Accounts (HSAs) were first made available in 2004, and we're starting to see some applications developing in the health insurance marketplace. HSAs provide participants with tax benefits for amounts accumulated in an "IRA-like" fund to pay health care expenditures. The funds held and accumulating in an HSA are not subject to income taxes.

The requirement for eligibility is that the individual must be covered under a high-deductible health plan (HDHP). The same insurer or entity that provides the HDHP does not have to administer the HSA. The purpose of the HSA is to hold funds to be expended on the medical care of the account beneficiary (or the account beneficiary's spouse or dependents). The HDHP will provide for the larger covered medical expenses for the account beneficiary and his or her spouse and dependents.

ELIGIBILITY AND CONTRIBUTION LIMITATIONS

An HDHP is a plan (it can be insured or noninsured) that has (1) an annual deductible of at least \$1,100 for an individual or \$2,200 for a family, and (2) an annual out-of-pocket limit (for deductibles, copayments, etc.) of \$5,500 for an individual or \$11,000 for a family (2007 indexed figures). Note: The insurance premium for the plan is not treated as an out-of-pocket expenditure for this limit. Generally, coverage under other health insurance in addition to the qualifying HDHP removes eligibility for an HSA, but there are exceptions.

Contributions to the HSA can be made by an individual outside of employment or by a participant's employer. For 2007, the maximum annual deductible contribution to an HSA is \$2,850 for an individual and \$5,650 for a family. There is a "catch-up" addition of \$800 (for 2007) for individuals aged 55 or older, which is scheduled to increase by \$100 each year until it reaches \$1,000 in 2009 and all subsequent years. Originally, the contribution could not be more than the HDHP's deductible, but this limitation was eliminated under legislation adopted in late 2006. The recent legislation also provided methods by which an HSA can be funded from an employee's IRA or certain other employee health plans. Deductible contributions can no longer be made once the individual is eligible for and enrolled in Medicare Part A or Part B.

PAYING MEDICAL COSTS FROM THE HSA

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" means any expense eligible for an itemized medical expense deduction under Code Sec. 213(d), which includes many items not usually provided by a typical health insurance policy. Although the payment of insurance premiums is not generally a qualified medical expense for this purpose, HSA distributions can be made for (1) continuation for health coverage under COBRA, (2) a qualified long-term care insurance policy, (3) a health plan while the beneficiary is collecting unemployment compensation, and (4) any health coverage (except a Medigap policy) when a beneficiary is eligible for Medicare.

A qualified distribution does not lose its tax-free status if made in a future year when the participant

no longer is eligible to make deductible contributions to the HSA. Although the account is held for the purposes of making distributions for the medical expenses of the account beneficiary, for administrative purposes, the HSA trustee or custodian may place reasonable restrictions on both the frequency and the minimum amount of distributions from an account.

Distributions made for purposes other than qualified medical expenses are taxable, and there is an additional 10 percent penalty applied to the taxable amount of nonqualifying distributions. There is an exception, however, to the 10 percent penalty for distributions after the participant's (1) death, (2) disability, or (3) attainment of age 65. In addition, distributions are not tax free if the medical expenditures are reimbursed from another health plan.

An important implication of these rules is that even if HSA accumulations are not used for medical expenses, they're not forfeited. After the participant reaches age 65, nonmedical distributions from the plan are treated much like IRA distributions, so there is little disadvantage in contributing to an HSA. Unlike flexible savings accounts that many employers currently sponsor, HSA contributions are not subject to a "use it or lose it" rule. If the participant stays healthy, contributions continue to accumulate from year to year. Furthermore, unused amounts accumulating in the account do not reduce the participant's contribution limit in the future.

PLANNING APPLICATIONS OF HSA PLANS

For businesses both small and large, these provisions can offer a way to manage the high costs of employee health insurance. An employer might be able to save some premium dollars by providing an HDHP as one of its options for employee health insurance. Higher-income employees who can afford contributions to an HSA may find the HDHP option financially attractive. Employers do not have actually to administer the HSA, and in fact may find this administration unappealing because of the costs and fiduciary responsibility to maintain separate accounts for each employee's accumulations. Fortunately, providers of HSA investment and administrative services are beginning to emerge, and participants will have a growing number of options. In general, if an HSA is available to a higher-tax-bracket employee, it is almost always an attractive option for the employee to adopt.

Is it possible for a business to provide HDHP coverage and make HSA contributions for selected executives only? An employer must make "comparable" HSA contributions for all employees actually eligible for employer-provided HDHPs. However, final tax regulations effective in 2007 do not appear to require nondiscriminatory eligibility for HDHP plan coverage, so the employer can choose a selective group for coverage. Insurers, however, may have rules that discourage or prevent adopting a discriminatory plan that is available only to a select group of highly compensated executives.

In summary, despite some of the limitations of HDHP/HSA plans as an alternative to traditional health insurance, the rules and the market for these plans are evolving in a way that makes them worth serious consideration for employers and individuals as a remedy for the seemingly uncontrolled growth of health care costs.

RECENT CASES AND RULINGS

TAX COURT RULES THAT IRS ABUSED ITS DISCRETION IN REQUIRING ESTATE TO POST BOND OR SPECIAL LIEN FOR DEFERRED ESTATE TAX

Qualifying estates holding closely held business interests are permitted by Sec. 6166 to pay the estate taxes caused by the inclusion of the business in installments. Using the 6166 installment election has several advantages, including a favorable 2 percent interest rate on portions of the deferred tax. The IRS has statutory discretion to require the posting of a bond or the requirement of a special lien (Sec. 6324A) if the 6166 election is made by the estate. In this case (*Estate of Roski v. Commissioner*, 128 T.C. No. 10), the IRS required a bond equal to double the amount of the deferred estate tax or a special lien as a prerequisite to allowing the estate's election to defer the tax. The IRS has apparently adopted a policy to make such requests of every estate that makes the 6166 deferral election.

The executor found it impossible or prohibitively costly to secure a bond. The executor requested that the IRS exercise its discretion not to make the bond or special lien request. The estate indicated that the assets of the estate were sufficiently marketable to cover the deferred costs and that a regular lien already applies to 6166 deferrals that makes the executor personally liable for the deferred taxes. The Tax Court held that the IRS cannot routinely require the bond or the special lien without applying the discretion required by statute on a case-by-case basis. The code section clearly places the discretion to apply the requirement and did not intend for the bond or special lien to be mandatory in every case. Nevertheless, the Court did not have sufficient factual information to conclude that the estate should not be required to post a bond or be subject to a special lien. The estate, however, will be able to make its case that the bond or

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***



**Albert E. Gibbons, CLU, ChFC, AEP
AEG FINANCIAL SERVICES**

1288 Valley Forge Road, #53
Phoenixville, PA 19460

Tel. (610) 917-8940

Fax. (610) 917-8962

Email. algibbons@algibbons.com

Web. www.algibbons.com