TAX UPDATE

The New Pension/Health Insurance Hybrid Option

By Eric L. Morgenthal

With signs of the recession still looming, small and large businesses alike have been searching for ways to improve cash flow. Slow revenue growth coupled with rising health insurance costs has reduced available funds for business owners to contribute toward retirement. Now, new legislation passed on December 8 under the Medicare Prescription Drug, Improvement and Modernization Act of 2003 has introduced a hybrid vehicle which enables business owners and individuals to address both concerns with one consolidated cost. The new available cost saving tool is known a Health Savings Account (HSA) and if my predictions are right, this one will take off pretty quick.

The IRS has recently released Notice 2004-2 which provides guidance about the qualifications and benefits of instituting HSAs. It further explains the taxation of contributions, distributions and account earnings. The devil with HSAs is in the details. It is highly recommended that anyone interested in establishing one should review the IRS Notice. Details are also available at their website, www.irs.gov.

No More "Use It Or Lose It"

Typically, employees who contribute toward their medical costs on a pre-tax basis are forced to make a difficult decision under the current "use it or lose it" system. Payroll dollars deducted for Flexible Spending Accounts are lost if not directed toward eligible medical expenses prior to year's end. Thus, employees need to estimate their costs accurately because unused contributions become wasted earnings. Like Flexible Spending Accounts, HSAs enable participants to tender cash contributions on a pre-tax basis. However, HSAs are not under the same "use it or lose it" system. Rather, unused funds set aside to meet qualifying high deductible health insurance expenses are subsequently treated like pension dollars to the extent they are not used. HSA dollars can be rolled from one year to the next and, most importantly, are portable so that account holders can carry their funds to their next place of employment.

Chris Hasbrouck is a Retirement Planning Specialist with Smith Barney and works closely with small businesses establishing HSAs. According to Mr. Hasbrouck, "now that it's no longer a use it or lose it situation, we're getting quite a few inquiries as to how to start one."

Eligibility Requirements

The universal appeal of HSAs will help fuel their popularity. In fact, an employment arrangement is not even required and taxpayers are permitted to establish HSAs on their own. As indicated in Notice 2004-2, an HSA may be maintained as either a custodial account or a trust with any insurance company or qualified bank. The account holder would not need permission from the IRS or an employer to create an HSA.

HSAs are available effective January 1, 2004. With an HSA, the health plan determines eligibility and not the income level of the account holder. Individuals may contribute to HSAs even when they have no compensation and even when their earnings are less than the amount they contribute. To form an HSA, the new statute requires that the account holder establish a high deductible plan with a minimum deductible amount of $1,000 for individuals and $2,000 for a family plan. There are no income-level phase-outs and participants in qualified retirement plans are still eligible to contribute to HSAs. In short, participation in a high-deductible health insurance plan is required to maintain eligibility. However, exemptions for other kinds of insurance (i.e. Workers' Compensation, Automobile, Fixed Daily Hospitalization Payout Policies and Liability Insurance) are provided in the statute.

Qualification to contribute to an HSA is determined on a month-to-month basis. Accordingly, annual contribution limitations are prorated if a plan is commenced during mid-year. Regardless, distributions used to pay qualifying medical expenses would continue to be excluded from gross income, even after an individual is no longer considered eligible to contribute to an HSA.

Contribution And Distribution Requirements

As with pensions, there are limits to how much the account holder may con- 10-percent penalty unless made after the account holder dies, becomes disabled or reaches 65 years of age.

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Death Of The HSA Account Holder

The IRS Notice provides preliminary guidance relating to the death of the HSA account holder. The HSA documentation should name the beneficiary of any cumulative account balance remaining. If made to a surviving spouse, the balance is excluded from income if used by that spouse for qualifying medical expenses. Otherwise, they are includible in income.

New provisions also dictate the tax implications of HSA account balances which pass to a party other than a surviving spouse. In that situation, the HSA terminates and the recipient would include the date of death fair market value of the account in income. The income inclusion may be reduced by the deceased beneficiaries' eligible medical costs paid from the account within one year of death.

Other Considerations

So are there any pitfalls to this new health savings vehicle? One is simply the danger of undertaking a savings arrangement that is hot off the press. For instance, would contributions be treated under the statute like health or pension funds, name-

tribute to an HSA each year. Contributions are limited to the lesser of the annual deductible held by the individual's high-deductible plan or $2,600 for individuals and $5,150 for families. They may be made until the individual reaches age 65. A six-percent tax penalty is imposed upon any excess contributions while catch-up provisions allow additional contributions for participants who are pre-retirement and between 55 and 65 prior to the end of the tax year. For 2004, the allowable catch-up contribution is set at $500. The overall contribution limit is reduced dollar for dollar by any Archer MSA contributions made in the same tax year. For married taxpayers, these limits are also impacted by whether the couple maintains joint or separate health insurance coverage. Contributions made on behalf of eligible family members are deductible from the income of the payer. For individual contributors, the deadline for tendering HSA contributions for any tax year is by April 15 of the following year.

The earnings on HSA funds grow tax free and are even distributed tax free if to pay or reimburse for qualifying medical expenses. But what are "qualified medical expenses"? The notice indicates that qualifying expenses are those not covered by insurance which were incurred after the HSA was established. It should be noted that although COBRA, long-term care insurance coverage and health insurance for the unemployed are considered "qualifying," standard health insurance premiums would not qualify.

The annual limit that an account is permitted to pay toward co-payments and deductibles is $5,000 for individuals and $10,000 for families. Distributions for any other purpose is includible in income and furthermore, is subject to a ly, would account holders be afforded the creditor protection often provided to pension assets? What happens if the funds in an HSA account decline in value? Would deductible HSA contributions paid on behalf of a family member constitute a "qualified transfer directly to the institution" under IRC Section 2503(e) which does not deplete the $11,000 annual exclusion that would otherwise be available? Could the HSA account be deemed subject to division via a Qualified Domestic Relations Order? There is also the danger of the account receiving a double hit in early retirement years. As the account holder grows older and the uncovered health care costs begin to rise, the cumulative balance may find itself reduced by both medical bills and pension distributions. Will the government ever require that a Required Minimum Distribution be taken? It doesn't appear so. They shouldn't anyway because, after all, the money may be needed in future years to fund uncovered qualifying health costs.

All obstacles aside, it appears that HSAs will become a popular savings tool for many. Personally, I would not be surprised to see other hybrid savings vehicles emerge after taxpayers digest the benefits of this one. Hey, how about a health insurance/long term care insurance hybrid option? Maybe we'll see it someday... but only time will tell.

Editor's Note: The author, Eric L. Morgenthal, Esq., CPA, M.S. (Taxation), maintains his law practice in Smithtown. He is the Chair of the SCBA Taxation Law Committee. Mr. Morgenthal is a member of the New York State, Nassau and Suffolk County Bar Associations, the American Institute of Certified Public Accountants and the NYS Society of Certified Public Accountants.