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Estate Planning Bulletin

Tax Tips for the Professional Advisor

April 2005

HEALTH SAVINGS ACCOUNTS: A New Financial Planning Opportunity

by Richard Y. LeMaster

At a time when the viability of Medicare is in serious doubt, individuals are beginning to take advantage of the new Health Savings Accounts (HSAs). Financial planners are finding HSAs one of the hottest new strategies employed by their clients to provide supplemental health coverage.

An HSA is a tax-exempt, funded trust or custodial account, owned by an individual, and administered by a bank, insurance company or another approved custodian. To be eligible to establish an HSA, an individual must (1) *not* be entitled to Medicare benefits (neither eligible nor enrolled) and (2) be covered by a high-deductible health plan (HD Plan). A high deductible health plan is a health plan with a deductible of at least \$1,000 for single coverage and \$2,000 for family coverage. Except for preventive care, the HD Plan cannot provide benefits for any family member (including the owner) before the entire family deductible is met. Also, out-of-pocket cost to the owner under the HD Plan cannot exceed \$5,000 for single coverage and \$10,000 for family coverage. The HD Plan must be the **only** health care plan under which the owner can receive benefits, with certain exceptions.

The mechanics of an HSA are simple. An individual establishes an HSA and the individual, his/her employer, or any other person, may make the contributions to the HSA. Contributions by the employer are excludable from gross income and are not subject to income tax withholding or FICA. The contributions, however,

are subject to non-discrimination rules. An employer who makes contributions to an HSA for an employee must make comparable HSA contributions for all comparable participating employees. The IRS interprets "comparable" to mean the same dollar amount or percentage of the deductible. Therefore, matching contributions based on the amount of compensation withheld are considered discriminatory. Contributions on behalf of employees customarily employed for fewer than 30 hours per week are tested separately for comparability purposes.

Contributions to an HSA by anyone other than the employer are treated as made by the owner and are deductible against adjusted gross income but not deductible for FICA or self-employment tax. All contributions to an HSA must be in cash and must not exceed certain contribution limits. In general, annual contributions are limited to the deductible under the HD policy and may be even less. Excess contributions are subject to a 6% excise tax unless refunded with earnings by the employee's tax return filing deadline, with extensions. However, the account may accept a rollover from an Archer MSA or another HSA.

Withdrawals from the HSA may be made tax-free for qualified medical expenses for the owner, his or her spouse or any qualifying dependent. Funds can also be withdrawn for purposes other than health care, but such withdrawals are subject to accelerated income tax and a 10% additional tax on the income if the owner has not yet become eligible for Medicare.

Any amounts contributed to an HSA in any given year can be carried over to the following year, allowing accumulation for many years. In

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this way the HSA becomes an attractive saving and investing vehicle. A conscientious financial planner will need to coordinate these accounts with the client's other investments to assure the integrity of the financial plan.

In many ways, an HSA is similar to another form of employee benefit – a flexible spending account (FSA) under a cafeteria plan. Both allow employees to have amounts withheld from their paychecks, before tax, to fund an account that can be used for the employee and his or her spouse and dependents. However, there are important differences. The FSA requires that the entire account be used up by the end of a calendar year. If it is not, the unused amount is forfeited. This rule encourages spending rather than saving – especially at year-end – because no one wants to leave money on the table.

In other ways, an HSA more closely resembles an individual retirement account (IRA). Both can be established by an individual who can make direct contributions – not just through payroll withholding. Both vehicles allow the owner to name a beneficiary to receive the account at the owner's death. If the beneficiary is the owner's spouse, the account remains an HSA. If not, the account becomes immediately taxable. Like an IRA and unlike an FSA, an HSA is not subject to COBRA continuation coverage.

However, the HSA does have its disadvantages as well. An HSA cannot be “pre-funded.” In other words, an individual cannot make an entire contribution of the maximum amount at the beginning of the year. This means that an owner, who incurs a large medical expense early in the year, may not be covered by his or her HD insurance (because the deductible has not been met) but cannot be immediately reimbursed from his or her HSA because he or she has not yet made sufficient contributions to the account. However, there is no time limit for submitting reimbursement claims. If the owner can afford to finance the deductible for a while, he or she can wait and submit claims when the account becomes large enough to reimburse them.

Although they serve a purpose, there is doubt as to whether HSAs are adequate to reduce the currently out of control increases in the cost of health care. Proponents say these consumer-

directed accounts will provide individuals with an incentive to become more prudent buyers of health care services. This, in turn, would reduce the demand for “unnecessary” services, resulting in a slower rate of premium increases. Critics say the wealthy will use HSAs as tax shelters and only younger, healthier members of the economy will use HSAs as a supplement to their health insurance. This would leave the sick and elderly at the mercy of an ever-increasing cost spiral. Both are probably correct at least to some extent. As with any policy change, there will be winners and losers. Only time will tell whether HSAs achieve their goal of reducing the cost of health care.

HSAs provide an attractive opportunity for those who can use them to accumulate funds for post-retirement medical expenses. At a time when Medicare's continued viability is in serious doubt, every eligible person should consider the possibility of establishing an HSA. Financial planners can perform a valuable service by making them available to their clients and pointing out their advantages.

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