



Medical Expenses: Pros and Cons of Tax Favored Funding Mechanisms

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In a previously published *Tax Adviser* article entitled “Deductibility of Tuition and Related Fees as Medical Expenses” (Goldsberry, Edward, “Deductibility of Tuition and Related Fees as Medical Expenses”; *The Tax Adviser*, Nov., 2002:701-701), the emphasis was to show that tax-deductible medical expenses may include items such as special school tuition and fees that are not commonly thought of as medical expenses. Taxpayers needing to fund large and on-going expenses of this sort will also be interested in exploring tax-advantaged ways to pay these expenses that could be potentially more beneficial than simply deducting them as medical expenses if and to the extent that they exceed 7.5% of Adjusted Gross Income. Examples of potential alternatives include funding via Section 125 “Cafeteria Plans”; Health Reimbursement Arrangements (HRA); Individual Retirement Accounts and/or 401(k) withdrawals; and Medical Savings Accounts (Archer MSA).

Section 125 Cafeteria Plan Reimbursements

Section 125 Cafeteria Plans are by far the most common tax-advantaged medical expense reimbursement arrangement (other than actual medical insurance). Flexible spending accounts (FSA) are funded by employee contributions on a pre-tax salary reduction basis to provide coverage for specified expenses (e.g. qualified medical expenses or dependent care assistance costs) that are incurred during the coverage period. Reimbursement is subject to reasonable conditions, including a maximum salary reduction amount that may be set by the terms of the plan. Participants must use the FSA amounts for the specified expenses, or else forfeit any amounts remaining as of the plan year end. (Prop Reg §1.125-1).

Actually obtaining reimbursement may be problematic since, as a practical matter, plan participants regularly report problems in convincing plan administrators that expenses such as special school tuition and fees are legitimate medical expenses, and therefore properly reimbursable by the plan. Also, reimbursements actually available are frequently less than the total actual medical expense due to employee mandated limitations on FSA funding

Health Reimbursement Arrangements

Another alternative may be a health reimbursement arrangement (HRA). An HRA is an employee benefit plan intended to reimburse employees for medical expenses not covered by other forms of insurance. In general, HRAs are funded by the employer without any employee salary reduction to reimburse the employee for substantiated medical care expenses incurred by the employee and the employee's spouse and dependents. HRAs typically provide reimbursement up to a maximum dollar amount for a coverage period, and may provide for carry-forward of any unused amount at the end of a coverage period. The reimbursed medical expenses are excludible from the employee's gross income, and deductible by the employer. An employer for this purpose may be a self-employed individual, and under limited circumstances covered employees may include the self-employed individual's spouse even if the spouse is the sole employee. Therefore, even though the self-employed individual may not be covered



directly, coverage may be available indirectly through the employee spouse. (See Rev Rul 71-588, 1971-2 CB 91; and PLR 9409001; and Industry Specialization Program, Coordinated Issue All Industries Health Insurance Deductibility for Self-Employed Individuals, UIL 162.35-02, 3/29/1999)

Withdrawals from Individual Retirement Accounts and Rollover Balances in 401(k) Accounts

Individuals may take withdrawals when and as they direct from their IRA and/or certain of their 401(k) or other qualified plan account balances (i.e. rollover account balances). This is certainly not preferable from a retirement planning view since the distribution will necessarily reduce the funds available at retirement, and will typically be both currently taxable and subject to premature withdrawal penalties. However, all or a portion of these withdrawals can be exempted from the 10% premature withdrawal penalty under a variety of circumstances. One of the exceptions to the penalty is that the premature withdrawal penalty will not apply to the extent that the taxpayer has medical expenses deductible after the 7.5% of AGI limitation.

401(k) Plan Hardship Withdrawals from Elective Employee Contributions

Section 401(k) plans may also be used to cover medical expenses. To take a hardship withdrawal, the participant must establish immediate and heavy financial need, and that the requested distribution does not exceed the amount necessary to satisfy the financial need. Treas. Reg. 1.401(k)-1(d)(2) provides the requirements for hardship distributions. Under the Reg., a distribution can be treated as made on account of immediate and heavy financial need if it is for the payment of expenses for medical care that were either previously incurred by, or are necessary for the medical care, of the employee, the employee's spouse, or the employee's dependents.. The Reg. also provides that the distribution will not fail to qualify just because it was reasonably foreseeable or voluntarily incurred. The amount distributed cannot exceed the amount needed to meet the financial need plus the estimated cost of anticipated income taxes and/or penalties on the distribution. Employers are permitted to treat the requested distribution as necessary if they can reasonably rely upon the employee's written representation that the need cannot be met with other means, including insurance, reasonable liquidation of assets, other eligible distributions or loans from employer plans or other reasonable borrowing. Employees are also required to agree to cease their contributions to the plan for a period of twelve months following the distribution.

Undesirable consequences include the obvious; the distribution and the consequent premature income tax and penalties are contrary to sound retirement planning. In this case, unlike the case of premature IRA distributions, the amount subject to penalty cannot be reduced by the amount of Schedule A deductible medical expenses.

Archer Medical Savings Accounts

The Medical Savings Account was created in 1997, and in its current form as the Archer MSA is set to expire at the end of 2003, but may still be established until then. Contributions after 2003 will be permitted for those participating in MSAs established before the end of 2003. Whether



Congress will again extend the expiration date remains to be seen, but some action is likely in the near term in light of concerns over the costs of medical care.

Contributions amounts are limited, but are fully tax-deductible as an adjustment to income for self-employed individuals or excludable from income in the case of employer funded plans. Income earned by the MSA is tax-exempt, and reimbursements from the MSA are excluded from income to the extent used to pay for medical expenses. Applicability of the MSA in its current form is questionable, however, in the case of families with special needs children where the family is likely to have large and continuing uninsured medical expenses over a number of years. In such cases the annual reimbursable expenses are likely to exceed the allowable contributions to the plan, and thus the tax-advantaged savings feature of the plan is lost. In such cases, the tax advantage of the plan will be limited to cases where the amount deductible as a plan contribution exceeds the amount that would have been deductible as a medical expense itemized deduction.

Conclusion

Families and individuals with long-term special medical needs and expenses often have unusual tax-planning needs. Limited avenues are available for taxpayers to use tax deductibility of medical expenses to help defray their costs. Tax advisers should be able to identify such situations and to recommend from among the potentially viable solutions.

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