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Medical Expenses: Pros can Cons of Tax Favored Funding Mechanisms

In a previously published 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 10% 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 (limited to $2500 per year beginning in 2013) 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.

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 the limitations beginning in 2013 or employer mandated limitations on FSA funding

Health Reimbursement Arrangements (Section 105 Plans)

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, HRA’s 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. HRA’s 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). Currently, there are technically no limitations upon the amounts reimbursed other than employer’s management of cost, and reasonable compensation of the employee. Beginning in 2018, total reimbursements in excess of

$27,500 will be subject to an excise tax under the provisions of the Affordable Care Act.

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 deductible medical expenses deductible after the 10% 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 reasonable 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.

Health Savings Accounts (HSA's)

The Medical Savings Account was created in 1997 and in its original form as the Archer MSA expired at the end of 2003. Contributions after 2003 will be permitted for those participating in MSA's established before the end of 2003.

Effective 2004, the Archer plan was replaced with the Health Savings Account. 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 HSA is tax-exempt, and reimbursements from the HSA are excluded from income to the extent used to pay for medical expenses. Participants are also required to carry a high deductible health insurance policy.

In ideal circumstances, participants can fund and accumulate maximum balances in the HAS, and pay out of pocket expenses not covered by their health insurance (including the high deductible), thereby saving for future major medical expenses.

Applicability of the HSA 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. However, the increase in the Adjusted Gross Income threshold from 7.5% to 10% for most taxpayers in 2013 may make the plan more desirable.

Conclusion

Families and individuals with long-tem 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.

Disclaimer

This article is intended to be a general explanation of the tax rules and is not intended to address specific cases. Determination of whether an expense qualifies as a medical expense for income tax purposes depends upon individual facts and circumstances.

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