Financial Planning Implications of TRHCA

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On Wednesday, December 20th, President Bush signed the Tax Relief and Health Care Act of 2006 (TRHCA). Although the primary focus of the bill was to renew and extend a number of popular tax breaks that were expiring imminently (or had already expired), in usual fashion Congress managed to add on several additional provisions with broad impact.

The Joint Committee on Taxation estimates that the total tax relief package will reduce Federal tax revenues by approximately $45.1 billion over the next 10 years. This material will not cover the entire breadth of the tax bill; instead, only the most notable provisions of TRHCA that will be relevant for financial planners are discussed, as listed below. Subsequently, each of these provisions is explained in further detail, followed by a brief discussion of some planning implications and consequences of the new rule or change.

- Deduction for state/local sales taxes retroactively restored and extended
- Above-the-line deduction for education expenses retroactively restored and extended
- Deduction for teacher's classroom expenses retroactively restored and extended
- New itemized deduction for mortgage insurance premiums
- New rules to allow usage of long-term unused Minimum Tax Credit carry-forwards
- Increase in penalties and IRS flexibility for frivolous returns
- Health Savings Accounts (HSAs) enhanced with numerous provisions, including:
    - Contribution limits expanded
    - Contribution restrictions for part-year coverage eliminated
    - Contribution comparability rules adjusted to allow additional contributions for non-highly-compensated employees
    - One-time rollover from IRA to HSA allowed
    - One-time rollover from FSA or HRA to HSA allowed
- Other miscellaneous rules

Deduction for state/local sales taxes retroactively restored and extended

Technical discussion

The American Jobs Creation Act of 2004 (AJCA) created the option for taxpayers who itemize their deductions to forgo deducting state and local *income* taxes, and in lieu to take an itemized deduction for state and local *sales* taxes paid, under IRC Section 164(b)(5). The provision was primarily targeted as tax relief for taxpayers who live in states that have little or no income taxes, such as Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. Taxpayers in those states received no benefit from the state/local income tax deduction, and consequently the ability to deduct sales taxes represented new tax relief. However, technically any taxpayer now has the option to take this (sales tax-related) deduction—which would, of course, be preferable any time the available deduction would be larger than the available deduction for state and local income taxes paid.

Unfortunately, AJCA created the sales tax deduction for only the 2004 and 2005 tax years, after which it lapsed. The new rules under TRHCA retroactively reinstate the sales tax deduction for the 2006 tax year, and extend it for 2007 as well, for an estimated cost of $5.5 billion in tax relief.

Going forward for the next two tax years, your clients' sales tax deduction may be based on actual sales receipts of the taxpayer, or alternatively the taxpayer may use tables prescribed by the Treasury, which are based on "typical" consumption by taxpayers and are referenced by state tax rates, filing status, number of dependents, and adjusted gross income.

<u>Geeky-but-potentially-tax-saving point</u>: Even if a taxpayer elects to use the tables provided, the individual may still add to the table amount any sales taxes paid with respect to motor vehicles (automobiles, motorcycles, motor homes, etc.), boats, and certain other similar items specified by the IRS.

Planning Implications

Unfortunately, the end-of-year nature of TRHCA means that virtually no taxpayer will have been accumulating the relevant sales receipts for the year, and consequently all taxpayers will likely be relegated to using the tables provided by the IRS. The IRS is now scrambling to update Publication 600 to provide the necessary tables for taxpayers. This will likely be out in the coming 1-2 months, but may delay taxpayers who wished to file early for refunds yet are now waiting for the new tables (especially those who live in the states mentioned above where the provision is much more likely to produce a useful deduction). For those who think the tax deduction may be relevant but aren't certain, and want to get a rough estimate of the deduction, review the 2004 version of Publication 600 at www.irs.ustreas.gov/pub/irs-prior/p600--2004.pdf. You'll notice immediately that the deduction by the table amounts alone is rarely higher than even a very modest amount of state and local income taxes, directing the focus to the states mentioned earlier.

<u>Immediate action to consider</u>: Since the purchase of motor vehicles and similar items produces a tax deduction in addition to the table amount, some individuals may find it appealing to complete such purchases before the close of the year to take advantage of the deduction in 2006. (Note that the sales tax deduction for motor vehicles may be reduced from the total sales taxes paid, if the general state tax rate is lower than that specifically applicable to automobile purchases.) **Planners may want to work with their clients' accountants, particularly in states where the likelihood of**

using the deduction is high, to determine whether making such purchases before the close of the year would actually produce a materially useful income tax savings.

For 2007, taxpayers may consider actually tracking their sales tax receipts throughout the year. Such a task is highly onerous for most and unlikely to be worth the cost and effort, but taxpayers who spend all or more than the entire amount of their Adjusted Gross Income may find such an exercise favorable, as their deduction may be significantly more than the table amounts. For those in states with moderate or high income tax rates, the sales tax deduction may still not be worthwhile enough to track, but this exercise may be particularly advantageous for those in the aforementioned states with little or no income taxes. In addition, if several particularly large purchases are anticipated for 2007 (e.g., automobiles, a large amount of home furnishings and electronics equipment, etc.), the large purchases may be enough to make receipt tracking more worthwhile. Unfortunately, though, adding up all the sales tax amounts from the receipts at the end of the year may still be an onerous task for many (or for their accountants!).

Above-the-line deduction for education expenses retroactively restored and extended

Technical discussion

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) created the option for taxpayers to take an above-the-line deduction of up to $4,000 for education tuition and qualifying fees under IRC Section 222 (originally a $3,000 maximum deduction, it increased to a $4,000 limit in 2004). However, the new rules that took effect in 2002 expired at the close of 2005. TRHCA reinstates the above-the-line education deduction for 2006, and extends it for the 2007 tax year as well, at an estimated tax cost of $3.3 billion.

The deduction limit of $4,000 is reduced to $2,000 for single taxpayers with Adjusted Gross Income above $65,000 ($130,000 for joint filers), and is reduced to $0 for those with AGI in excess of $80,000 ($160,000 for joint filers). Unlike some phaseouts, the reductions in the maximum amount are not pro-rata across the income thresholds, but instead are simply reduced in steps from $4,000 to $2,000 to $0.

Parents who claim the above-the-line deduction for education costs cannot also claim the HOPE Scholarship or Lifetime Learning Credits for that same student. In addition, the deduction is only applicable for higher education costs, and not for elementary or secondary school tuition.

Planning Implications

For many taxpayers, the above-the-line education deduction represents not only an appealing tax deduction, but the only tax deduction available for education, because the HOPE Scholarship and Lifetime Learning Credits phase out entirely at $55,000 of AGI ($110,000 for joint filers). However, taxpayers who have education expenses in 2006 and have income low enough to still be eligible for more than one education tax benefit will need to compare the net tax effect of each of the options to determine which one – the education deduction, or the HOPE Scholarship or Lifetime Learning Credits as applicable – produces the greatest tax savings. Fortunately, this can be accomplished easily in most instances with tax preparation software like TurboTax, or with the assistance of a competent tax preparer.

Immediate action to consider: It's notable that education expenses include not only those attributable to classes in the current year, but also to an academic term beginning in the first three months of the following year. Consequently, taxpayers who find themselves eligible for the education deduction who have not otherwise incurred sufficient education expenses to maximize the deduction may wish to write a tuition check by December 31 for an academic term starting in early 2007, to take advantage of the reinstated deduction in 2006.

Geeky-but-potentially-tax-saving point: Because the $65,000 and $80,000 AGI thresholds (twice that amount for joint filers) represent a 'cliff' for the deduction, it may be particularly advantageous to plan income or expenses in the final week of the year (to the extent there is any flexibility) so that AGI finishes just under these thresholds. Otherwise, for example, an individual with education expenses who unwittingly ends out with an AGI of $80,002 will receive no deduction, whereas an AGI of $79,998 would have produced a $2,000 education deduction!

Deduction for teacher's classroom expenses retroactively restored and extended

Technical discussion

The Job Creation and Worker Assistance Act of 2002 (JCWAA) created the opportunity for "eligible educators" – kindergarten through 12th grade teachers, instructors, counselors, principals, or aides in any elementary or secondary school, who work at least 900 hours during the academic school year – to receive an above-the-line deduction of up to $250 for personal expenses associated with their employment, under IRC Section 62(a)(2)(D). Expenses eligible for the deduction included those for books, many types of supplies, computer equipment (including related software and services), other equipment, and supplementary materials used in the classroom.

Unfortunately, this deduction created by JCWAA expired at the close of the 2005 tax year. TRHCA has retroactively reinstated and renewed the rule for the 2006 and 2007 tax years, at an estimated tax cost of $0.4 billion.

Planning Implications

Although the magnitude of this deduction is fairly small, it is nonetheless significant that the government estimates this incredibly popular deduction was claimed by more than 3,000,000 taxpayers in 2005.

Immediate action to consider: As an end-of-year tax planning item, teachers who have not yet incurred $250 of eligible expenses but expect to incur such costs soon would be advised to make expenditures before December 31st. Although school is not in session for nearly all schools next week, teachers who make their purchases in 2006 will be eligible for the deduction in 2006, notwithstanding the fact that the acquired materials might not be used in the classroom until 2007. However, it's also important to remember that as a tax deduction, this merely reduces the after-tax impact of the purchase – it's still an expenditure, and teachers shouldn't make unnecessary purchases that cost 100% of the dollars spent just to recover a percentage of those dollars as a tax deduction!

Geeky-but-potentially-tax-saving point: For teachers that have made purchases in excess of the $250 limit, the expenses are still deductible as unreimbursed employee business expenses. These would be taken as a miscellaneous itemized deduction, subject (along with other deductions in that category) to the 2%-of-AGI threshold, on Schedule A.

New itemized deduction for mortgage insurance premiums

Technical discussion

TRHCA creates, for the first time ever, an itemized deduction for mortgage insurance premiums paid with respect to a primary residence (or designated second home) under the new IRC Section 163(h)(3)(E). The deduction applies only to mortgage insurance premiums associated with loans that are treated as acquisition indebtedness (acquisition indebtedness is the tax classification of a mortgage that is used to acquire, purchase, or substantially improve the residence).

The deduction only applies to mortgage insurance contracts issued in 2007, and thus will generally not apply to mortgage insurance premiums associated with existing mortgages that were acquired in 2006 and earlier.

The mortgage insurance premium deduction applies only for the 2007 year, and will no longer provide a deduction after 2007 unless Congress decides to extend this new rule. In addition, the mortgage insurance premium deduction begins to phase out for those with AGIs in excess of $100,000 (regardless of whether filing single or jointly, although the threshold is $50,000 for married filing separately status), and phases out completely once AGI exceeds $109,000.

The phaseout increment is 10% of the otherwise allowable deductible mortgage insurance for each $1,000 (or partial amount thereof) that AGI exceeds $100,000. Thus, for example, an individual with $101,500 of AGI would have crossed two $1,000 increments (one full, and one partial), and thus would face a 20% reduction – effectively being allowed to deduct 80% of the otherwise deductible mortgage insurance premiums.

Mortgage insurance premiums must generally be amortized over the life of the loan, and typically will not be able to produce an excess deduction if they are accelerated or prepaid in 2007. This will technically depend on whether the mortgage insurance stems from private insurance or the Federal Housing Administration (FHA) – which require the amortization treatment – as opposed to mortgage insurance through the Veterans Administration (VA) or Rural Housing Administration (RHA), which may allow for some deductibility of prepayment.

Beyond the one-year opportunity for deducting mortgage insurance premiums, TRHCA also creates new reporting requirements on mortgage insurance premiums for lenders. Any individual who pays an aggregate of more than $600/year in mortgage insurance premiums will have those amounts reported to the taxpayer, and to the IRS, presumably to facilitate the tracking of the new deduction, and to further track the deduction if it is extended in the future. However, it is notable that the new reporting rules, which take effect starting in 2007, do not expire at the end of 2007 as the deduction does. Ostensibly, the IRS will update Form 1098 to handle the expanded reporting requirement.

Planning Implications

Mortgage insurance premiums represent an additional cost of borrowing, and generally apply any time the loan-to-value (LTV) ratio of the mortgage exceeds 80%, with higher-tier premiums applicable as the ratio crosses higher thresholds.

In an effort to avoid the cost of mortgage insurance, many borrowers will establish a first mortgage just below the 80% LTV limit, and then obtain a smaller second mortgage like a home equity line of credit or home equity loan to cover the additional need. Although the second mortgage will generally have a higher rate (due to its being in second position), the cost of a higher rate on that smaller amount is often less than paying a mortgage insurance surcharge on the entire primary mortgage.

For example, John Smith is purchasing a $300,000 residence, and only has $35,000 available as a down payment. His required loan for the remaining $265,000 would represent 88.3% of the value of the property, requiring mortgage insurance.

If John was otherwise able to obtain a 6% 30-year mortgage, his two hypothetical choices might be: a) a $265,000 mortgage at 6% with mortgage insurance adding the effective equivalent of another 0.5%/year in cost; or, b) acquiring a $240,000 first mortgage at 6% for 30 years, and a $25,000 second mortgage at 8.0% for 15 years. In this example, John's payment for (a) would be approximately equivalent to a 30-year 6.5% mortgage of $265,000, or $1,675/month, and for (b) would be $1,439 for the 30-year first mortgage and $238 for the 15-year second, for a combined total of $1,677/month. In this case, the nominal payments are virtually identical, but since the first has non-deductible mortgage insurance, it will actually be more expensive on an after-tax basis. The second option effectively ends up being more favorable because it has converted the non-deductible mortgage insurance to deductible mortgage interest.

Under the new rules, this analytical basis still applies, but must be extended to account for the fact that the mortgage insurance payment will now be deductible. In some cases, this may result in a more favorable result for the mortgage insurance, while in others the dual-loan approach may still be more favorable. The final result will depend on the individual's marginal tax rate, the precise interest amounts and amortization periods of the loans, and the loan amount and credit quality of the borrower which ultimately affects the interest rates applied and the amount of mortgage insurance required by the lender under their risk-based pricing methodology.

HOWEVER, there is an important caveat to these new rules! Unfortunately, one must bear in mind that TRHCA granted the ability to deduct mortgage insurance payments ONLY in 2007! Thus, although the individual's decision to select between a mortgage insurance option or a dual-loan approach may be in place for many years, the deductibility rules will actually change after the first year. Congress may or may not ultimately decide to extend the rules beyond 2007 – that remains to be seen. In the meantime, the one-year-only effect of the rule will potentially make it significantly less appealing, particularly for those who expect to maintain the high LTV ratio for a number of years and thus would potentially face mortgage insurance costs beyond 2007. In the meantime, anyone analyzing the trade-off will likely need to account for the risk that the current rules really WILL expire at the close of 2007, allowing this as a one-year-only mortgage insurance deduction.

In addition, it's important to remember that the rules only apply for loans that are originated IN 2007 – it's not a new deduction for anyone who currently has a loan with mortgage insurance. However, since the deductibility of mortgage insurance payments only applies for those actually paid IN 2007, the option also will become less appealing as the 2007 year wanes. Those who obtain such a mortgage in the later half of 2007 may make 3-4 payments in that year, and consequently would have only 3-4 payments of mortgage insurance that would be deductible. In such a case, it is unlikely that the deduction will produce much of a material benefit for most taxpayers.

Overall, the mortgage insurance premium deductibility is a nice new opportunity, but may rarely be useful given its extremely limited scope, until/unless Congress decides to expand the applicable timeline for the rules and allow their benefit to extend for multiple years.

New rules to allow usage of long-term Minimum Tax Credit carry-forwards

Technical discussion

When an individual faces an Alternative Minimum Tax (AMT) liability, that is due to an AMT adjustment that altered the timing of income or expense recognition (such as accelerating income or deferring an expense), the taxpayer receives a Minimum Tax Credit (MTC). The MTC is a future tax credit against an individual's regular tax liability, to the extent that its use will not cause them to be subject to the AMT (i.e., to the extent that their regular tax liability is not reduced below the AMT's tentative minimum tax). The primary purpose of the MTC is to prevent a taxpayer from paying taxes twice on the same economic gain – once in the year it was taxed under the AMT system, and again when it is taxed under the regular system – by providing a tax credit from the first event that helps to offset the tax liability of the second event.

However, if a taxpayer is subject to AMT the following year, none of the MTC will be allowed, because the MTC is only a credit against the individual's regular tax liability to the extent the taxpayer is not subject to the AMT. Thus, an individual who is subject to the AMT year after year (or is so close to it that only a very small amount of the MTC can be used) may carry forward a large MTC for an extended period of time. Fortunately, there is currently no limit on the number of years the MTC may be carried forward.

In an effort to relieve this situation, TRHCA has adjusted the rules for MTCs by allowing them to be further used to reduce tax liability, effectively enabling part of the credit to be used regardless of whether the individual is subject to the AMT.

Specifically, TRHCA has altered IRC Section 53(e) to make a portion of the MTC a refundable tax credit, based on the amount of an individual's "long-term unused MTC." In turn, the long-term unused MTC is defined as an MTC carryforward attributable to years before the third year preceding the current year. In other words, for a taxpayer in 2007, the three preceding years of MTCs would be eligible (from 2004-2006), and any MTCs from prior to 2004 (i.e., 2003 or earlier) would be treated as long-term unused MTCs.

In addition, when prior year MTCs are otherwise used, they must now be absorbed on a first-in, first-out basis, which means the oldest credits are utilized first. This is designed to prevent an individual from selectively attempting to utilize MTCs from recent years in order preserve and extend the age of other MTCs in an attempt to make them become long-term unused MTCs.

Once the long-term unused MTC has been determined, the refundable portion of the MTC under the new rules follows a slightly complex formula, which provides for the refundable MTC to be the greater of:

a) the lesser of $5,000 or the remaining amount of the long-term unused MTC; or
b) 20% of the long-term unused MTC

In essence, this formula means that for anyone with more than $25,000 of long-term unused MTC, the refundable amount will be 20% of that. For anyone with less than $25,000 but more than $5,000, the refundable MTC will be $5,000. For anyone with less than $5,000, the full remaining amount can be used (extinguishing the remaining MTCs).

The MTC refundable credit amount itself will begin to phase out at higher income levels, based on the rules also applicable to the phaseout of personal exemptions. Thus, in 2007, for single individuals with AGI in excess of $156,400 (or married joint filers in excess of $234,600), the refundable portion of credit will phase out by 2% for each $2,500 in excess of the threshold. To the extent the refundability is phased out, the individual would still maintain the MTC, it would simply be relegated to the normal rules and may end up being carried forward again to future years.

Under TRHCA, these new rules allowing for the refundability and loosening of restrictions for the MTC will apply starting with tax year 2007, and ending with tax year 2012. In 2013 and beyond, these rules will no longer apply.

Planning Implications

As a result of the incentive stock options boom of the late 1990s, many taxpayers faced very large tax bills attributable to the AMT system specifically because of this AMT timing adjustment (recognizing the ISO exercise in an earlier year than it otherwise would have been under the regular tax system). However, the pervasive creep of the AMT system, accelerated with the income tax bracket cuts that began under EGTRRA, has meant that many individuals with large MTC amounts have been unable to utilize the credits.

For example, let's assume that John Smith exercised nearly $1,100,000 of ISOs in 2000 at the market's peak, and after paying a very large tax bill, ended out with an MTC of $260,000 for future years. However, in 2001, as the tax brackets changed (and John's ISO exercises were finished), John's regular tax liability was only $25,000, but his tentative minimum tax under the AMT system was $19,000. In this case, John would only be able to use $6,000 of his MTC carryforward (reducing his regular tax liability from $25,000 down to being equal to the $19,000 tentative minimum tax), and the other $254,000 would have been carried forward. If in 2002, the AMT creep further narrowed this range, John's regular tax liability in 2002 might have been $25,000 again, but his AMT liability might have become $21,000, allowing only $4,000 of the MTC and a carryforward of $250,000. If after 2002, John was always subject to AMT, his remaining $250,000 MTC would be carried forward indefinitely.

Under the new rules starting in 2007, since all of these MTCs were from years prior to 2004, John would be able to apply the new refundable MTC rules. Assuming his income was not above the threshold amounts for the phaseout, John's refundable MTC would be equal to (under the formula above) 20% of his $250,000 of long-term unused MTCs, or $50,000. If John was otherwise subject to the AMT and his tax liability was $25,000 this year, John would be eligible for a $50,000 refundable tax credit thanks to the new rules. Instead of having to pay $25,000 under the AMT, he would receive a $25,000 refund.

For some taxpayers with years of large MTC carryforwards, these new rules will be a financial boon, suddenly freeing up what may be tens or even hundreds of thousands of dollars of unused (and otherwise potentially unusable!) tax credits. This may unlock literally thousands of additional dollars onto their personal balance sheets as they receive large tax refunds beginning in 2007, enhancing their ability to fund and meet other financial planning goals.

For clients who were specifically trying to minimize income and avoid the AMT for the sole reason of attempting to harvest carryforward MTCs, such steps are no longer as necessary under the new legislation. Certainly, there may still be some benefit to further maximizing the use of available MTCs, but this may now be weighed more evenly against other tax planning strategies that might increase income, such as partial (or full) Roth conversions.

It is also notable that there may still be a Technical Corrections tax bill to further address these new rules, due to a discrepancy between how the 20%-of-long-term-unused-MTC rules are written in the tax code versus how they were discussed in Congressional committee. It appears that the original intent of the provision was to allow 20% of the original long-term unused MTC amount to be applied each year, which would effectively exhaust all of the carryforward MTCs in 5 years. However, the rules as written will apply a declining-balance method to the 20% calculation. For example, if an individual has $1,000,000 of MTCs, the allowable amount in the first year would be $200,000 (20% of $1,000,000), but in the second year it would only be $160,000 (20% of the remaining $800,000), in the third year $128,000 (20% of the remaining $640,000), etc. Under this method, the successively smaller available increments will extend the actual unwinding of the MTC well beyond the 2012 end date of the legislation, as compared to applying 20% of the original amount, which would allow for $200,000 of the MTC each year and ensure that the original amount is entirely relieved by 2012.

It remains to be seen whether Congress will return to fix this apparent drafting “mistake” or not, but fortunately it will not have relevance until 2008 (the second year that the calculation would apply, since 20% in the first year will always be correct), so there is time for the issue to be addressed.

<u>Geeky-but-potentially-tax-saving point</u>: For clients that will be unlocking substantial long-term unused MTCs in 2007, consider adjusting tax withholdings or estimated tax payments to take into account the lower expected Federal tax bill that will be due at the end of the year, improving cash flow during the year. However, remember that these are Federal credits and will not affect state-level income taxes!

Increase in penalties and IRS flexibility for frivolous returns

Technical discussion

If a taxpayer files a tax return that fails to contain the proper and necessary information for the determination of tax or clearly presents incorrect information for tax assessment, and involves a frivolous position or otherwise appears to be an attempt to impede the administration of the tax system, the IRS could apply a $500 penalty for the frivolous submission. The position would be deemed frivolous if it had no basis in fact or in law.

Under TRHCA's revisions to IRC Section 6702, these rules are expanded and the penalties are increased. The IRS will now be able to levy a fine as high as $5,000 for frivolous tax filings. Specifically, the penalty may apply to a tax return filing if:

1) the purported return doesn't contain information on which the substantial correctness of the self-assessment [of tax] may be judged; or
2) the purported return contains information indicating on its face that the self-assessment is substantially incorrect; and
3) the conduct described in (1) and (2) above is based on a position which the IRS has identified as frivolous or reflects a desire to delay or impede the administration of federal tax laws.

The new rules above, and their associated fines, may be applied not only to income tax filings, but instead to any tax return required under the Internal Revenue Code.

Furthermore, the penalties may also now be applied to frivolous requests for certain IRS hearings and negotiations. The new rules also provide the IRS greater latitude to dismiss frivolous requests outright without following the otherwise applicable IRS mandated procedures. If a taxpayer submits a request for a hearing and is notified that the submission has been deemed frivolous, the individual will be allowed to withdraw the request within 30 days and avoid the penalty.

As a part of the TRHCA provisions, Congress has specifically requested that the IRS create and periodically revise a list of positions that are identified as being frivolous for the purposes of the penalty.

Planning Implications

For the most part, it's probably fairly rare for the clients of most financial planners to file frivolous income tax returns. Nonetheless, ever-widening access to the internet has unfortunately provided promoters of many frivolous tax evasion techniques a marketing opportunity to take advantage of some taxpayers at their own expense. Consequently, there has been a substantial increase in the quantity of frivolous tax filings in recent years, which in turn led to the Service's request to Congress for additional tools and latitude to fight such behavior and promote compliance with the tax system.

The primary thrust of these new rules, in the context of financial planners, is that planners should be aware that the IRS is now pursuing frivolous income tax positions more aggressively and may counsel certain 'aggressive tax clients' accordingly. For an excellent discussion of many of the common tax protestor challenges, and why they're invalid, I highly recommend the excellent information at http://www.quatloos.com/tax_protestors.php.

Health Savings Accounts (HSAs) enhanced with numerous provisions

Technical discussion

Health Savings Accounts (HSAs) under IRC Section 223 were originally created under the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (MPDIMA). HSAs are available to any individual who is covered by an eligible high-deductible health plan (HDHP) and has no other disqualifying coverage. An eligible HDHP must, in 2006, have a deductible of at least $1,050 for individuals or $2,100 for families, and the annual out-of-pocket expense limit cannot exceed $5,250 for individuals or $10,500 for families (these dollar amounts are all indexed annually for inflation).

Contributions to HSAs are tax deductible, even if the taxpayer does not otherwise itemize deductions, and may also be funded on a tax-free basis by employers. Growth on HSA accounts is tax-deferred, and withdrawals from an HSA are tax-free if used for qualifying medical expenses. Non-qualified withdrawals from an HSA will be subject to income taxes, and will also be subject to a 10% penalty if used for nonmedical expenses before age 65. Individuals may continue contributing to HSAs as long as they still maintain an HDHP and are not enrolled in Medicare.

Under TRHCA, Congress has sought to expand the appeal of HSAs and make them easier to fund with numerous new provisions. The five most significant expansions under TRHCA, each of which discussed further below, include:

- Contribution limits expanded
- Contribution restrictions for part-year coverage eliminated
- Contribution comparability rules adjusted to allow additional contributions for non-highly-compensated employees
- One-time rollover from IRA to HSA allowed
- One-time rollover from FSA or HRA to HSA allowed

Except for the last provision allowing FSA or HRA rollovers to HSAs, all other provisions take effect beginning in the 2007 tax year.

<u>Contribution limits expanded</u>

Under the original HSA rules established under MPDIMA, contributions to an HSA were limited to the lesser of the high deductible health plan’s actual annual deductible, or a specified dollar amount adjusted annually for inflation. For 2006, the annual amount was $2,700 for self-only coverage, and $5,450 for family coverage. These limits were applied on a one-twelfth monthly basis for each month that the individual was covered under an eligible HDHP.

Under TRHCA, the restriction limiting HSA contributions to the plan’s annual deductible, if less than the specified dollar limit, is eliminated. Consequently, contributions to HSAs will simply be based on the annual dollar limit, which is scheduled to increase in 2007 to $2,850 for self-only coverage and $5,650 for family coverage.

In addition to these dollar limits, individuals who are at least age 55 and are under 65 may make additional catch-up contributions. The catch-up contribution limit was $700 in 2006, will increase to $800 in 2007, and will continue increasing by $100/year until it reaches $1,000 in 2009.

Contribution restrictions for part-year coverage eliminated

Under the original MPDIMA rules for HSAs, the contribution limits were actually calculated on a monthly basis, and thus an individual who was only covered by an HDHP for 6 of the 12 months of the year would only be eligible to contribute up to 6/12 = 50% of the otherwise-maximum amount.

Under the new rules of TRHCA, an individual who maintains an HDHP on the last day of the year is treated as being covered by an HDHP for the entire year. Consequently, those who initiate HDHP coverage after January of a particular year may still make the full maximum HSA contribution, whereas under the prior rules they would be restricted to a partial contribution based on the number of months enrolled.

However: if an individual makes an HSA contribution in excess of the partial year limit specifically under these rules, the individual must maintain their HDHP coverage for a 12 month period (from the first day of the month they became eligible, under the last day of the 12^{th} following month). If coverage ceases within that 12 month period for any reason besides death or disability, any excess contributions above the otherwise-applicable partial year limit must be reported in income, and will also be subject to a 10% additional penalty tax. This rule is intended to prevent taxpayers from enrolling in HSA coverage late in the year for the sole purpose of obtaining an HSA contribution tax deduction, only to cancel the coverage shortly after the new year, by requiring that the coverage remain in place for a longer period of time.

Contribution comparability rules adjusted to allow additional contributions for non-highly-compensated employees

Employers may contribute to HSA accounts on behalf of employees, but such amounts must be "comparable contributions" for all participating employees who have the same category of HDHP coverage, under IRC Section 4980G. Comparable contributions are defined as being either the same dollar amount, or the same percentage of the deductible, for eligible participating employees. If the employer makes contributions that violate the comparability requirements for the year, the employer is subject to a 35% excise tax on the aggregate amount contributed to HSAs in that year.

Under a new exception to this rule created by TRHCA, employers may choose to make larger HSA contributions to non-highly compensated employees (non-HCEs) than for highly compensated employees (HCEs). However, the rule only operates in one direction; contributions for non-HCEs may be higher than HCEs, but the employer still cannot discriminate against non-HCEs in favor of HCEs. Furthermore, the contributions must still be comparable for all non-HCEs.

Determination of whether an individual is an HCE is made under the same rules applicable to nondiscrimination testing for qualified plans. Under IRC Section 414(q), an HCE is an employee who is a 5% owner at any time during the current or preceding year, or has compensation in excess of $100,000 (as indexed for 2007) and (if elected by the employer) was in the top-paid group (the top 20 percent of paid employees of the firm).

<u>One-time rollover from IRA to HSA allowed</u>

In order to expand the ability of individuals to fund their HSA accounts, Congress has provided under TRHCA that taxpayers may make a once-in-a-lifetime rollover from an IRA to an HSA to accelerate HSA funding contributions. Only traditional IRAs are eligible; SEP and SIMPLE IRAs are not eligible for these new rollover rules. Roth IRAs are also potentially eligible, if the distribution would otherwise be a non-qualified distribution includible in income.

The rollover must be accomplished as a trustee-to-trustee transfer, but will be treated as a tax-free transaction and will not be subject to the 10% early withdrawal penalty otherwise applicable to early IRA distributions. Because the transaction is otherwise treated as a non-taxable rollover distribution from the IRA, the taxpayer will not be eligible for an HSA contribution deduction (since the funds were already pre-tax from the IRA). To support this for IRAs that have after-tax contributions, the normal pro-rata ordering rules for IRA distributions are superseded, and instead any rollover distribution from an IRA to an HSA will automatically be treated as coming first from amounts that would otherwise be included in income. This ensures that such IRA-to-HSA rollovers are funded entirely and only with pre-tax dollars.

The maximum rollover contribution is limited to the amount of the individual’s annual HSA contribution dollar limit. In addition, rollover contributions from an IRA to a HSA reduce the individual’s otherwise-eligible HSA maximum contribution on a dollar-for-dollar basis.

In a similar manner to anti-abuse rules discussed earlier, if an individual makes an IRA-to-HSA rollover contribution, the individual must maintain his/her HDHP coverage for a 12 month period (from the first day of the month they became eligible, under the last day of the 12th following month). If coverage ceases within that 12 month period for any reason besides death or disability, any amounts contributed from the IRA must be reported as income, and will also be subject to a 10% additional penalty tax.

<u>One-time rollover from FSA or HRA to HSA allowed</u>

In a similar manner to the IRA rollover rules discussed above, TRHCA also allows individuals to roll over amounts from a Flexible Spending Account (FSA) or a Health Reimbursement Arrangements (HRA) to an HSA.

Again, the rollover is only allowed on a once-in-a-lifetime basis, but appears to be able to occur once from an FSA and once from an HRA, if the individual happened to be a participant in both. The rollover distribution from the FSA or HRA to the FSA is made on a tax-free basis, allowing the amounts to be excluded from the employee's income for both income and employment tax purposes. Unlike the rollover from an IRA, though, the FSA or HRA transaction is actually treated as a rollover contribution, and consequently does not affect or reduce an individual's own HSA contribution limit.

The maximum amount eligible for rollover from the FSA or HRA is the lesser of the account's balance on September 21, 2006, or on the date of distribution. The rollover must be contributed directly by the employer, and the transaction must occur by December 31, 2011.

In order to maintain an HSA, an individual must not have other first-dollar coverage, and in some cases participation in an FSA itself may disqualify an individual from an HSA – which would also indirectly make the individual ineligible to complete this transfer. This can be particularly problematic for the FSA 'grace period', which allows an individual to make FSA expenditures up to 2.5 months after the close of the taxable year. To facilitate the transition, the TRHCA rules also state that the grace period portion of FSA coverage may be disregarded (allowing for HSA participation) for the following year as long as the balance of the FSA is $0 at the end of the year, or the individual is making an FSA-to-HSA rollover in an amount equal to the remaining balance in the FSA at the end of the year.

To comply with comparability rules, if an FSA or HRA rollover to an HSA is offered to an employee, it must be offered to all eligible HDHP participants. In addition, consistent with the anti-abuse rules applied for the new HSA rules, if an individual completes a rollover from an FSA or HRA to an HSA, the individual must maintain their HDHP coverage for a 12 month period (from the first day of the month they became eligible, under the last day of the 12^{th} following month). If coverage ceases within that 12 month period for any reason besides death or disability, any amounts contributed from the FSA or HRA rollover must be reported in income, and will also be subject to a 10% additional penalty tax.

Planning Implications

In general, the starting point for making decisions about HSA participation still begins with the economics of the HSA arrangement itself. This involves an evaluation of the trade-off between obtaining a tax-deduction for HSA contributions and tax-free treatment of HSA withdrawals, in exchange for the fact that a higher deductible health plan potentially requires that more dollars will be spent on health care (for which the tax treatment only mitigates cost). Thus far, there has been a great deal of variability by state and by insurer as to the appeal of HSAs, depending on the size of the premium difference between a high deductible health plan and the health plan option the employee (or employer) otherwise would have selected.

Assuming that the HSA otherwise makes sense for a particular individual, the new rules of TRHCA expand the ability of clients to actually fund their HSAs. The removal of the plan's annual deductible as a contribution limit may help many individuals to maximally fund an HSA without actually being required to select the highest possible deductible. In addition, the expansion of contribution limits for part-year coverage creates additional appeal to create HSAs later in the year, where a full year's worth of funding is allowed even if enrollment in the HDHP occurred for only part of the year. However, it is notable that if an individual has part-year coverage because they were enrolled in an HDHP at the start of the year but cancelled the coverage before the end of the year, the partial year restrictions apparently will still apply. Thus, the partial year provisions are favorable for those who have part-year coverage because they start later in the year and maintain the coverage; it does little for an individual who currently has HDHP coverage but decides to cancel it before the end of the year.

The expanded comparability rules allow for employers to be more generous in making contributions for the benefit of rank-and-file non-highly compensated employees, but it will remain to be seen whether employers will take advantage of such provisions. To the extent it allows employers to provide some additional benefit for non-HCEs, while the employer compensates HCEs in other manners, this new flexibility may be appealing. Prior to this, employers that simply wanted to provide a non-HCE-only benefit would have been required to contribute on behalf of HCEs as well. Nonetheless, the desire of employers to contribute more money to HSAs as a feature of an employee benefits package remains to be seen.

The most interesting provisions of TRHCA's provisions regarding HSAs appear to be the new rollover opportunities. However, these provisions may ultimately prove to be more hype than substance, particularly regarding the IRA rollover opportunity. Although the media has latched onto this new opportunity early, it has been under-recognized that the rollover amount is limited to one year's worth of annual HSA contributions, and that the rollover itself must still coordinate with the individual's other HSA contributions.

Consequently, the new IRA rollover opportunity, at least as a funding mechanism, appears to be desirable only for those that otherwise have absolutely no other available dollars to fund the HSA. For those who have non-IRA dollars available, the ability to make a deductible HSA contribution, allowing for a current year tax deduction and the opportunity to leave the IRA intact for retirement goals, would seem to be more desirable.

On the other hand, the downside may be limited – to the extent that the funds aren't used on a tax-free basis for medical expenses, they will still ultimately be available to pay retirement expenses or any other purpose without penalty and subject to income taxes at age 65 (NOT age 59 ½; after the rollover, the money would be subject to HSA distribution rules, which are under a different code section: 223(f)(4)), and from that point on will be receiving similar treatment to the original IRA dollars.

In this case, the tradeoff is the ability to use the HSA dollars in the meantime for medical expenses on a tax-free basis, versus the lessened flexibility to use the funds for other purposes without a 10% penalty, since IRAs allow for numerous exceptions to the penalty including reaching age 59 ½, substantially equal periodic payments, higher education expenses, and more, while HSAs only allow exceptions for death or disability under IRC Section 223(f)(4)(B) until the individual reaches age 65.

<u>Geeky-but-potentially-tax-saving point</u>: However, for those in more severe financial situations, who may have exhausted other available assets and actually have medical expenses that must be funded with IRA dollars, a tax savings opportunity arises. Although a withdrawal from an IRA for medical expenses is excused from the 10% premature distribution penalty under IRC Section 72(t), the distribution must still be reported as income, resulting in an income tax liability. If the same dollars are rolled over to an HSA, and then used to fund the applicable medical expenses, the individual may avoid the income tax liability on the payment of those expenses.

The rollover provisions from FSAs or HRAs to HSAs may be adopted more widely than the new IRA rollover rules, since these represent not an alternative funding source for the HSA's annual contribution, but instead are a method of shutting down existing HRAs or FSAs to transition to HSAs. Although many employees may find FSAs more desirable because they don't require the use of a high-deductible health plan, the use-it-or-lose-it rules of the FSAs are often a point of frustration and may make HSAs more desirable. Ultimately, the ability to complete FSA or HRA rollovers may not itself be the cause of an employer to transition from one plan type to another, but to the extent that employers decide to make a transition, expect to see these new rollover provisions used to preserve dollars available to employees that are already in the plans.

Other miscellaneous rules

Technical discussion

Beyond the extensive list of new provisions under TRHCA already discussed, there are a few final items that are noteworthy for clients in limited circumstances. These other miscellaneous provisions include:

- Retroactive reinstatement and renewal of the D.C. first-time homebuyer credit
- New reporting requirements for ISO and ESPP stock transactions

<u>Retroactive reinstatement and renewal of the D.C. first-time homebuyer credit</u>

A first-time homebuyer of a principal residence in Washington D.C. is allowed a $5,000 tax credit on the purchase. The credit applies if it is the first home you have purchased in the District of Columbia, regardless of whether you have owned property elsewhere, but can be used only once by a taxpayer. The credit phases out for joint filers by $250 for every $1,000 that AGI exceeds $110,000, thus fully phasing out by $130,000 of AGI (for single filers, the phaseout begins at $70,000 of AGI and fully phases out by $90,000 of AGI).

This tax credit originated in 1997, but has been subject to lapse and reinstatement before. Most recently, the credit had lapsed at the close of 2004, and was extended under the Working Families Tax Relief Act of 2004 through the close of 2005. Under TRHCA, it is retroactively reinstated for 2006, and is further extended through 2007.

<u>New reporting requirements for ISO and ESPP stock transactions</u>

Under new TRHCA reporting requirements, when a corporation transfers a share of stock to an employee pursuant to an exercised incentive stock option or employee stock purchase plan, the corporation must provide an informational return to the IRS reporting the transaction.

Formerly, corporations were required to provide a statement to the exercising employee for self-reporting purposes, but were not required to provide reporting information directly to the IRS.

Planning Implications

For financial planners who have clients living in Washington D.C., or ones considering a move to that area, the first-time homebuyer tax credit (a bit of a misnomer, since it only refers to the first time a District of Columbia home is purchased!) is effectively a reduction in the otherwise-applicable cost of the residence. With the densely packaged Washington D.C. area, including local suburbs in both Maryland and Virginia, the tax credit may be a factor in deciding where to purchase a residence. Of course, even from only a tax perspective, other factors should weigh into the decision as well, including the fact that Washington D.C. income tax rates are often higher than the state and local income taxes of the surrounding suburb areas. Nonetheless, the outright opportunity for a $5,000 tax credit may still be a material factor in the decision-making process for some clients.

The new reporting requirements for ISO and ESPP transactions will generally not require any direct planning response, but it is important to realize that such transactions are now being reported to the IRS. To the extent that a taxpayer fails to properly reporting the income tax consequences of associated transactions (including the potential Alternative Minimum Tax implications of ISO exercises), the new reporting requirements suggest that taxpayers may be more likely to get caught in the future for their errors.

Final Summary

By the standard of other tax cuts in recent years, the Tax Relief and Health Care Act of 2006 is neither particularly large nor especially expansive in its scope. Nonetheless, a bill that started off primarily as a piece of tax-extending legislation (some of which was significant itself) incorporated many other provisions that affect financial planners and their clients, from a notable expansion of Health Savings Accounts to tax relief for clients with large Minimum Tax Credit carryforwards.

As with many recent tax bills, several of the provisions involved are only applicable for limited periods of time, and thus sometimes represent narrow windows during which clients can benefit. This will require vigilance and up-to-date information on the part of financial planners to stay on top of the opportunities for clients.

Hopefully, the information contained here can be of service in that pursuit.