State of the Union - Part 4

Medical Expense Account

Overview

Over the course of this series, I have been pontificating on a number of points. First, ERISA and tax regulation have in my view had the unintended effect of reducing benefits for workers and business owners instead of protecting benefits. In the realm of retirement planning, defined benefit plans have virtually disappeared from the landscape. As a result, each of us will have a new retirement date - the earlier of age 95 or our passage from Planet Earth.

My premise is that every business owner would like to have a defined benefit plan as the foundation of the business owner's retirement plan if the business owner did not have to contribute for employees. Of course, this type of discrimination is exactly what ERISA was designed to prevent.

Obamacare seems to be limping down the runway for implementation. Nevertheless, the term "49ers and 29ers" seem to be new terms being heard in employee benefits planning with respect to healthcare. Someday (sooner than we expect) and absent repeal (fat chance!), business owners with fifty employers or more will have to provide coverage for employees.

Employers with less than thirty employees do not have to provide coverage. for employees. The item regarding healthcare reform that seems to have a consensus is that the cost of healthcare will rise dramatically. As a result, the business owner finds himself facing a huge amount of uncertainty regarding healthcare coverage for employees and himself.

The defined benefit plan may be the "Swiss Knife" of retirement planning for its ability to provided a fixed retirement benefit for the business owner. The contribution levels for defined benefit plans depending upon the age of the business owner can exceed the defined contribution maximum contribution threshold by 3-8 or 9 times. Less well known is the ability of the defined benefit plan to also provide important ancillary benefits. One of the critical ancillary benefits is the Medical Expense Account under IRC Sec 401(h). These medical expense accounts are an important tool that allow the business owner to plan and provide for the post-retirement medical expenses including long-term care.

The significance of the medical expense account extends beyond the relative uncertainty of medical expenses. The 401(h) account can also provide a source of funding for long-term care expenses. The explosion of Alzheimer's Disease among others seems to reinforce the idea that medical care and innovation has extended life but not the quality of life. Generally speaking, it is pretty difficult if not impossible to qualify for Medicaid if you are an affluent business owner, and the cost of nursing home care can easily "break the bank" quickly with costs for an average nursing home averaging between $90,000-120,000 per year depending upon where you live.

Long Term Care insurance never made the dent in the marketplace for this problem that it was expected to make. Some people found that insurance companies managed to find a way to exclude claims (Surprise! Surprise!). The inflation rate for healthcare costs is much higher than the general inflation rate. Additionally, the average time in a nursing home can be 2-5 years.

Medical Expense Accounts under IRC Sec 401(h)

A medical expense account under IRC Sec 401(h) is an account within a defined benefit pension plan for the payment of the sickness, accident, hospitalization, and medical expenses of retired employees and the spouses and dependents of retired employees. The assets are segregated from assets designated for the payment of retirement benefits.

What type of medical expenses can a 401(h) account cover? See Appendix A. The 401(h) account can cover treatment and expenses for traditional and alternative medical treatment as well as the cost of hospice and nursing home coverage.

The medical benefits provided under a 401(h)arrangement are considered subordinate to the plan's retirement benefits if at all times the aggregate contributions made to provide the medical benefits and any life insurance protection do not exceed 25 percent of the aggregate contributions (made after the date that the plan first includes the medical benefits) exclusive of contributions to fund past-service credits.

The term" retired" for purposes of eligibility to receive medical benefits under IRC Sec 401(h) means that the participant is eligible to receive retirement benefits under the plan or is treated as retired by the employer by reason of the employee's permanent disability. An employee who must terminate employment with the employer as a condition of retirement is not considered retired.

Ancillary benefits such as medical expense, pre-retirement death benefit and disability must be non-discriminatory. The medical expense arrangement cannot discriminate in favor of officers, shareholders, supervisory employees, or high compensated arrangements with respect to coverage or with respect to contributions and benefits. The determination of whether or not the arrangement discriminates is made with reference to the retirement portion of the defined benefit plan as well as the medical expense arrangement.

Throughout this State of the Union series, I have been promoting the planning merits of relying on the exemption found in IRC Sec 410(b)(3)(A) for employees covered under a collective bargaining agreement. This exemption allows the business owner to exclude employees from all ERISA-based employee benefit programs. The exemption allows the business owner to exclude his employees from the business's series of pension plans - defined benefit, 401(k) and profit sharing. The business owner will customize the medical expense account to cover uninsured medical and long-term nursing home expenses.

The 401(h) plan within the defined benefit plan needs to specify the medical benefits that will be available and must contain provisions for determining the amount that will be paid. Furthermore, such benefits, when added to any life insurance protection provided under the defined benefit plan, must be subordinate to the retirement benefits provided by the plan.

The 401(h) plan requires the establishment of a separate account must be established to fund medical expense benefits. The separation is for recordkeeping purposes only and the plan may invest the contributions to the 401(h) account in the same manner as it invests funds used to provide retirement benefits.

401(h) plan contributions to fund medical benefits must be reasonable and ascertainable. The employer must at the time it makes a contribution, designate the portion of the contribution allocable to funding medical benefits. It must be impossible at any time prior to the satisfaction of all liabilities under the plan for any part of the corpus or income of the medical benefits account to be used for, or diverted to, any purpose other than providing medical benefits under the plan. The payment of necessary or appropriate expenses attributable to the administration of the medical benefits account, however, does not affect the qualification of the plan.

The plan must provide that any amounts that are contributed to fund the 401(h) account and that remain in the account after satisfaction of all liabilities arising out of the operation of the medical expense account arrangement are returned to the employer. The plan must expressly provide that if an individual's interest in the medical benefits account is forfeited prior to termination of the plan, an amount equal to the amount of the forfeiture will be applied as soon as administratively possible to reduce employer contributions to fund the 401(h) account

In summary, these medical expenses are made with pre-tax dollars. the investment earnings within the Plan accrue on a tax-deferred basis. Under IRC Sec 105, the benefits received under the Plan for medical expenses are non-taxable to the participant.

Strategy Example

John Smith, age 64, is a dentist operating a small practice in New York City. He has a few employees. The combination of tuition payments (high school and college) along with the high cost of living and taxes have delayed John's retirement plans. As a result, he has found himself in the "catch up" mode but feels trapped by high taxation and the need to include his employees in his pension planning.

Furthermore, John's family has a long medical history of dementia in old age. John would like to incorporate a 401(h) account into his retirement planning to cover these unrelated medical costs. John will take advantage of the exemption under IRC Sec 410(b)(3)(A) and unionize his several employees with Local 928.

John earns well in excess of $255,000 per year. The plan will include a medical expense account for -John - funded at the maximum level 25 percent of aggregate contributions.

The recommended contribution to fund the retirement benefit for John is $350,000 . Additionally, an additional $87,500 each is added on top of the retirement contribution in order to fund the 401(h) account. However, John is able to make a maximum contribution is Year 1 of $853,000. The contribution creates a net operating loss in his S corporation. His CPA is able to amend his 2012 and 2011 tax returns for an adjustment using the NOLs.

The total pension contribution is $437,500 per year in Year 2-5. The total contribution for the medical expense account over the projected five year funding period is $437,500 before considering investment income. At the current costs, the 401(h) account has enough funding for 4-5 years of nursing home coverage.

Summary

The 401(h) Plan within qualified retirement plans for business owners is virtually unknown. Why?

On one hand, pension administrators, CPAs or financial service professionals receive no compensation as a result of recommending and implementing this Plan. On the other hand, the oncoming healthcare storm and crisis creates a high premium for the business owner to set aside for his post-retirement healthcare and long term care expenses for the business owner and spouse.

The ability to create a discriminatory retirement and post retirement health plan is a significant step in planning for an uncertain future. The business owner is able to create a large "war chest" for retirement and healthcare. As I have said, the business owner only has three choices - (1) Pay himself (2) Pay the Government or (3) Give the money to charity.

APPENDIX A

SAMPLE: Post-retirement medical benefits that may be provided under IRC 401h Account

Benefits are not limited to those contained in this list.

Acupuncture
ADD Counseling and Assistance
Air Lift Transportation (Both US and Non US)
Alcoholism
Alternative Healthcare
Alternative Medicines
Ambulance
Artificial Limbs
Artificial Teeth
Assisted Living Facilities
Asthma and Allergy Prevention and Treatment
Birth Control Pills
Braces
Braille-Books and Magazines
Chiropractors
Christian Science Practioners' Fees
Contact Lenses Including Examination Fee
Co-Pays
Cosmetic Surgery (Even Though not by a Physician)
Cost for Care Outside the United States
Cost of Operations and Related Treatments
Counseling
Crutches
Deductibles
Dental Cosmetic Surgery
Dental Fees
Dentures
Dependent Care
Dermatologist Care
Diagnostic Fees
Drugs
Electrolysis
Experimental Care
Eyeglasses, Including Examination Fee, Laser Surgery for Vision Correction
Fees of Practical Nurse
Fees for Healing Services
Fees of Chiropractors
Fees for Fitness Programs and Facilities
Fees of Licensed Osteopaths
Group Therapy
Handicap Persons' Special Schools
Flu Shots
Hair Transplants
Health Insurance Premiums
Hearing Devices and Batteries
Holistic Care
Hospice
In Home Care
Hospitalization Insurance
Hospital Bills
Insulin
Laboratory Fees
Laetrile by Prescription
Lasik Eye Surgery
Hire Lead Base Paid Removal-Children with Lead Poisoning
Retirement Home for Medical Care
Long Term Care, Nursing Homes
Medical Information Plan
Medicines
Membership Fees for Medical Services, Hospitalization, Clinical Care, Health Maintenance, Health club memberships
Nurses Fees, Nurses Room and Board
Social Security Tax (Where Paid by Taxpayer)
Obstetrical Expenses
Operations (100% of All Costs)
Orthopedic Shoes
Oxygen
Personal Trainers
Physical Therapy
Physician Fees
Premiums for LTC
Preventive Care including but not limited to Spa Facilities, Usage Fees for Facilities
Prosthetics
Psychiatric Care
Psychologist Fees
"Seeing-eye" Dog and its Upkeep
Specialists and Specialized Treatments
Specially Equipped Cars
Special Care Costs for Disabled Dependents
Special Diets
Sterilization Fees
Support Groups
Surgical Fees
Therapy Treatments
Transportation Expenses for Medical Services including Preventative Care
Tuition Fee (part), if College or Private School Furnishes Breakdown of Medical Charges
Tuition at Special School for Handicapped
Viagra
Vitamins
Wheelchair
Weight Loss Programs
Wigs
X-rays