

THE JURIS DOCTOR FAMILY WATCH

Daniel H. McKinney & Associates
Estate Planning Group

A NEWSLETTER FOCUSING ON
ESTATE PLANNING FOR
ASSET PROTECTION

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HEALTH SAVINGS ACCOUNTS RECEIVE FAVORABLE TAX TREATMENT

Beginning January 1, 2004, individuals were permitted by Congress to establish Health Savings Accounts which carry with them significant tax advantages. An "eligible person" must not be eligible for Medicare or be a dependent and must be covered only* by a High Deductible Health Plan (HDHP). An HDHP is a plan which has an annual deductible of at least \$1,000 for self-only coverage or twice that amount for family coverage. Also, the sum of the annual deductible and other out of pocket expenses cannot exceed \$5,000 for self-only coverage or twice that amount for family coverage.

If a contribution is made by an employer, the contribution is tax deductible to the employer and is a pretax salary reduction to the employee. Contributions made by an individual are an "above the line" deduction, i.e. deductible in determining gross income. Contributions on behalf of an eligible person may also be made by family members** though the contribution is subject to any gift tax applicable. Because there are no compensation requirements, the eligible person can use the contribution to shelter all forms of income from tax including interest, pension, dividends, stock gains and the like. Contributions*** can be made as early as the first day of the tax year and as late as April 15, of the following year.

Contributions grow tax free, roll-over from year to year allowing significant build-up, and are portable.

Distributions to pay qualified medical expenses are tax free only in a year in which the annual deductible is met. Distributions not used to pay qualified medical expenses are subject to income tax and a 10% penalty unless the eligible person has died, become disabled or reached age 65. Once established, expenses may be paid though the person is no longer an "eligible person" or covered by an HDHP.

Ordinarily, expenses can be incurred only after the HSA has been established. However, since the period between the enactment of the law and the effective date was so short, many taxpayers were unable to set up an HSA account because they could not locate a trustee or custodian to open them. IRS has provided relief in a transition rule. For 2004, a person who establishes an HSA on or before April 15, 2005 may pay medical expenses incurred on or after the later of January 1, 2004 or the first day of the month that the person became eligible.

Transition period relief is also available for prescription drug coverage. Ordinarily, favorable tax treatment is not available for contributions where a person is covered by an HDHP that does not

provide drug benefits and by a separate plan or rider that pays drug benefits before the minimum annual deductible of the HDHP is met. However, this rule is suspended until January 1, 2006 and contributions can be made to an HSA based on the annual deductible of the HDHP.

The IRS is currently developing "safe harbors" or procedures that will be considered preventative care. An individual can be covered by an HDHP that pays for preventative care without meeting the ordinary high deductible. Preventative care includes periodic health evaluations, testing, routine prenatal and well-child care, immunizations, tobacco cessation programs, weight-loss programs and screening services.

For additional information, contact our office.

* Exceptions exist for insurance coverage as permitted by statute or for accident, disability dental, vision and long term care.

** Family member is not defined.

***Up to an annual maximum - For 2004 - self only coverage monthly contribution is 1/12 of the lesser of the annual deductible under the HDHP or \$2,600. For family coverage, the formula is the same except the maximum is \$5,150. For individuals 55-65, an additional \$500 catch up amount is permitted which increases each year until reaching a maximum of \$1,000. Contributions do not need to be made monthly but can be made as convenient.

RELYING ON EMPLOYER INFORMATION FOR RETIREMENT PLANS CAN BE FINANCIALLY DEVASTATING

Carle Clinic Association claims to be one of the nation's largest medical-practice groups. Together with the Carle Foundation, it operates several clinics plus the hospital affiliated with the University of Illinois in Urbana-Champaign. Carle promised employees, including physicians, a pension that could be as large as 50% of average earnings. Doctors Helfrich and Nelson learned to their dismay, however, that the total annual pension under Carle's defined-benefit plan could not exceed \$160,000. Paying more would cost the plan its tax qualified status which allows Carle to deduct pension expenses and employees to defer until retirement all taxes on the value of their interest. When the plan refused to pay what Nelson and Helfrich believed they were owed, they filed suit under the Employee Retirement Income Security Act (ERISA). Helfrich and Nelson contended that the summaries distributed to employees overrode the terms of the plan.

The court disagreed. The court noted that three documents or "summaries" were part of the record but do not remotely look like summary plan descriptions. Summary 1 is a single page handout. Summary 2 is a brochure that describes Carle's fringe benefits. Summary 3 is a section of the employee handout. The court surmised the

"summaries" were prepared by Carle and not the plan.

Every pension plan must publish a summary plan description (SPD) and conflicts between the plan and the SPD are resolved in favor of the SPD. Though Helfrich and Nelson want to extend this principle to other descriptive material, that argument, and the whole suit even, reflects confusion between the employer and the plan. Each is a separate entity. Plans can control the contents of a summary plan description. Plans cannot control what recruiters, managers or human resource employees say. So, while summary plan descriptions have legal effect and may be relied on, employer prepared summaries cannot be enforced against the plan without disregarding the boundary between two distinct entities: the plan and the employer. To make matters worse for the doctors, they not only lost the promised retirement benefits but also had to pay Carle's attorney fees!

The moral of the story: for many persons the most valuable assets they own are their retirement plan and a home. Relying on employer representations without reviewing the summary plan description can be financially devastating.

MILITARY TAX RELIEF

Late last year Congress passed the Military Family Tax Relief Act of 2003 for the benefit of active duty as well as national guard and reserve personnel. Highlights are:

1. The Military death benefit is \$12,000 retroactive to September 10, 2001 and the entire amount is now tax free.

2. For purposes of the income tax exclusion on personal residence capital gains, Military personnel called to active duty may suspend the five year ownership and use test* during any period they are on qualified extended duty. The five year period cannot be extended beyond 10 years. The duty station must be at least 50 miles from the residence or the person must be residing under orders in government housing for a period of more than 90 days or for an indefinite period.

Also, since the call to active duty will be considered a qualifying trigger, service personnel who sell a personal residence before the two year period of ownership and use expires can take a pro-

rata share of the \$250,000 gain. (\$500,000 for joint filers). The provision is retroactive for home sales to May, 6, 1997. The normal 3 year period to file amended tax returns to obtain a refund has been extended so military personnel have until November 11, 2004, to file an amended return back to 1997.

3. Reservists who stay overnight more than 100 miles from home while in service may deduct unreimbursed travel expenses (transportation, meals and lodging) as above the line deductions. The deduction is limited to the rates for expenses authorized for federal employees including per diem in lieu of subsistence.

4. The various extensions granted to combat zone participants to file returns or pay taxes will also apply to those serving in contingency operations.

* To exclude gain to the limits described above, the home must have been owned and used as a principal residence two out of the 5 years prior to the sale

U.S. SUPREME COURT SAYS OWNER OF BUSINESS IS EMPLOYER AND EMPLOYEE FOR PURPOSES OF CREDITORS' RIGHTS

Raymond Yates, M.D. was the sole shareholder and president of a professional corporation that maintained a profit sharing plan for which Yates was the administrator and trustee. From the plan's inception at least one person other than Yates or his wife was a participant. As required for favorable tax treatment by the Internal Revenue Code and The Employee Retirement Income Security Act of 1974 (ERISA), the plan contained an anti-alienation provision so that no benefit or interest in the plan was subject to assignment or alienation. In other words, the anti-alienation provision makes a person's interest in an ERISA plan unavailable to his creditors.

In 1989, Yates borrowed \$20,000 from the plan. The terms of the loan required Yates to make monthly payments to the plan over the five-year period of the loan though Yates did nothing until November 1996 when he used the proceeds from the sale of his house to make two payments to the plan totaling \$50,467 which paid off the principal and interest due on the loan. After the payment, Yates' interest in the plan amounted to about \$87,000.

Three weeks after Yates repaid the loan to the plan, Yates' creditors filed an involuntary bankruptcy petition against him. In 1998, the bankruptcy trustee asked the bankruptcy court for orders directing the plan to turn over Yates' payment for the benefit of creditors.

The bankruptcy court and, ultimately, the district and appellate courts, agreed with the trustee that the repayment to the plan was a preferential transfer, i.e. the transfer impermissibly benefitted

one creditor over others. The court also determined that Yates was not an employee under ERISA and, therefore, could not rely on the anti-alienation provision to protect the payment from creditors. The U.S. Supreme Court had a different view, however.

The lower courts followed prior cases which held that a sole proprietor or sole shareholder of a business is considered an employer and not an employee for purposes of ERISA and the anti-alienation clause.

The Supreme Court determined that ERISA contained multiple indications that Congress intended that working owners qualify as plan participants. In fact, ERISA and the Internal Revenue Code both provide that a working owner may have dual status as an employer and an employee. Ultimately, the court reversed and remanded the case for further proceedings in view of Yates' failure to make periodic repayments. Specifically, the lower courts needed to determine:

1. Given Yates' failure to honor periodic payment requirements, did the 1996 repayment, despite defaults, become part of the plan thereby excluding them from the bankruptcy estate; and
2. If so, were the payments beyond the reach of the bankruptcy trustee's power to recover the payments as a preferential transfer?

This case is significant because it changes the law in Ohio and Kentucky so that a plan participant shareholder in a single shareholder company qualifies for an ERISA protection previously only available to an employee but not the owner of the company.

STATUTE ASSISTS PARENTS TO PROVIDE FOR DISABLED CHILDREN

Special needs trusts, when properly set up, permit persons to make funds available for the benefit of a disabled family member without disqualifying the recipient from Medicaid health benefits. Frequently changing policy, aggressive agency litigation, and case law which was not crystal clear or well established, made relying on special needs trusts precarious. Regulations passed by the Department of Job and Family Services in 2002, were a substantial improvement over previous regulations. These regulations were recently codified

by the legislature, thereby making them statutory and removing the Department's ability to change them. In other words, the requirements a trust must meet to constitute a valid special needs trust can be changed only by the legislature. This lends stability and increases the confidence with which persons can be assured that their disabled family member will not be disqualified from health benefits.

* Based on an article by William Browning. For complete copy see Browning, Wm., *Probate Law Journal of Ohio*, March/April

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