

May 1, 2003

Dear Client/Friend:

The cost of providing health insurance for employees continues to escalate at an astonishing rate. Not only is the cost of health care and hospitalization on the rise, but the cost of prescription medication, long-term care, vision and dental care are also increasing at alarming rates. Virtually everyone has been affected and will continue to be affected by this negative trend.

In order to contain corporate expenses in the current economic environment, many companies have shifted the burden of increasing health insurance premiums to employees by raising the employees' share of premiums, increasing deductibles, co-pays, and maximum annual out-of-pocket expenses. However, in many cases, these measures alone are not enough to offset the increasing cost of providing coverage. As a result, additional options are being considered to help defray the rising cost of health care without inflicting undue hardship on employees or business owners:

- Flexible Spending Account (FSA) under IRC Section 125 – These accounts are generally administered by the employer on behalf of employees. Employees fund the account with pre-tax dollars via salary reduction in order to provide coverage for specified expenses (i.e. qualified medical or dental expenses, dependent care assistance costs, etc.). Typical expenses that employees would be reimbursed for through an FSA could include co-pays, deductibles, prescription medication, eyeglasses, contacts, etc. Because the funds are contributed on a pre-tax basis, an FSA is attractive to most employees. It should be noted, however, that unspent funds at the end of the year revert to the employer.
- Health Care Reimbursement Account/Arrangement (HRA) under IRC Section 105 – These accounts are generally administered and funded by the employer to reimburse employees for medical expenses not covered by other forms of insurance. An employer will typically set aside a tax-deductible \$1,000-\$2,000 per year for each employee that can be used to defray the out-of-pocket expenses incurred by the employee. Some employers are opting to set up an HRA in conjunction with a switch to a “catastrophic” health insurance plan with high deductibles and co-pays. Effectively, basic health care such as routine doctor visits and prescription medication is provided through the HRA, with the catastrophic health insurance available to cover major medical procedures.

- Medical Savings Account (MSA) under IRC Section 106/220 - These accounts have limited applicability because no new contributions may be made to an MSA after 2003, except by or on behalf of individuals who previously made MSA contributions and employees who are employed by a participating employer. MSA's are currently available for small employers (i.e. 50 or fewer employees) and their employees, as well as self-employed individuals. Contributions to an MSA are deductible by the employer with an employer-sponsored plan or by the self-employed individual to arrive at adjusted gross income. MSA's are available to employees or self-employed individuals covered under a high-deductible health plan. MSA's are not available if the individual is covered under any other health plan (excluding dental, long-term care, vision care, disability, etc.).

As with most types of benefit plans, there are limitations on contributions and distributions, as well as qualifications for participation in each of the above plans. Additionally, the tax-exempt status of the above plans can be jeopardized if distributions are made for other than qualifying expenses. Therefore, when considering a plan, it is important to consult with your tax advisor and benefits specialist to ensure compliance and to evaluate the costs and benefits of adopting such a plan. We have qualified individuals that would be happy to assist with this analysis.

It is also important to remember that unreimbursed medical expenses in excess of 7.5% of adjusted gross income are deductible by individuals as an itemized deduction. This includes expenses incurred by spouses and dependents. Qualifying medical expenses for this purpose include amounts paid for the diagnosis, mitigation, treatment and prevention of disease as well as nursing services, insurance premiums for coverage of medical expenses, qualified long-term care services, dental expenses, eye glasses and contacts, hearing aids, prescription medication, and various other expenses. Again, we can assist with determining the deductibility of specific expenses incurred. Although the 7.5% base makes this deduction unavailable for many taxpayers, the increasing cost of health care may make the deduction feasible in future periods. Therefore, keeping records of these costs is advisable.

Protecting your wealth and the profitability of your business is our top priority. Planning for and controlling medical care costs continues to be an important aspect of financial security. We are here to help you determine the right course of action.

Very truly yours,

Angela Gatto