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"[T]he object of a Constitution is to restrain the government, as that of laws is to restrain individuals."

— John C. Calhoun, The Fort Hill Address

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Wealth Creation Strategies

Congress Makes the IRA Charitable Transfer "Permanent"

Congress frequently renews tax "breaks" for a year at a time, often in late December—for the year almost past. On occasion retroactive tax law has been passed in *January* for the preceding year. Your tax pros rely on vendors to accurately program software that takes into account such changes weeks before the Season begins. This always adds unnecessary challenges to tax preparation, not to mention planning.

Congress did its usual thing in December 2015, retroactively renewing a number of special deductions, credits and opportunities. However, in a welcome change to its *modus operandi*, it not only extended many of these breaks to future years, but made some "permanent."

Direct charitable donations from IRAs

The most positive permanent change is the IRA charitable transfer. This allows those age 70 ½ and up to make direct transfers from their IRA to a qualified charity, count the transfer as a Required Minimum Distribution (**RMD**, required by those with IRAs in that age group) and exclude the transfer entirely from taxable income. The tax savings for those engaging in this strategy vs. writing a check from one's personal non-IRA account can be substantial.

Comparison of charitable giving strategies: tax savings from a $5,000 charitable donation

Marginal tax bracket	Non-itemizer via checkbook	Non-itemizer via IRA charitable transfer	Itemizer via checkbook	Itemizer via IRA charitable transfer
15% bracket	Zero	$750	Up to $750	$750
27.75% † hidden bracket	Zero	$1,388	Up to $750 †	$1,388
25% bracket	Zero	$1,250	Up to $1,250	$1,250
46.25% ‡ hidden bracket	Zero	$2,315	Up to $1,250 ‡	$2,312

† A taxpayer in the nominal (advertised) 15% bracket is in a 27.75% hidden tax bracket as 85% of Social Security "benefits" are being phased in to the taxable base. For this individual, an itemized deduction saves up to 15% while a reduction in income saves 27.75%. "Up to," because until charitable donations lift total itemized deductions up and over the standard deduction, the donations don't save a dime.

‡ A taxpayer in the nominal (advertised) 25% bracket is in a 46.25% hidden tax bracket as 85% of Social Security "benefits" are being phased in to the taxable base. For this individual, an itemized deduction saves up to 25% while a reduction in income saves 46.25%.

In a rational world, taking an IRA withdrawal and donating the proceeds *or* directly transferring from the IRA would lead to identical tax savings. However, tax law isn't rational.* For those who don't itemize personal deductions on Schedule A, taking a withdrawal and *then* making the donation results in zero tax savings. In the example above, itemizers may save as much as 25% of the donation, but frequently less. Making donations directly from IRAs often saves 27.75% of the donation for those who might otherwise save zero or 15%, and as much as 46.25% (or even 55%) for those in the nominal 25% tax bracket. This is largely due to hidden, super-tax rates as Social Security "benefits" are added to the taxable base.

Extortion by another name

Once non-Social Security income plus 50% of Social Security benefits hit $25,000 for single and $32,000 for joint filers, every $1,000 increase in non-Social Security income forces $500 of Social Security benefits to be added to the taxable base, until 50% of the Social Security benefits are taxed. Because such benefit payments have grown

enormously since Social Security was first taxed in 1984 and the $25,000/ $32,000 figures were never adjusted for inflation (had they been, they'd be nearly $60,000/$77,000 today), recipients quickly pass into the next level of calculations, created by a 1993 law. Beginning in 1994, $850 of Social Security benefits were subjected to tax for every $1,000 increase in non-Social Security income when that other income plus 85% of Social Security benefits hit $34,000 for single and $44,000 for joint filers. This maxes out when 85% of Social Security benefits are added to the taxable base. These figures, too, have never been adjusted for the nearly 65% depreciation of the dollar's value since 1994.

If $850 of Social Security benefits are added to the taxable base for every $1,000 of additional non-Social Security income, you're really taxed on $1,850. Since 15% of $1,850 is $277.50, the *real* tax rate for those in the nominal (advertised) 15% tax bracket is ($277.50/$1,000 =) 27.75%. Because 85% of the Social Security isn't fully phased in to the taxable base for some joint and many single filers until they are well into the 25% "nominal" bracket, the tax rate can get much higher than advertised on a "chunk" of income (until 85% of Social Security benefits are taxed). Such hapless taxpayers pay 25% of $1,850 even though their real income increased by only $1,000. Since 25% of $1,850 is $462.50, the *real* tax rate on the additional $1,000 of income for these moderate-income taxpayers is ($462.25/$1,000 =) 46.25%. In addition, there may be hidden phase ins of an obscure "repayment" of favorable treatment of long-term capital gains and qualifying dividends, along with phase outs of certain itemized deductions (miscellaneous and medical) that can increase the *real* marginal tax rate to as high as 55%. While we occasionally see taxpayers stuck in these super-high tax brackets, there's not a lot that can be done—except for this IRA charitable transfer strategy. While the maximum allowable yearly direct charitable transfer from IRAs is $100,000 per person, this "direct donation" provision can turbo-charge tax savings for even small donations.

The phase in of Social Security benefits occurs at what are now very moderate income levels. The awful 27.75% hidden tax rate hits once non-Social Security income reaches $21,000 -$28,000 for most single Social Security recipients ($34,000-$38,000 for joint filers); many single recipients succumb to the confiscatory 46.25% rate on a "chunk" of income when non-Social Security income reaches $35,000 (rare for joint filers). Due to this phase in of Social Security benefits and the fact that many mature donors don't itemize deductions (or if they do, until charitable donations lift total deductions up and over the "standard" deduction they don't save a dime), direct IRA charitable transfers generally reduce the tax burden by *much* more than writing a personal check and taking a deduction.

Additional income over the "base amount" increases the amount of Social Security benefits on which you must pay tax

	Filing Status		Each additional $1 of income taxed as if you earned
	Single	Married Filing Joint	
50% base Social Security amount †	**$25,000**	**$34,000**	**$1.50**
85% base Social Security amount ‡	**$32,000**	**$44,000**	**$1.85**

† Once other income plus 50% of Social Security benefits exceed the figures in this row, for every $1 of additional non-Social Security income, 50 cents of Social Security benefits are added to the taxable base.

‡ Once other income plus 85% of Social Security benefits exceed the figures in this row, for every $1 of additional non-Social Security income, 85 cents of Social Security benefits are added to the taxable base.

Real life examples

Many clients are sucker punched at the 46.25% confiscatory rate on nearly $10,000 of RMD income every year.** While one client needs to live on some of what's left of the $10,000, she donates $5,000 to charity every year. In prior years when itemizing deductions, the most she saved was ($5,000 x .25 =) $1,250; in some years, she saved zero because the standard deduction was larger than her itemized deductions (the *larger* of the standard deduction or itemized deductions is taken). She now makes a $5,000 IRA charitable transfer, saving $2,312 (46.25% of the $5,000) in federal income tax yearly. Her RMD is $12,000; rather than taking that and then donating $5,000, she withdraws and pays tax on only $7,000, while she donates $5,000 directly from her IRA.

Another client is subject to the 46.25% hidden tax rate on $2,000 of income. He previously donated $1,000 yearly and reaped no tax benefit because he never itemized. Now, he can afford to give away the entire $2,000 because, after a ($2,000 x .4625 =) $925 tax savings, the net cost is only $1,075—barely more than he previously gave without any tax savings.

To give you a better idea of how this works, here's a 2015 comparison of a Social Security recipient who deposits his $4,000 RMD into his personal checking account (thereby turning IRA funds into non-IRA funds) and then writes a personal check for a $4,000 donation, vs. one who makes a $4,000 direct IRA charitable transfer in lieu of his RMD.

Comparison of a single non-itemizer donating from non-IRA funds vs. one donating directly from an IRA

	$4,000 donation made from non-IRA funds	$4,000 direct IRA charitable transfer	Decreased income subject to tax	Decreased federal tax with IRA charitable transfer
Non-SS & non-IRA Income	$35,000	$35,000		
IRA RMD subject to tax	$4,000	$0 †		
Taxable Social Security ($22,000 gross benefits)	$18,100	$14,700	($3,400)	
Adjusted Gross Income	$57,100	$49,700	($7,400)	
Less personal exemption and standard deduction (65 & up)	($11,850)	($11,850)		
Taxable Income	$45,250	$37,850	($7,400)	
Total Federal Income Tax	$7,113	$5,263		$1,850 ‡

† Donations made in lieu of the RMD are not subject to tax.

‡ Additional savings accrue to those living in states with an income tax. For example, this couple saves $204 in California state income tax at their 4% tax rate. However, for states that tax Social Security benefits (which should be a consideration, even if minor, in deciding where to retire and when to take distributions), state income tax can be substantially higher. For example, although Nebraska has a much lower maximum tax rate than California, it's a flatter one—this couple is in the 5.1% NE bracket—and Social Security benefits are added to the taxable base using the federal formula. A Nebraskan couple with similar income could save nearly $400 in state income tax by engaging in this strategy.

The $4,000 distribution resulted in the addition of $3,400 (85% of the $4,000) of Social Security to taxable income, increasing total taxable income by $7,400. Since this single person is in the nominal (advertised) 25% marginal tax bracket and taxable income is increased by the IRA distribution plus 85% of the IRA in the form of Social Security, the real tax rate is (25% + 85% of 25% =) 46.25%. As mentioned above, due to several other phase outs (miscellaneous itemized deductions, medical itemized deductions and a 5% hidden additional tax for those in the 25% nominal bracket with long-term capital gains or qualifying dividends), we've seen clients at this income level subjected to 55% real marginal tax rates. For those smacked at these rates who wish to make even small donations, direct donations from an IRA are a no-brainer.

Because Social Security benefits are usually fully phased in to the taxable base while still in the 15% nominal (advertised) bracket, moderate income joint filers will usually experience no more than a 27.75% savings for IRA charitable transfers.

Comparison of jointly filing non-itemizers donating from non-IRA funds vs. ones donating directly from an IRA

	$4,000 donation made from non-IRA funds	$4,000 direct IRA charitable transfer	Decreased income subject to tax	Decreased federal tax with IRA charitable transfer
Non-SS & IRA Income	$50,440	$50,440		
IRA RMD subject to tax	$4,000	$0 †		
Taxable Social Security ($35,000 gross benefits)	$29,750	$26,350	($3,400)	
Adjusted Gross Income	$84,190	$76,790	($7,400)	
Less personal exemptions and standard deduction (65 & up)	($23,100)	($23,100)		
Taxable Income	$61,090	$53,690	($7,400)	
Total Federal Income Tax	$8,239	$7,129		$1,110 ‡

† Donations made in lieu of the RMD are not subject to tax.

‡ This taxpayer also saves $160 if a California resident. A similarly situated Nebraskan could save nearly $370.

Savings for higher income earners
Higher income earners are subject to phase outs (the gradual or instantaneous decrease) of tax credits and deductions, as well as phase ins (the gradual or instantaneous increase) of various other taxes or tax equivalents, including the Medicare premium surcharge (income determines the Medicare premium surcharge two years later). Modest IRA charitable transfers can save substantial taxes. Several clients donate just enough from their IRAs to avoid a Medicare premium surcharge, which runs $600-$900 per person per tier. Additionally, some deductions, including medical and miscellaneous deductions, don't count until they hit a certain percentage of Adjusted Gross Income (AGI); as AGI decreases, more of these deductions "count." Itemized deductions and personal exemptions are also subject to phase-outs as AGI increases. IRA charitable transfers decrease AGI and can save thousands of dollars yearly for some clients subject to these phase ins and phase outs.

2018 Medicare premium costs and surcharges based on 2016 MAGI †

Tier #	Single Filer	Joint Filers	2018 Medicare Part B annual premium per person	Instant cliff-surcharge (hidden tax) per person	Increase in 2018 surcharge vs. estimated 2017 surcharge
1	$85,000 and below	$170,000 and below	$1,493		
2	$85,001 - $107,000	$170,001 - $214,000	$2,089	$596	$96
3	$107,001 - $133,500	$214,001 - $267,000	$2,984	$895	$236
4	$133,501 - $160,000	$267,001 - $320,000	$3,880	$896	$1,128
5	Above $160,000	Above $320,000	$4,775	$895	$1,266

† MAGI = Modified Adjusted Gross Income, which for this purpose includes so-called tax-free municipal interest income.

Stipulations for making IRA charitable transfers
Direct IRA charitable transfers of up to $100,000 per person annually can be made only by those age 70 ½ and older. While RMDs are required for those at and over this age, direct IRA charitable transfers can reduce or eliminate taxable RMDs. For those who need their RMDs (or more) to live, they can withdraw their RMD and also make a charitable transfer. But be careful: charitable transfers are not allowed from retirement accounts other than IRAs, SEPP-IRAs and SIMPLE-IRAs. However, most other retirement accounts, including 401ks and 403bs, can be rolled in to an IRA. To qualify as a direct IRA charitable transfer, the funds cannot be withdrawn and then donated; they must be transferred directly to the charity by the IRA custodian. Those with multiple IRAs can take all RMDs, including those considered made via charitable transfers, from any one IRA. Most bankers and brokers make the process easy; Scottrade, for example, requires easily-obtained online withdrawal and "make the check out to" forms for each donation. Ameriprise can provide an online form, which is otherwise manual. Neither charges, even for multiple small donations. We believe you must obtain an acknowledgement letter from the charity for each donation of $250 or more; this may require that you follow up. As of now, the year-end IRA distribution Forms 1099 don't indicate tax-free transfers, so you must track and let your favorite tax pros know how much was transferred directly to charities come tax time!

* Tax law isn't rational in part because government seeks to hide the level of real taxation, but also because it is often designed to "nudge" taxpayers into doing things they wouldn't normally do, incentivize taxpayers into doing things they might otherwise do less of and into not doing things they might otherwise do more of, or provide political favors to crony capitalists (like with wind energy credits). I can't quite figure how the IRA charitable transfer got tucked into the law, except as a favor to retiree-constituents and, perhaps, charities.

** The discussion that follows this under "real life examples" assumes the last "chunk" of income is taxed at this rate and that part of the income includes RMDs. Income that exceeds this hidden bracket is taxed at the lower 25% nominal rate and the strategy may not be quite as valuable.

Other Exciting Changes

American Opportunity Credit
The American Opportunity Credit (AOC) applies to the cost of tuition and classroom-required books, supplies and equipment for as many as four years of post-secondary education. It's a dollar-for-dollar credit of the first $2,000 of qualifying expenses, with a 25% credit on up to an additional $2,000 of such expenses. This creates a credit worth up to $2,500 per student per year for up to four years of post-secondary education for joint filers with incomes below $160,000 (phased out at $180,000, creating a hidden 37.5% marginal tax rate for those with one qualifying student and 50% for those with two such students; it pays to plan if in or near this phase-out range) and single filers below $80,000 (phased out at $90,000, creating a hidden 40% marginal tax rate for those with one qualifying student and 65% for those with two such students; it *really* pays to plan if in or near this phase-out range!). The credit has been made permanent, albeit unadjusted for currency depreciation (aka inflation).

The bad news is a 1098-T (T = Tuition) is now required to claim the credit and, because the IRS intends to match returns claiming the AOC with a 1098-T filed by the college or university, refunds on such returns could be delayed. Since the 1098-T reports only tuition, we don't think they'll try to match the dollar amount of the credit claimed. However, these forms are so poorly designed, who knows?* Worse, because new rules prohibit claiming a credit if a 1098-T isn't issued, if grants and scholarships paid all of the tuition and the school decides not to issue a 1098-T, you may not be able to claim a credit for other eligible costs. We'll see how this goes.

Even worse, the extraordinary complications such credits can create have not diminished. These involve the interplay of distributions from Section 529 "education savings plans" (which can pay for additional school-related expenses such as room and board), scholarships, grants and penalty-free distributions from IRAs. Several of our most sophisticated (and costly, but we always make sure we're well worth it!) returns have involved challenges involving maximizing the tax savings from this ridiculously complicated array of options.

Educator expense deduction made permanent; now includes "professional development"
K-12 teachers have been allowed a $250 adjustment to income (not requiring itemizing) for classroom tools and supplies for much of the past couple of decades. This has not only been made permanent, but has been expanded to include "professional development" costs (education to improve skills for qualifying teachers). While tiny, it's helpful for teachers who don't itemize deductions, or whose employee business expenses don't exceed 2% of Adjusted Gross Income (the level at which such "miscellaneous" itemized deductions begin to "count"). It's also now indexed for inflation. An obvious question is why don't other employees get this break? (In the ancient days—the 1970s—many employee business expenses were deductible whether you itemized or not!) Perhaps it's because teachers have a powerful lobby. But I digress.

Bonus depreciation
50% of the cost of new (not used!) business or rental property with a depreciable life of 15 years or less can be immediately expensed, with the balance depreciated over its normal IRS-approved useful life. This provision is scheduled to phase out after five years. While not as helpful as it was prior to the advent of the new repair vs. capitalization rules for rental property owners, it may nonetheless be helpful for some (especially those making "land" improvements, including driveways and landscaping projects, as well as restaurant improvements). While most states recognize the 50% bonus depreciation allowance, unsurprisingly California is not among them. For most small business owners, except for certain automobile purchases, it's nearly worthless due to the Section 179 expense allowance, described next.

Section 179 expense allowance
This now-permanent provision allows up to a total of $500,000 of the cost of most new or used business equipment, machinery and furnishings to be immediately expensed rather than depreciated over three, five, seven or more years. Unfortunately for many business owners, California only allows a $25,000 expense allowance. Additionally, the allowance is nearly worthless for vehicles with a "gross vehicle weight rating" (GVWR, which you will find on a label on the driver's side door jamb) of up to 6,000 pounds and limited to $25,000 multiplied by the percent of business use for vehicles with a GVWR of more than 6,000 pounds and for which more than 50% of miles driven each year are for business purposes. The $500,000 limit is now indexed for inflation.

Solar energy system credits
The 30% credit for the installation of a qualified solar energy system or qualified solar water heating system on one's main (or second/vacation) home, which was due to expire at the end of 2016, has been extended to the end of 2019. Under current law, the credit will decrease to 26% for 2020 installations and 22% for 2021 installations, after which it goes away. Solar energy equipment producers' and sellers' stock prices increased about 50% on the news (indicating this is really an indirect government subsidy to government-favored private businesses).

Sales tax in lieu of state income tax deduction
The option to deduct sales tax instead of state and local income taxes was made permanent. There is an profitable "bunching" strategy that some taxpayers in states with a state income tax can take advantage of; we'll likely cover this in a future *WCS*.

Miscellaneous new provisions
1. Passports can now be revoked for anyone who owes more than $50,000 in past-due taxes. It's not yet clear what may be considered

"past due," but I suspect Big Brother will eventually restrict overseas (and possibly internal) travel in cases less than egregious.

2. Congress has authorized the IRS to use private collection agencies to collect those past-due taxes. So much for the idea "the IRS never calls you." The next call you hang up on from a purported representative from the IRS trying to scam you out of your savings could be a representative collecting for the IRS if you truly owe them money—but bear in mind, they will never call without nearly countless love-letters and likely years elapsing from the time the tax was assessed.
3. The deduction for property mortgage insurance (PMI) for those with Adjusted Gross Incomes under $100,000, phased out quickly at $110,000, was extended only for 2016. Note the limit and phase-out applies for both single and married filers; this is yet another tax-related disincentive to marry (see issue # 52 of *Wealth Creation Strategies* for a plethora of marriage penalties).
4. The Social Security strategy in which the older spouse files and suspends, thereby allowing the younger spouse to collect one-half of the older spouse's Social Security at the younger spouse's "full retirement age," has come to an end. This strategy allowed both spouses to let their Social Security "annuity" grow to age 70. The controversial strategy (even many of those who sold the strategy via seminars and software believed it wasn't originally intended to work this way) was terminated by an equally controversial provision tucked into the new law in unceremonious fashion, unbeknownst to nearly everyone including, no doubt, the congresscritters who passed the law without reading it.
5. A special exclusion of taxable gain on forgiveness of certain debt secured by one's residence was extended for 2015 only. California has not extended this special exclusion.

* Both the 1098-T and the tax return form on which the credit is claimed, Form 8863, are among the more poorly designed IRS forms. The 1098-T inexplicably reports either the actual tuition paid during the tax year *or* the amount billed by the "institution of higher learning," even though only the tuition actually paid during the year can be used to calculate the credit. Form 8863 asks only for *total* amounts paid for tuition *and* classroom-required books, supplies and equipment. A better designed form would have a spot for tuition on one line on Form 8863, facilitating easy 1098-T matching, and all other allowed expenses would be reported on a separate line. They should have consulted me.

Health Savings Accounts and Extraordinary Tax Savings Opportunities

Health Savings Accounts (**HSA**s) offer outstanding tax benefits for medical spending. Contributions reduce taxes, while any withdrawals that can be associated with qualifying medical expenses are completely tax-free. The withdrawal rules make them much better than expected, as explained below. Earnings in the account are also tax-free. Those covered by a qualifying HSA-compatible high deductible health plan (**HDHP**) either on their own, through an employer or even through the "Marketplace" can open and enjoy the benefits of an HSA.

I introduced Health Savings Accounts in a comprehensive piece back in 2005, "Health Savings Accounts and You," issue # 20 of *Wealth Creation Strategies* (well worth re-reading on our website). In a subsequent *WCS* piece (issue # 31), I referred to HSAs as "an IRA and a Roth IRA wrapped into one," making them better than any retirement plan. Except for 401ks with matching employer contributions, eligible taxpayers with only enough cash for one type of plan should usually* first fund an HSA. If offered, they are much better than employer-based Flexible Spending Accounts (FSAs), which have "use-it or lose-it" provisions.

These fast-growing plans deserve to be far more widely used. Only 4% of employers offered HSAs when I wrote issue # 20 (likely taken to its fullest in Singapore**, which boasts medical spending at 4% of GDP compared to the U.S. at close to 20%, with a per capita income 50% higher than ours). Now, roughly 30% of employers offer HSAs, with 15 million people participating in employer-based plans (long including myself and my associate, Kristin Ericson, EA). As recently as 2008 only 6 million Americans had an HSA; now it's more than 20 million. It's time to re-examine HSAs and introduce unheralded tax savings opportunities that HSAs can provide and do our small part in helping to turn that 20 million into 330 million.

Basic rules: requirements and contribution limits

First, you need a qualifying HDHP. An HDHP is a lower premium, higher deductible health insurance plan with deductibles as low as $1,300 for individuals ($2,600 family). Once you have an HDHP, you can open a separate HSA savings account and make tax-deductible contributions up to an annual limit based on whether you have a self-only or a family plan; both are adjusted for inflation. For 2016 a single taxpayer can contribute and/or have contributed by an employer as much as $3,350 to an HSA, while a family can contribute or have contributed by an employer up to $6,750. Those aged 55 and up can make additional "catch-up" contributions of $1,000 yearly. The entire contribution is deductible against income to arrive at federal and most states' (but appallingly not California) Adjusted Gross Income (**AGI**), or isn't included in AGI to the extent of employer contributions. Even if a taxpayer has one family insurance plan covering both spouses and dependents, each spouse may contribute to his or her own HSA account. This allows, for example, one qualifying (55 and up) taxpayer to contribute as much as $7,750 to her account and the other qualifying spouse (55 and up) to contribute $1,000 or more to his account, for a total of up to $8,750. Allowable contributions are pro-rated for the

number of months you had both an HSA and qualifying compatible HDHP. There is no contribution phase out for those with higher incomes.

Medicare enrollees (generally, those age 65 and over) cannot make HSA contributions, but lower-aged spouses can. Contributions can be made at any time during the year by either you or your employer, and can be made by you for the prior year up to the initial due date of the tax return (April 15), just like with IRAs. This creates some wonderful tax planning and finessing opportunities.

The "real" tax savings is often greater than you think

HSA contributions, whether made by a taxpayer or employer, reduce AGI. Because of the nearly countless hidden tax brackets and complexity built into the tax code, a reduction in AGI can reduce taxes by far more than the "advertised" marginal tax rate. For a taxpayer with real estate losses and whose income is in the range of $100,000 to $150,000 of Modified AGI ("modified" by the fact that, for this purpose only, Social Security benefits are subtracted from AGI but do not include tax-free muni interest income) in which allowed real estate losses are phased out, HSA contributions can result in "real" tax savings that may be 50% higher than the nominal advertised rate of 25-28%. For taxpayers in the tuition credit phase-out AGI range of $80,000 to $90,000 ($160,000 to $180,000 for married filers), the real tax savings can be a stunning 37.5%. HSA contributions can boost deductions by $2,000 in an instant (for a possible $500 additional tax savings, in addition to a likely 25%-of-HSA contribution savings) for taxpayers who hit the tuition deduction AGI threshold points of $65,000 or $80,000 ($130,000 or $160,000 for joint filers). Retirees under age 65 who are already collecting Social Security and whose Social Security is at least partly taxed may save 27.75% of any HSA contribution.

Where to go for an HSA

Accounts can be set up with many banks, credit unions and brokerage firms (including Vanguard through HealthSavings Administrators and T.D. Ameritrade through HSA Bank). If your employer offers a qualifying HDHP, you can use their HSA bank or your own. You own the HSA account, including any part an employer contributes for you; account balances carry forward from year to year and accumulate until used, even long after retirement. You can switch banks if you change employers. If you no longer have an HDHP, withdrawals from the HSA are tax-free so long as you spend the funds on qualifying medical expenses. All HSA accounts include checks and/or debit cards, which you can use to pay most medical expenses directly.

Eligible medical costs

The funds in an HSA can be used (tax-free!) to pay for *any* qualifying medical expense during your lifetime for you and your dependents. "Qualifying medical expense" includes most anything you think of as relating to mind or body except for non-prescribed over-the-counter drugs, vitamins, supplements and optional plastic surgery. Qualifying expenses include not only the "normal" stuff you'd think of such as doctor's visits, hospital stays, prescription drugs and lab tests, but also dentistry, optometry, ophthalmology, chiropractic, acupuncture, doctor-prescribed medical supplies, many over-the-counter medical supplies (like band aids and contact lens solution), psychiatry, psychology and even Christian Science practitioners.

Surprising qualifying medical expenses

Weight loss program for a doctor-diagnosed disease (like obesity)	**Alcoholism and other-drug addiction treatment**	**Smoking cessation programs**
Crutches	**Prescription exercise equipment**	**Guide dog & related costs like food & vet**
Contact lenses, solution, supplies, glasses, LASIK surgery	**Prescribed air conditioning required for breathing**	**Oxygen and related equipment**
Home improvements † for prescribed health reasons (includes pool, whirlpool, ramps)	**Prescribed reclining chair**	**Handicap equipment and telephone/TV for impairments**
Hearing aids, repairs & batteries	**Special school or home costs for the physically or mentally impaired**	**Tuition for a dependent child with a learning disability**

† For built-in improvements, to the extent these don't increase the value of the home.

Surprising qualifying OTC medical expenses

Birth control (should be OTC soon)	**OTC braces & supports for limbs, back, etc.**	**First aid supplies including band aids**
Prescribed OTC allergy & sinus medications and nasal sprays	**Prescribed OTC acid controller, indigestion & stomach remedies**	**Prescribed OTC sleep aids, eye drops, laxatives, pain relief & motion sickness remedies**

Surprisingly, certain health premiums are eligible for payment by or reimbursement from HSAs: COBRA continuation coverage, insurance costs while receiving unemployment insurance, the employee's share of employer-sponsored health insurance and certain long-term care insurance costs (subject to IRS mandated limits). Under current law, you can use accumulated funds to pay for medical expenses and most retiree insurance costs (including Medicare parts B and D and Medicare Advantage plans, but not supplement policies like Medigap). Most importantly, you can either pay directly from the HSA, or reimburse yourself for such expenses *any time after you personally pay the expense*, so long as the expense was never deducted on a tax return. This opens the floodgates to fun and interesting strategies for both low and high income taxpayers.

Fun tax strategies

Low income taxpayers who "can't afford" an HSA but who have a qualifying HDHP should *open* one as soon as eligible, even with only $50. Why? Because they can reimburse themselves at any time after paying for qualifying medical costs incurred after opening the HSA and take a deduction for the reimbursed contribution! Say, for example, Bill had out-of-pocket qualifying medical costs of $2,000 since setting up an HSA early in the year (remember: the later in the year he sets it up, the lower the allowable contribution). Bill can, by April 15 of the following year, contribute $2,000 to the HSA, withdraw it the next day to pay himself back and deduct $2,000 for the contribution (so long as the contribution was allowable). Depending on tax bracket and eligibility for Retirement Contribution Credits the tax savings can be as large as 50% of the contribution.

High-income taxpayers can fund an HSA and let it accumulate, paying all medical costs with non-HSA funds. It can be left to grow and used to pay for medical expenses in retirement when income may be lower. Further, these expenses can be reimbursed tax-free years or even decades later if qualifying medical expense records are saved and you can show such expenses were never reimbursed by insurance or deducted on a tax return. Ron Roberson, CPA***, gave an example in a recent individual income tax update: Cathy, who has maxed out HSA contributions since 2010, wants to withdraw $15,000 from her IRA for a vacation. The tax will be $5,100, leaving only $9,900 for the vacation. However, with proof (i.e., receipts) of non-reimbursed and non-deducted qualifying medical costs of at least $15,000 since opening her HSA in 2010, she can take the $15,000 from her HSA completely tax free.

Don't leave anything behind

Upon death, remaining account balances can be rolled over to a surviving spouse, who continues to use the HSA as the original HSA owner used it. However, once a single survivor dies, any remaining funds are included in the gross income of the beneficiary or the estate of the HSA owner, which converts income that should be tax-free to taxable income. Therefore, from a long-term tax- and death-planning perspective, HSAs should *always* be spent or reimbursed on qualifying medical expenses before death occurs (consider this and Roth conversions for death-bed planning). Since uninsured and non-deducted medical costs incurred any time after an HSA is opened can be reimbursed years or even decades later, appropriate records of qualifying medical expenses are a new category of deductions for which records should in some cases be kept indefinitely.

There is every reason to maximize contributions to HSAs. Contributions are tax deductible and employer contributions are tax free on federal and most state income tax returns. There is no federal tax on earnings. (States that don't allow deductible contributions tax the earnings—which includes, annoyingly, California). All qualifying medical expenses are tax free when paid or reimbursed from the HSA, up to moment of death. HSAs are one of the great no-brainers of tax planning.

* "Usually," because to the extent low-income savers' retirement credits can be triggered with IRA and/or Roth IRA contributions, exceptions should be made.

** For a terrific article on the Singaporean system, which combines a free market approach with a bit of heavy-handed coercion to force participation—but which the libertarian in me finds an agreeable compromise compared with the absurdly poor government-controlled top-down third-party payer statist system we've had since before the introduction of Medicare, see http://www.freedomworks.org/content/fixing-us-health-care-system-look-singapore.

*** Ron Roberson, CPA deserves credit for the inspiration in writing this article even if I'd long been thinking about it. After trying to read the thoroughly incomprehensible IRS publication on the subject a decade ago, I began looking for a class devoted to deciphering and dissecting HSAs. I still find no such classes offered among my "usual" potpourri of continuing education providers, but Ron devoted a half hour out of a recent four-hour individual income tax update in which he discussed these tax planning ideas.

HSA Annual contribution maximums †

Tax year	HDHP coverage type	Annual contribution limit	Catch-up contribution limit age 55 & up (per person)	Maximum contribution limit age 55 & up
2015	Self-Only	$3,350	$1,000	$4,350
	Family	$6,650	$1,000	$8,650
2016-2017	Self-Only	$3,350	$1,000	$4,350
	Family	$6,750	$1,000	$8,750

† Subject to annual cost of living adjustments, if any.