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The 65-Day Rule may provide for tax savings

For most individual taxpayers, the tax year ends on Dec 31st. The 65-day Rule, a friendly term for the IRC 663(b) election, allows the distributions from a trust to its beneficiaries within the first 65 days of the year to be treated as prior-year distributions. In other words, for the 65 days into 2023, which ends March 6th, distributions from a trust may be attributed to the 2022 tax year.

The benefit of the 65-day Rule is that it allows the trustee more time to optimize the trusts and beneficiaries' tax liability. Typically, it's wise to distribute income from a trust to a beneficiary for tax purposes. The trust may deduct the distributed income on its tax return, and the beneficiaries treat the distributions as income. The trust's effective tax rate is likely higher than the beneficiaries. Trust and estates tax brackets are condensed, with anything above $13,400 in income being taxed at the highest marginal rate, 37%. Comparatively, for married couples that file jointly, income above $648,000 is where the 37% rate begins to apply.

If you are the beneficiary of a trust, it's important to coordinate with the trustee, your CPA, and potentially the trust's CPA, to help optimize the tax liability.

Health Savings Accounts and Healthcare costs

Most Health Savings Accounts (HSAs) are not optimally invested. There are 32 million HSA accounts with over $100 billion in assets, and only $34 billion of it has been invested. Most HSAs are idling in cash and are likely losing valuable healthcare purchasing power. HSAs offer triple-tax benefits: the contributions are tax-deductible, the growth is tax-deferred, and withdrawals used to pay for qualified healthcare expenses are tax-free. HSAs are like a 529 college savings plan for healthcare.

The amount one can contribute to an HSA is relatively modest compared to other tax-deferred saving vehicles such as 401(k) plans. However, one may have an HSA in addition to other qualified plans such as a 401(k). The annual HSA contribution limit is $3,650 for individuals, $7,500 for families, and a $1,000 catch-up provision for those over 55. One requirement is that the account owner is enrolled in a high-deductible health plan that typically has lower premiums than more comprehensive plans.

A beneficial strategy is to contribute to the HSA, invest the funds, and avoid withdrawing from the account to help maximize growth potential. The HSA owner should fund current medical needs with post-tax savings and cash flow and keep all receipts in a safe place. If needed, owners may withdraw funds from the HSA in the future to reimburse past medical expenses.

How does the HSA help with healthcare inflation? Contributing $7,500 today will allow the taxpayer to deduct this amount from their taxable income. Assuming the $7,500 is invested and compounds at an average of 8% annually, the initial contribution will grow to approximately $75,000 after 30 years. Historically, healthcare costs have risen by 5.5% a year, and a $7,500 procedure today may cost $37,000 in 30 years. The $75,000 in the HSA will more than cover the cost of the procedure.

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The HSA is especially beneficial for families with non-dependent children under the age of 26 who can fund an HSAs using the family maximum contribution limit. Also, HSAs may be a good option for young adults, potentially your children, who have a long-time horizon and are likely to remain healthy for some time.

Please reach out to your Wealth Manager to explore whether the HSA is available to you and benefits your wealth plan.

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