New Health Insurance Tax Break

by Gregory L. White, CPA and Fred Green, Registered Health Underwriter (RHU)

Commonly referred to as HSAs, Health Savings Accounts first became available in 2004, and for many fishermen, the new program offers both tax savings and more affordable health insurance.

Self-employed workers have for many years been able to deduct their health insurance costs. However, in practice, their out-of-pocket medical expenses did not usually provide a tax benefit; this is where HSAs provide a significant tax advantage.

How it Works

In a nutshell, an HSA has two components:

High-Deductible Health Plan In order to utilize an HSA, you must first purchase a qualified high-deductible health insurance plan. Because of the high deductible, these plans feature much lower premiums yet offer excellent coverage in the event of significant medical claims. Obviously, those who are relatively healthy are going to benefit the most from these plans, while those who regularly incur significant medical expenses may opt for a different package.

Added Bonus for Those Who Don't Currently Have Insurance If you don't have health insurance now, you are likely to be charged much more for medical services than people who do. But once you obtain insurance, healthcare providers are normally required to give you the discounted rates negotiated by the insurance carriers. Due to contracting, most doctors and hospitals must write off a portion of their bills.

Caution You should consult with a health insurance professional on such issues as pre-existing medical conditions.

Important Note Not every high-deductible health plan qualifies as an HSA compatible product. Certain criteria must be met in order to be considered an HSA qualified plan.

Health Savings Account The other component is the HSA account. The HSA is very similar to an IRA. That is, you make tax-deductible contributions; funds accumulate tax deferred and can be invested in a variety of options. However, unlike an IRA, HSA funds can be withdrawn tax-free and penalty-free at any time to pay for qualified medical expenses (refer to IRS publication 502 for what qualifies as a medical expense). Unused funds may accumulate from year to year.

Caution If you make withdrawals from the HSA before you are 65, and the withdrawals are not to pay medical expenses or to reimburse yourself for medical expenses you have already paid, you will be subject to a 10-percent penalty tax, and must also include the withdrawn amounts as income.

How to Get Started

Apply For A Qualifying High-deductible Plan A health insurance broker can help you pick the right plan.

Then Open a Health Savings Custodial or Trust Account This account is similar to an IRA account. However, like the insurance, certain criteria must be met in order to be considered an HSA qualified account. The accounts are rarely with the same company you purchase your insurance from.

Usually the funds are initially deposited into an interest-bearing bank account. However, they can be invested in stocks, bonds, and mutual funds. Most people keep a portion of their funds in fixed accounts to cover their deductible and co-insurance expenses.

Tax Benefits

Tax Deduction Deposits made to the account are 100-percent tax deductible whether or not you itemize your taxes. The maximum contribution in 2005 to an HSA for a family of two or more is $5,200 or the deductible, whichever is less. Therefore, a family with a $5,000 deductible could make a $5,000 contribution. An additional catch-up provision of $600 in 2005 applies for those over 55 years old.

Earnings Accumulate Tax Deferred That is, unlike your regular bank account, you do not have to report income that is earned on the account.

Tax-Free Withdrawals Unlike an IRA or 401(k), funds withdrawn from the account to pay for qualified medical expenses are withdrawn tax free for qualified medical expenses.

Cover Medical Expenses When You Retire If you are age 65 or older, the amount withdrawn from your HSA for non-medical purposes is treated as retirement income and is subject to normal income tax, but is not subject to the 10-percent penalty. Other qualified medical expenses from an HSA include out-of-pocket expenditures while enrolled in Medicare, including Medicare premiums, deductibles, coinsurance and co-pays but not Medigap premiums. Additionally, funds can be withdrawn to pay qualified long-term care insurance premiums subject to IRS limits.

Conclusion

See your tax professional and consult an insurance broker to make sure that HSAs are right for you.

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