

February 2004

Health Savings Accounts

We're writing to tell you about an important change to the tax rules that could significantly lower your out-of-pocket costs for health care. Even if you've already heard some news about the new health savings accounts (HSAs) enacted by Congress and signed into law by President Bush last December, we want to fill you in on some more of the details that now have become available.

Starting this year, eligible individuals can use HSAs to cut their federal income tax bills. Better yet, HSAs are available to high-earners and low-earners alike. There are no phase-out rules to rob more prosperous individuals of the tax-saving benefits.

Basic Rules

HSAs operate somewhat like the flexible spending accounts (FSAs) that some employers currently offer to their employees who want to defer part of their own money into an account on a pretax basis to be used later to reimburse themselves for out-of-pocket medical expenses. These funds may then be withdrawn tax-free to reimburse the account beneficiary for out-of-pocket medical expenses. Unlike an FSA, however, whatever's left in the HSA at year-end can be carried over to the next year. In addition, HSAs can be set up by the self-employed or even a nonworking spouse.

Naturally, since we're talking about the tax law, there are a few catches with the new HSAs. The most significant requirement is that HSAs are only available to individuals who only carry health insurance coverage with relatively high annual deductibles. By that, we mean their health insurance coverage must come with at least a \$1,000 deductible for single coverage or \$2,000 for family coverage. However, for many self-employed individuals, small business owners, and employees of smaller companies, these thresholds won't be a problem. In addition, it's okay if the insurance plan doesn't impose any deductible for preventive care (such as annual checkups).

The other requirements for setting up an HSA are that an individual can't be eligible for Medicare benefits or claimed as a dependent on another person's tax return. For individuals who can meet these requirements, they can make tax deductible HSA contributions for 2004 that are limited to the lesser of:

1. their insurance plan's deductible amount (which must be \$1,000 or more for self-only coverage or \$2,000 or more for family coverage), or
2. \$2,600 for single coverage or \$5,150 for family coverage.

For 2005 and beyond, all the above figures will be adjusted for inflation.

An account beneficiary, who is 55 or older by the end of the tax year for which the HSA contribution is made, is allowed to make a larger deductible contribution. Specifically, the annual contribution limit that would otherwise apply is increased by \$500 for 2004 and \$600 for 2005.

When an employee, self-employed, or even unemployed person sets up the HSA, the deduction for contributions to the account is claimed in arriving at adjusted gross income (the number at the bottom of page one on your return). Thus, eligible individuals can benefit whether they itemize or not. Unfortunately, however, the deduction doesn't reduce a self-employed person's self-employment tax bill.

When an employer contributes to an employee's HSA, which will most likely be rare except in the case of a closely held business, the contributions are exempt from federal income, Social Security, Medicare, and FUTA taxes. One potential trap with employer contributions is that employer may face a 35% excise tax if comparable contributions are not made for all employees who have comparable coverage during the same period. For this purpose, a *comparable contribution* means the same amount or the same percentage of the health insurance deductible. The comparability rule is applied separately to part-time employees who customarily work fewer than 30 hours per week.

Section 125 cafeteria (cash or benefit) plans are allowed to offer salary-reduction HSA contributions for eligible employees as part of the menu of plan choices. Thus, employers can sponsor the HSAs, but require employees to use their own (pretax) money to fund them.

Setting up an HSA

An HSA can be set up at a bank, insurance company, or any other outfit the IRS deems suitable (such as a brokerage firm). The HSA must be established exclusively for the purpose of paying the account beneficiary's qualified medical expenses. These include uninsured medical costs incurred for the account beneficiary, spouse, and dependents. However, for HSA purposes, health insurance premiums don't count as qualified medical costs - neither do higher deductibles and higher out-of-pocket maximums for out-of-network benefits.

The tax rules for HSAs are quite similar to IRAs. For example, individuals can make HSA contributions for a particular tax year as late as April 15th of the following year. In addition, federal-income-tax-free rollovers from one HSA into another are permitted (limited to one such rollover per 12-month period).

Conclusion

HSAs seem like a match made in heaven for those individuals currently paying health care costs out of their own pocket using after-tax dollars. Provided these individuals have (or are willing to change to) health insurance coverage that qualifies as a high-deductible policy, there really doesn't seem to be a downside to setting up an HSA because any unexpended amounts at year-end will carryover to later years. Setting up an HSA should allow such an individual to pay their medical expenses with pretax dollars. For example, for someone in the 28% tax bracket, this is like getting a 28% discount on their medical expenses since Uncle Sam will pick up the rest of the costs in tax savings.

For individuals who own their business and are covered by health insurance through their company, having their company fund their HSAs can make sense. (However,

remember, this isn't always true because of the nondiscrimination rules discussed earlier that require you to cover other similarly situated employees.)

This is just a quick overview of the HSA rules. If you'd like to know more about whether HSAs are right for you, please feel free to call us.

Very Truly Yours,

Krebs & Co., CPA's, Inc.
dba **Krebs Advisory Group**