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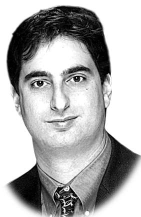
Deductible health care expenses: Your Treasure Island?



Expert Opinion

JEFFREY KATZ

Shiver me timbers. The continual rises in health care costs are high enough to set a pirate's ship to sea.

Ways to deal with those costs are the subject of an ongoing debate. While many people wait to see how everything shakes out, the government already subsidizes some lucky taxpayers' medical costs.

If you are not cashing in on these benefits, you may be taking a long walk down a very short plank or facing shipwreck.

GETTING ON BOARD

Ahoy, matey. There is no reason to feel like you have been set alone and adrift into open seas without an oar. Tax benefits are available to self-employed individuals and wage-earning employees alike.

Effective with tax year 2003, self-employed people can deduct 100 percent of their health insurance costs. The tax savings can reduce the after-tax cost of health coverage and prevent finances from running aground.

Most taxpayers can deduct health insurance premiums as itemized medical costs, but only to the extent that total medical expenses exceed 7.5 percent of adjusted gross income (AGI). For taxpayers subject to the alternative minimum tax (AMT), total medical expenses must exceed 10 percent of AGI.

Devious taxpayers in the past have "bunched" their health care expenses by deferring or accelerating certain procedures, such as elective surgeries, glasses or orthodontics from one year to the next or by paying any unpaid medical or dental bills in a specific year – qualifying the total medical expense for the deduction but still losing a portion of the deductibility.

The self-employed can fully deduct the premiums and other medical expenses as "nonitemized" deductions, reducing AGI, without resorting to bunching. By picking the health insurance and other medical expenses up as above-the-line (front of the tax return) adjustments to income, taxpayers can surf the income limitations otherwise imposed by the AGI rules.

A CHANGING TIDE?

Employee sickness and accident insurance benefits are generally taxable to the employee if the employer pays the benefits or the benefits are attributable to employer-provided coverage under an accident or health plan not includable in the employee's income.

However, these benefits are excludable from income if they are for medical expense reimbursements or payments for loss of limbs or disfigurement (think Captain Hook).

The employer-provided coverage itself is excludable from an employee's income. For these exclusions from income to apply, accident and health plans must be set up "for employees" and not "for owners."

Benefits paid to highly compensated employees under a self-insured medical reimbursement plan are includable in income if the plan is discriminatory. Where owners are also employees, paid as employees and allow other employees to participate, these reimbursements may be excludable from income.

These self-funded, self-insured plans, also known as Section 125 plans, do not require third-party administrators. The plan documents are relatively straightforward and, once set up, require little if any maintenance – thereby reducing the chance of audit and crashing on the bluffs (with the Internal Revenue Service).

CHARTING A COURSE FOR WAGE EARNERS

Employer contributions to medical savings accounts (Archer MSAs) may also be excludable from an employee's income.

Archer MSAs, introduced by the Health Reform Act of 1996 and available to the public since 1997, offer a tax-favorable way for qualifying individuals to set aside funds – or have their employer do so – to meet future medical needs.

Contributions to an Archer MSA are generally deductible when made. The fund's earnings and the distribution are not taxed when used to cover qualified medical expenses. Distributions for other purposes are taxed and subject to a 15 percent penalty unless made after age 65, death or disability.

WHICH MATES ARE ELIGIBLE?

To qualify for an Archer MSA, you must be covered only by a "high deductible health plan." (Separate coverage through insurance or otherwise for accidents, disability, dental, vision or long-term care is also OK.)

For 2003, a high deductible health plan is one with an annual deductible of at least $1,700 and not more than $2,500 for self-only coverage or at least $3,350 and not more than $5,050 for family coverage.

Deductions are limited on deposits made to the MSA, which max out at 75 percent of the total deductible limit, and the deduction cannot exceed your gross compensation.

The plans must be established and maintained by your employer (or spouse's employer) who qualifies as a "small employer" (50 workers or less). There are also limitations on the number of plans that may be established.

To qualify, act quickly because plan enrollment may be capped after this year.

Reaching this sunken treasure requires a good compass and a qualified first mate (tax adviser) to plan the course. Plan your voyage wisely and you may find riches waiting in your mailbox.

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