Health Savings Accounts – A New Take on Health Care Benefits

President Bush, in his recent convention speech, plugged Health Savings Accounts (HSAs) as a way to help small businesses afford health care benefits for their employees.

Health Savings Account? What is it?

In December of 2003, Congress passed a law called the Medicare Modernization Act. Slipped in was a section on Health Savings Accounts (HSA) – an idea designed to help individuals save for medical expenses on a tax-free basis.

Briefly, an HSA is money put into a special account to pay for current and future medical expenses. The account is owned by the individual. The money can come from any combination of employer or employee contributions. Money going into HSAs is tax-deductible; it grows tax-deferred, and money removed for qualified medical expenses is tax-free. At the end of the year, any money not spent remains in the account for use in the future.

To begin, an individual must enroll in a high deductible health insurance plan. The minimum deductible is $1000 for an individual or $2000 for family coverage. In addition the plan has a cap on the maximum out of pocket expenses of $5000 for an individual and $10000 for a family.

The high deductible pays off.

Once they have a high deductible health insurance (HDHI) plan, the individual opens a Health Savings Account. He or she can contribute the LESSER of the insurance deductible or a maximum allowable contribution to the account. (In 2004, this amount is $2600 for individuals or $5150 for families - and could increase from year to year with inflation). (NOTE: The figures for 2005 have been released. In 2005, the max allowable contribution $1000 for an individual and $2620 for families. The cap on out-of-pocket expenses has been increased to $5115 and $10250 respectively). The contributions are totally tax deductible. You do not have to make the maximum contribution – a portion will do if that's all you can afford. The money in the account can then be used to pay for medical expenses not covered by the insurance.

So, instead of paying really high premiums for health insurance that has a small deductible for doctors' office visits or prescription drugs, the situation would be reversed. The HDHI premiums are smaller and you pay the high deductible and co pays from the money you placed in the Health Savings Account. In the long run, you should be paying less for health care costs in total.

So how is the government helping me give my employees health coverage?

An employer contribution to the HSA is deductible by the employer. It's also not taxable to the employee as income – a great fringe benefit. Contributions can even be made in a cafeteria plan.

Insurance companies won't always work with small businesses. They say our company is too small for a group insurance plan.

You don't need to be in a group. You can assist each employee in your company to open their own Individual Health Savings Account. Your company can still make contributions – fully deductible to your company, and not taxable to your employee. If you contribute as an employer, then contributions must be comparable for all participating employees, either the same amount for all OR the same percentage of annual deductible. Part timers can be treated separately.

What about self-employed ?

Self –employed persons can get a high deductible insurance health insurance plan and open an individual HSA.

How does it work for an individual?

One advantage is that the contributions to the accounts are an “above the line” deduction for the individual.

What does above the line really mean?

That means the amount put into the account reduces your taxable income. Without the HSA, you must itemize deductions on your return to take any medical deductions. In addition, the itemized deductions have to be more than 7 ½% of your gross income to get any credit at all. On an income of $30000/ year, using itemized deductions, you would have to have medical expenses of $2250 to take any deduction. HSA money is deductible from the first dollar, even if you don’t itemize.

The money in the HSA account can be put into any investment that is approved for IRAs, including bank accounts, annuities, stocks, mutual funds, bonds and real estate. Unused dollars are not lost, they remain in the account and are available for future needs. The HSA is also portable. It belongs to the individual, is under their control, and travels with them if they change jobs.

This is beginning to sound like an IRA.

The HSA is very much like an IRA. The Health Savings Account gives you (or your employees) a tax free way to save for health care just like you currently save for retirement or your children’s’ education. At the same time, by law, there is a cap on out-of-pocket expenses in the HDHI plans. There is a limit on how much you would have to pay – a catastrophic event would not cause a disaster.

And here’s some of the fine print:

An individual who wishes to open a HSA has to buy a HDHI plan, can’t be covered by other health insurance (except disability, long term care, vision or dental insurance) , can’t be enrolled in Medicare, and can’t be claimed as a dependent by someone else.

What happens when you need the money from the account?

Money taken from the HSA, also called “distributions” is completely tax free if taken for “qualified medical expenses”. What’s qualified? Any expenses that would be tax-deductible according to the IRS. Permitted expenses include surgery, prescriptions, eyeglasses, etc. Recent rulings have included over-the-counter drugs. The full list can be found in Publication 502 on the IRS's Web site www.irs.gov <http://www.irs.gov>.

The money can also be used for COBRA continuation or other health plan coverage in case of unemployment. For anyone on Medicare it can be used to pay Medicare premiums. You can also use the money to pay for long-term care insurance.

The account holder (not the employer or insurance company) decides when to take a distribution.. Remember, though, that the IRS ultimately decides what are qualified medical expenses, so ALWAYS keep receipts to prove the expenses. If money is taken out and not used for medical expenses, then the amount becomes part of taxable income AND an 10% additional tax (penalty) is assessed. There is an exception. After age 65, the individual can use the funds tax-free for Medicare premiums and co-pays, or withdraw it for non-medical reasons and pay only income taxes.

Some examples of how the HSA saves money.
The John Doe family of Oklahoma is a family of four with a traditional health plan that has a $500 deductible and a 20% copay each time they need medical care. Also, each doctor’s office visit costs $25. This coverage costs $648.50 per month, a total of $7,782 per year for the insurance – and this is a total out-of-pocket cost if they NEVER need the doctor throughout the year. If they need any medical care, they will also pay $500 before the insurance kicks in (the deductible) plus the $25 for each visit and 20% for a copay. They could easily run way over $8000 total medical expenses with very little illness in the family at all.

The Doe family decides to try an HSA. They find a high deductible plan with a $2000 deductible (the minimum required for a family HSA). This plan has no copay and no charge for doctor’s visits after the $2000 deductible is met. The premium for this plan is $429.05 per month, $5148.60 per year. They put $2,000, an amount equal to the deductible, into an HSA account. Their out of pocket expenses are now $7148.60 for the year. In addition, since the $2000 they put into their Health account is tax deductible, they have saved $460 in taxes. If they have no health needs this year, they $633 in health care costs. If you add the $640 in tax savings, they are more than $1200 ahead of the game. The best part is that they still have access to the HSA contribution for future needs. When you pay traditional insurance premiums, you “use it or lose it” - the money is simply gone if you do not get sick.

Example 2 with a higher deductible
The Doe family finds a plan with a $3000 deductible. Here they pay a 20% copay after the deductible is met. The premium on this plan is $238.44/month or $2,861.28 per year. They put $3,000 in their HSA. Their total outlay is now $5861.28 for health care costs. Their tax saving is $690. Their total savings over their old traditional plan is more than $2,600. If the Doe family has any medical problems this year, they can pay the out-of-pocket amounts from their HSA money. If not, the money remains in the account.

A family that does not use all the money put in their HSA from year to year can ultimately lower their costs even more. As the amount in their HSA account gets larger (through investment, earnings and continued contributions) they can afford to choose medical plans with higher deductibles – they have a cushion. The over all health care expenditures as a percentage of their income may decrease over time.

What are the advantages of the HSA?
It encourage savings for future medical expenses, the accounts are completely portable, no use it or lose it, it can grow just like an IRA and high deductible health insurance premiums should be less costly than the premiums of traditional health insurance plans.

Are there possible disadvantages? Critics worry that relatively healthy and wealthy people will leave traditional health plans making those more expensive for those who remain in the plans.

Investment of these accounts could also be a problem: The money can grow tax-free if you don't need it all for medical expenses. But it's also possible that investments don't do well and the account loses money. You could end up with a high deductible and not enough money in the fund to cover out-of-pocket expenses.

For more information.

The high-deductible health plans that are required by HSAs are available through your traditional insurers – more are offering them every day.

A list of trustees for Health Savings Accounts is at www.hsainsider.com , which is managed by the HSA Coalition, a Washington nonprofit organization.

The HSA concept is a new one and the rules covering them are changing frequently. Six technical corrections have been released by the IRS in just 9 months – each one making changes to the rules. President Bush has also made a proposal to make high deductible insurance premiums deductible. They are not now, but this could change in the future. Be sure to consult with your tax professional before making any moves. Updates to this article and links to IRS changes can be found on our website at www.taxvisions.com