

Health Savings Accounts: A Financially Healthy Alternative

Let's Talk Tax

By Brett Hersh, EA, MBA

Regardless of the side one takes in the health care debate, all differences center on the best way to meet a common, three-point challenge: How to: 1) reduce the cost of health care, while 2) maintaining the healthcare quality, and, 3) simultaneously increasing the number of Americans who have access to healthcare. Although it has had little share of the public debate, congress has already created a health insurance “arrangement” designed specifically to meet these challenges. This arrangement provides insurance that is significantly less expensive, places downward pressure on health care costs, incentivizes savings and healthy behavior, and offers a generous tax deduction to those who participate. It is also portable between employers and can even double as a tax-deferred retirement account. The arrangement I am referring to is called a Health Savings Account (HSA). In today's column, I will discuss the basics of HSAs and highlight a health-insurance alternative that could benefit you, your family, or your employees.

At its essence, an HSA is a tax-deferred savings account coupled to a high-deductible health plan (HDHP). The HSA is used to pay for medical expenses not covered by the insurance policy's deductible, while the high-deductible health plan acts as a catastrophic safety net. Qualified contributions made by the owner to the HSA are tax deductible to the owner. Contributions made by the HSA owner's employer are not included in the employee's income. Money withdrawn from the HSA is tax free if used to pay for qualified medical expenses.

To qualify for an HSA, its owner must be covered by an HDHP. For 2010, a health plan will qualify as an HDHP if it has a minimum annual deductible of \$1,200 for an individual, “self only” plan, and a maximum annual out-of-pocket expense of \$5,950. For families, a health plan will qualify as a HDHP if it has a minimum annual deductible of at least \$2,400 and a maximum out of pocket of \$11,900. The plan can still qualify as an HDHP if it offers preventative care benefits, such as annual physicals, prenatal care, and immunizations, even if these benefits have no deductible or a lower deductible than those listed above.

The Health Savings Account associated with the HDHP is used to pay for qualified medical expenses that occur before reaching the annual out-of-pocket limit. HSA distributions used for qualified medical expenses are tax free. Qualified medical expenses include most items that qualify as itemized medical deductions on schedule A. HSA funds used to purchase non-prescription, over-the-counter medications (not deductible on schedule A) also qualify as tax-free distributions. HSA distributions used for anything other than qualified medical expenses are counted as income and are subject to an additional 10% penalty. If you become disabled or are at least 65 years old, non-medical distributions will be subject to income tax, but not the 10% penalty. Funds remaining in the HSA at the end of the year are carried forward to the following year and are not taxable until removed.

Contributions to the HSA are, up to limits discussed below, tax deductible if made by the HSA owner. HSA contributions made by someone other than the owner (except for the owner's employer) are still deductible by the owner. The owner's deduction for HSA contributions is calculated using Form 8889 and is reported as an adjustment to income on the front of form 1040. The owner does not need to itemize in order to take this deduction. Contributions made by the HSA owner's employer are not counted as income to the owner. Employers deduct qualified contributions to employees' HSAs as an “employee benefit.”

Contribution limits are adjusted annually and apply to total contributions made by the HSA owner, the owner's employer, and those made by others on the owner's behalf. For 2010, taxpayers with a self-only high deductible health plan (HDHP) can contribute \$3,050 (for 2009 this limit was \$3,000). Taxpayers with a family HDHP can contribute \$6,150 in 2010 (\$5,950 for 2009). Annual contributions over this amount are subject to a 6% excise tax each year until the excess funds are withdrawn.

In this article, I have only had time to discuss the bare-bone basics of HSAs. I was not able to elaborate on factors that may impact your particular situation. Is an HSA right for you, your family, or your employees? Be sure to consult with your insurance agent and tax professional before making a decision.

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