Cannon Insights
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Planning Ideas—Health Savings Plans

Health insurance can be one of a family's larger monthly expenses. This is especially true for self-employed individuals and early retirees. The self-employed often face difficulty in acquiring insurance at group rates and must purchase more expensive individual coverage instead. Early retirees don't qualify for Medicare until age 65, and with fewer employers offering post-retirement health insurance, they can be forced to purchase individual coverage. Even employees that participate in an employer's group plan are being asked to bear an increasingly larger share of the health insurance burden.

An attractive alternative to traditional health insurance, especially for affluent and high net worth (HNW) clients, is the Health Savings Account (HSA). Health Savings Accounts came into existence as a result of the enactment of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003.

In general, the idea is that an individual purchases a health insurance plan with a high deductible. A deductible is the amount that must be paid before insurance coverage begins. This should result in a less expensive insurance policy because the insured, not the insurer, is at risk for routine healthcare up to the deductible amount. An HSA allows the insured to save for the uninsured medical costs in a tax-efficient manner, lowering the overall outlay.

Eligible Individuals

The first step in determining whether an HSA is appropriate for your client is to determine whether he or she is an **eligible individual.** An eligible individual for participation in an HSA is defined as an individual that:

- Is covered under a high-deductible health plan on the first day of any month for which the individual wishes to make a contribution;
- Is not covered by any other health plan (with certain exceptions for plans providing certain limited types of coverage);
- Is not enrolled in Medicare (generally, has not yet reached age 65); and
- May not be claimed as a dependent on another person's tax return.

This definition is broad enough to include most clients interested in an HSA, provided they are covered under a **high-deductible health plan.**

High-Deductible Health Plan

Generally, a high-deductible health plan (HDHP) is a health plan that satisfies certain requirements with respect to deductibles and out-of-pocket expenses.

Specifically, for single coverage, a HDHP has an annual deductible of at least $1,200 and annual out-of-pocket expenses (deductibles, co-payments and other amounts, but not premiums) not exceeding $5,950 (2011). For family coverage, a high-deductible insurance plan has an annual deductible of at least $2,400 and annual out-of-pocket expenses not exceeding $11,900 (2011). These amounts are indexed for inflation.

Contributions to HSAs

Any eligible individual may contribute to an HSA. Where the HSA is established and sponsored by an employer, the employee, the employer or both may contribute to the HSA. Family members may also make contributions to an HSA on behalf of another family member as long as that other family member is an eligible individual.

The maximum contribution to an HSA in 2011 is $3,500 for individuals or $6,150 for families. The entire annual amount can be paid from December through April 15th of the following year.

In addition to the maximum contribution amount, **catch-up contributions** are allowed for individuals age 55 and older who are not enrolled in Medicare. For 2010 the catch-up contribution was $1,000.

Deductibility of Contributions

Contributions to HSAs are deductible in determining adjusted gross income (above the line deductions).

Employer contributions to the employee's HSA are treated as employer-provided coverage for medical expenses and are excludable from the employee's gross income.

Distributions

In general, distributions from an HSA may be received at any time and made for any purpose. However, the purpose for which the distributions are made and their timing determines how they are taxed. Distributions for purposes other than the following are included in income and may be subject to a 10 percent penalty tax:

- Distributions to reimburse for Qualified Medical Expenses;
- Distributions at ages 65 and older; and
- Distributions after the account holder's death.

Qualified medical expenses—These are expenses paid by the account beneficiary, or his or her spouse or dependents, for medical care as defined in the Internal Revenue Code, but only to the extent the expenses are not covered by insurance or otherwise.

Generally, health insurance premiums are not qualified medical expenses except for the following:

- Qualified long-term care insurance;
- COBRA health care continuation coverage; and
- Health care coverage while an individual is receiving unemployment compensation.

Jane, age 70, participated in an HSA for several years prior to retiring. Jane would like to tap $300 of these funds to help pay for her Medicare Part B premiums this year. Result: The $300 is not includible in Jane's income because these funds are being used for a program that is considered a qualified medical expense.

Qualified long term care insurance premiums may be reimbursed from HSA accounts up to what is known as "age-based eligible amounts." These are amounts specified by the IRS for certain age ranges. Although the age-based eligible amount is usually less than the actual LTC premium, the benefit of a tax-free reimbursement for such amounts is significant.

Distributions from HSAs to reimburse for qualified medical expenses are income tax free.

Distributions ages 65 and Older—In general, HSA distributions to individuals age 65 and older to reimburse for medical expenses such as Medicare can also be paid from an HSA tax free.

On the other hand, distributions to pay for non-medical expenses (including premiums for Medigap policies) are included in the individual's income. However, such distributions are not subject to the 10 percent penalty tax.

Distributions following Death—The taxation of distributions following the death of the account owner varies depending on whether the beneficiary is the surviving spouse or not.

Upon an employee's death, any balance remaining in the HSA becomes the property of the HSA beneficiary of the account. If the surviving spouse is the named beneficiary, the HSA becomes his or her HSA. The surviving spouse can use the funds in the inherited HSA property for his or her own medical expenses tax free. Funds withdrawn for non-medical purposes are included in income and may or may not be subject to a penalty fee depending on the spouse's age. If the spouse is under age 65 the 10 percent penalty will apply. If over age 65, no penalty will apply even if the funds are used for non-medical purposes.

If the HSA passes to a person other than the surviving spouse, the HSA ceases to be an HSA and the beneficiary is required to include the value of the HSA assets in income. For beneficiaries other than the decedent's estate, the includable amount is reduced by any payments from the HSA made for the decedent's qualified medical expenses, if paid within one year after death.

Becky, age 57, inherits an HSA at her husband's death. The account contains $11,000. Rebecca withdraws $600 to cover personal medical tests. Result: The $600 is not included in Rebecca's income.

HSAs and Retirement Planning

HSAs offer several benefits to retirees:

- Distributions from HSAs are tax free to the extent they are used to reimburse for qualified medical expenses. This means that retirees can use amounts accumulated in HSAs to help them pay for Medicare copays, deductibles and coinsurance. In addition, reimbursements can be used to pay for items such as preventive care, vision and dental treatment, and long-term care insurance premiums that are not covered by Medicare.
- Early retirees can use tax-free distributions from HSAs to pay for COBRA and reimburse out-of-pocket expenses not reimbursed by COBRA coverage.
- Retirees who find that they do not need the amounts in their HSAs to meet medical costs can use the accumulated amounts for any purpose. In general, however, amounts not used to reimburse for medical expenses will be included in income. Distributions for non-medical purposes received after age 65 are includible in income, but are not subject to the 10 percent penalty tax.

Bottom Line

This is the time of year when health insurers notify insureds of upcoming premium increases. Add value to your client relationship by offering to discuss health insurance options including HSAs.

Planning Ideas and similar topics are covered in great detail in many of Cannon's professional development solutions. To find out more visit: www.cannonfinancial.com.

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