



## Health savings can be tax shelter

By Thomas A. Fogarty, USA TODAY

A potentially lucrative tax shelter becomes available to the masses next month, courtesy of the Medicare act Congress just passed.

In IRA-like fashion, investors soon can build tax-sheltered nest eggs to cover out-of-pocket medical costs. Called a Health Savings Account, the new investment vehicle permits a taxpayer, starting in 2004, to shelter up to \$4,500 annually.

But there's a catch. The new accounts are linked to high-deductible health insurance plans. The accounts are designed in part to help consumers pay for health expenses until insurance benefits kick in.

Just how popular the new accounts will become remains unclear. But their cost-saving features and likely promotion by big employers could make them huge. (**Related chart:** [Health costs and the income tax](#))

### Uses for accounts

The new Health Savings Accounts provide a broad range of tax-free withdrawals including:

- Doctors, dentists and hospitals
- Artificial limbs
- Drugs
- Eyeglasses and contacts
- Chiropractic
- Laboratory expenses
- Nursing home costs
- Physical therapy
- Psychoanalysis
- X-rays
- Nursing home insurance premiums

"They have the potential to become the dominant kind of health care financing in the next five to 10 years," says Greg Scandlen, a health care expert at the Galen Institute, a Washington think tank.

But they aren't for everyone, says Scandlen, an advocate of the new accounts. Families with young children probably will benefit more from traditional managed-care options such as preferred provider organizations. And, he says, HSAs demand more planning than many people are willing to give.

But the new accounts could become the preferred route for families with few health care spending needs, as well as those who spend \$4,000 or more a year, he says.

The self-employed and others who buy individual health policies can plunge in as early as next month. Workers insured through employers could see them during their next open enrollment period, when they're allowed to adjust workplace benefits.

Insurers Golden Rule of Lawrenceville, Ill., and Fortis Health of Milwaukee, plan to begin selling HSAs on the first business day of 2004. Others say they need time. "We're not poised to jump in, but we're assessing the legislation," says Mutual of Omaha spokesman Jim Nolan.

How the new accounts work:

### The health care angle

High-deductible health insurance policies are now the rage. By leaving more costs for a patient to cover out-of-pocket, rapidly rising insurance premiums will moderate, the theory goes.

President Bush and Republicans in Congress favor investment accounts to help more Americans cover expenses until a high-deductible policy kicks in. As defined in the new Medicare legislation, which Bush is expected to sign, a high-deductible policy is \$1,000 for individual coverage, \$2,000 for a family.

The accounts have the potential to accumulate huge balances over years of contributions and investment

gains. In theory, that puts consumers in a better position to pay for their own health care as they grow old, when costs typically peak. The new law imposes two requirements for opening an HSA:

- It must be done in conjunction with high-deductible health coverage.
- A taxpayer must be under 65 — the age of Medicare eligibility — when opening an account.

### **The tax angle**

Few Americans — particularly among the young — are likely to max out annual contributions just so they can pay drug and nursing home bills in old age. But the tax incentives are powerful for those who do, or for anyone who wants to build a modest account to cover routine health expenses.

The accounts will join about a half dozen other major provisions in the federal law that provide a tax advantage for health care spending. But nothing now in the law combines the broad eligibility and generous tax benefits of HSAs. "This is far and above superior to all the other ones that are out there," says Jay Nawrocki, legislative analyst at tax publisher CCH.

Contributions, investment growth and withdrawals for health-related expenses are all free from taxation. That makes tax benefits superior even to IRAs. With IRAs, the money is taxed either before it goes into the investment account, or as it is taken out. Of course, money from an IRA, when taken after age 59½, can be spent without restriction.

Health savings accounts carry generous annual contribution limits. The law allows an annual tax write-off equal to the deductible amount of the accompanying health care plan. But the tax write-off can't exceed \$2,250 for an individual plan, \$4,500 for a family plan. Limits bump higher in years ahead.

For taxpayers 55 and older, the new law permits an additional \$500 contribution in 2004. And, like IRAs, contributions may be made for the previous year through April 15.

CCH's Nawrocki says health-savings accounts are likely to diminish the popularity of flexible-spending accounts.

Flex-spending accounts permit workers to make pretax contributions by payroll deduction to meet health care costs.

But they have two big drawbacks: Money in the accounts earns no interest; and unspent funds must be forfeited at the end of each year.

Flex accounts won't be rendered obsolete, though, because they allow pretax purchase of routine health care items not now covered by HSAs.

In general, tax-free expenditures for HSAs mimic those the IRS now allows as deductions to taxpayers who have been smacked by unusually high medical bills.

An HSA holder who uses the money for a non-health expenditure pays tax on it, plus a 10% penalty. After age 65, a withdrawal used for a non-health purpose will be taxed, but not penalized.

### **The investment angle**

The new law imposes few restrictions on how money might be invested. Health insurers will be first out of the box to offer the new accounts, but banks, brokerages and mutual fund companies are free to jump in, says Scandlen of the Galen Institute.

HSAs now have a first cousin in tax law, Archer Medical Savings Accounts. In seven years of existence, Archer MSAs haven't gotten much use, partly because of strict eligibility requirements. HSAs replace them.

Brian McManus, vice president at Golden Rule, says the company's first HSA will direct all investment money to an interest-bearing savings account. Fortis Health Vice President Scott Krienke says his company will offer HSA investors a choice of a savings account or an array of mutual funds.

As with IRAs, Scandlen says, HSA investors are allowed to hold multiple accounts, but they'll be subject to a single annual contribution limit.

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## Health costs and the income tax

A new tax shelter, the Health Savings Account, will be available in 2004 for people with high-deductible health plans. The law defines high deductible as at least \$1,000 for an individual plan, \$2,000 for a family plan. How the tax law treats health care costs:

	Health Savings Accounts	Health reimbursement	Flex accounts	Medical-dental expense tax deduction
<b>Who qualifies?</b>	All taxpayers under age 65 covered by a high-deductible health plan.	Workers whose employers provide it.	Workers whose employers provide it.	Taxpayers who itemize.
<b>Purpose</b>	Promote use of high-deductible insurance plans by sheltering income used to pay health care costs.	Employer-funded program to reimburse workers for out-of-pocket costs of a high-deductible health plan. May cover part or all of plan's deductibles.	Worker-funded accounts used to pay out-of-pocket medical and dental costs, including over-the-counter drugs.	Limits tax liability for those with high medical expenses relative to their income.
<b>Tax benefits</b>	Tax-free contributions and withdrawals when used for health expenses. Non-health withdrawals after age 65 are taxed but not penalized.	Plan costs are tax deductions for employer. Reimbursement to worker is not treated as income.	Contributions, which are made from payroll withholding, are exempt from income tax.	Income tax deduction for insurance premiums and out-of-pocket medical and dental costs.
<b>Comments</b>	Annual contribution limits: Maximum of \$2,250 to meet an individual health plan's deductible; \$4,500 for family plan. Replaces Archer MSAs. Effective Jan. 1.	Employer may keep the money when a worker quits or retires.	Worker forfeits unspent money at the end of each year. No interest paid on account balances.	Only qualifying expenses in excess of 7.5% of adjusted gross income may be deducted.

Sources: IRS, CCH, HealthcareShopper.com

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