Leveraging Tax-Favored Health Plans

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With all the changes that have taken place over the years, it is now much harder to take advantage of a tax deduction for medical expenses on your federal income tax return. First of all, in general, you must itemize your deductions, and these must be over 10% of your Adjusted Gross Income (AGI) to benefit from the medical deduction. With the recent increase in the standard deduction in the Tax Cuts and Jobs Act of 2017, which also raised the percentage-of-AGI limit from 7.5% to 10%, fewer taxpayers will itemize.

Fortunately, tax deductions for medical expenses aren't the only ways to maximize tax benefits related to healthcare costs. This paper provides a brief overview of several important options, including:

- Medical Savings Accounts (MSAs)
- Health Savings Accounts (HSAs)
- High-Deductible Health Plans (HDHPs)
- Health Flexible Spending Arrangements (FSAs)
- Health Reimbursement Arrangements (HRAs)

Medical Savings Accounts (MSAs)

The Archer MSA program was discontinued on December 31, 2007, and thus Archer MSAs may no longer be established. While Archer MSAs have largely been replaced by HSAs, eligible individuals can still be covered by existing Archer MSA accounts.

Archer MSAs were created to help the self-employed and certain small employers (with 50 or fewer employees) with medical care costs by establishing savings accounts in conjunction with high-deductible health insurance policies. Today, HSAs offer the same benefits as an MSA to a larger group of people. But if you still have an existing MSA, you can continue to make deductible contributions and use distributions for qualified health expenses without incurring a tax or penalty. You can also roll over an Archer MSA to an HSA, which could be beneficial if you are looking for better investment options for the funds and the ability to contribute more.

A Medicare Advantage MSA is an Archer MSA designated by Medicare to be used solely to pay the qualified medical expense of an account holder who is enrolled in Medicare. Therefore, if you are over age 65 and healthy, you may want to review this Medicare plan that includes a tax-favored savings account.

Just like a regular Archer MSA, a Medicare Advantage MSA is provided in conjunction with a high-deductible health insurance policy, meaning you have to pay for medical costs out-of-pocket until you meet your policy deductible. Not all out-of-pocket costs will count toward your deductible: These must be expenses that are related to Medicare Part A (hospital insurance) and Part B (medical insurance that covers services such as doctor office visits, preventive services, etc.)

With a Medicare Advantage MSA, Medicare makes the annual deposit into the account each year. The amount going into the account is determined by the insurance company using an actuarial calculation. The contributions are not included in your income, and distributions from a Medicare Advantage MSA that are used to pay for qualified medical expenses aren't taxed. Any unused amounts roll over into the following year.

These plans are administered through the federal Medicare program. According to the Kaiser Family Foundation, of about 19 million enrollees in Medicare Advantage, only 5,000 are in programs that use an MSA. You can get more information at Medicare.gov.

Health Savings Accounts (HSAs)

Health Savings Accounts (HSAs) were introduced in 2003 to replace the Archer MSAs. HSAs were designed to be supplemental and allowed individuals to manage future healthcare costs with pre-tax dollars today. Each spouse who is an eligible individual must open a separate HSA: You cannot have a joint HSA.

As these are currently structured, you could build a future tax-advantaged account to supplement retirement income. The idea would be to fully fund an HSA to the maximum each year, take the full tax deduction annually, invest the assets, and then pay for pre-retirement qualified medical expenses out-of-pocket. The goal is to achieve the largest HSA possible during retirement. At retirement, you have a tax-free source to pay qualified medical expenses.

To be eligible to open and contribute to an HSA, you must:

- Be covered under a high-deductible health plan (minimum deductible and out-of-pocket maximum).
- Participate in no other health plan.

You are disqualified from having an HSA if you:

- Have a Health Reimbursement Account (HRA) or FSA (unless it is a limited-purpose HRA or FSA).
- Participate in Medicare (Instead, consider the Archer MSA discussed previously.).
- May be claimed as a dependent on someone else's tax return (regardless of whether the dependent is actually claimed).

There are other HSA advantages, including the following:

- Account contributions reduce federal income-tax adjusted gross income and are allowed for both standard and itemized deductions.
- Like an IRA, funding can be made anytime between the beginning of the calendar year and before the tax-filing deadline for that year.
- HSAs are portable and can be transferred to any HSA custodian.
- There are investment options that may include interest-earning savings, checking, and money market accounts, or investments such as stocks, bonds, and mutual funds that offer the potential to earn higher returns but carry more risk (including the risk of loss of principal). Make sure that you carefully consider the investment objectives, risks, charges, and expenses associated with each option before investing.
- It is not a "use it or lose it" account. Funds roll over from year to year.

You can use your HSA funds for many types of healthcare expenses. Although you can't use funds to pay regular health insurance premiums, you can withdraw money to pay for specialized types of insurance such as long-term care insurance. IRS Publication 502 contains a list of allowable expenses.

HSAs offer triple tax advantages that include:

- Pre-tax contributions
- Tax-deferred growth
- Tax-free withdrawals for qualified medical expenses

Qualified healthcare expenses include:

- Prescription drugs
- Eyeglasses
- Deductibles
- Co-payments

Expenditures that are not qualified expenses:

- Over-the-counter drugs or cosmetic surgery
- Health insurance premiums *unless* premiums are for:
  - Long-term care
  - COBRA
  - Healthcare coverage while receiving unemployment compensation
  - Medicare and other healthcare coverage if you are 65 or older
  - Dental (including orthodontics) and vision

There is no rule against using your HSA funds for expenses that aren't healthcare related but be careful: You'll pay a 20% penalty if you withdraw money and use it for nonqualified expenses, and you'll owe income taxes as well. Once you reach age 65, however, the penalty no longer applies, though you'll owe income taxes on any money you withdraw that isn't used for qualified medical expenses.

Maximum annual contributions for 2019

(All sources, whether made by you, your employer, or your family members.)

Single	Family
$3,500	$7,000

(Age 55 or older – $1,000 Catch Up)

High-Deductible Health Plans (HDHPs)

An HDHP is catastrophic health coverage that pays benefits only after you've satisfied a high annual deductible. Some preventative care such as routine physicals may be covered without being subject to the deductible. Once you've satisfied your deductible, the HDHP will provide comprehensive coverage for your medical expenses, though you may continue to owe co-payments or coinsurance costs until you reach your plan's annual out-of-pocket limit. You must be enrolled in an HDHP, either on your own or through your employer.

A qualifying HDHP must limit annual out-of-pocket expenses including the deductible. Once this limit is reached, the HDHP will cover 100% of your costs as outlined in your policy. Because you're shouldering a greater portion of your healthcare costs, you'll usually pay a much lower premium for an HDHP than for traditional health insurance, allowing you to contribute the premium dollars you're saving to your HSA. Your employer may also contribute to your HSA or pay part of your HDHP premium. When you need medical care, you can then withdraw HSA funds to cover your expenses or opt to pay your costs out-of-pocket if you want to save your account funds.

It's all about weighing your current exposure to medical expenses when you are evaluating an HDHP versus another employer health plan.

HDHP Limits for 2019		
	Self-only Coverage	Family Coverage
Minimum annual deductible*	$1,350	$2,700
Maximum annual out-of-pocket expenses (including the deductible)**	$6,750	$13,500

* However, your deductible may be higher, depending on the plan.

**This limit doesn't apply to deductible and expenses for out-of-network services if the plan uses a network of providers. Instead, only deductibles and out-of-pocket expenses for services within the network should be used to determine if the limit applies.

Healthcare Flexible Spending Accounts (FSAs)

Whereas Health Savings Accounts are "savings" accounts, Flexible Spending Accounts are "spending" accounts.

Allowed by your employer as a stand-alone plan or as part of a more comprehensive cafeteria plan, an FSA allows you to pay for certain qualifying expenses with pretax dollars. With an FSA, you contribute pre-tax earnings to the plan, usually through salary reduction, and submit qualifying expenses to the plan for reimbursement. Qualifying expenses can include medical expenses.

How does an FSA work?		
1.	**You make an FSA election.**	You elect to contribute a specified amount to the FSA plan each plan year. This election generally must be made before the start of each plan year and is irrevocable. Therefore, you must estimate qualifying expenses for the coming plan year. Participation in an FSA is voluntary: You do not have to contribute to the FSA. *While contribution elections are irrevocable, a plan may allow participants to change contribution amounts in specific situations. For example, a plan may permit a participant to change a contribution election during the plan year if the participant gets married or divorced or has a child.*
2.	**You submit qualifying healthcare expenses for reimbursement.**	The FSA reimburses you for qualifying medical and dental expenses that are properly submitted. Only expenses that are incurred during the plan's period of coverage will be reimbursed. The period of coverage generally means the plan year (while this is often a calendar year, it does not have to be). However, the terms of a plan may allow the period of coverage to provide a grace period of up to 2½ months after the end of the plan year. FSA plans that allow an extra 2½ months effectively have a 14-month and 15-day coverage period. *Plans may also allow an additional period of time to submit expenses for reimbursement after the close of the coverage period. For example, an FSA that operates on a calendar year might provide for reimbursement of expenses incurred through March 15 (2½ months after the end of the plan year) but might allow you to submit those expenses through April 15.*
3.	**Unused funds are forfeited ("use it or lose it").**	Any funds remaining in your FSA after all qualifying expenses for the coverage period have been paid are generally forfeited. This is commonly known as the "use it or lose it" rule. However, in late 2013, the IRS issued Notice 2013-71, which modified the Section 125 "use it or lose it" rule for healthcare FSAs to allow these plans to permit up to $500 of unused amounts to be carried over to the following plan year. In this case, the grace period is not available. If you have an FSA, make sure to check to see if your plan allows for the carryover provision.

Qualifying medical expenses under a healthcare FSA

Expenses that can be reimbursed by a healthcare FSA include the annual deductibles for a healthcare plan as well as any qualified medical and dental expenses that your health plan does not cover.

For 2019, the FSA annual contribution limit is $2,700. Note that employers may impose their own lower limits.

Health Reimbursement Arrangements (HRAs)

A health reimbursement arrangement (HRA) is an employer-sponsored healthcare option that allows you to pay for medical costs using a pool of employer-provided funds. An HRA will reimburse you for qualified medical expenses incurred up to a maximum amount per coverage period. You must submit receipts or other documentation in order to be reimbursed for qualified healthcare expenses.

HRA advantages:

- HRAs are funded solely by employers. An HRA cannot be funded by a salary-reduction election either directly or indirectly through a cafeteria plan.
- HRAs can be used to pay for health insurance premiums (e.g., major medical plans), as well as services typically not covered by health plans (e.g., eyeglasses or alternative medicines).
- HRA reimbursements are generally excludable from the employee's gross income, provided the reimbursements are for qualified medical expenses as defined by the tax code.
- HRAs can allow participants to carry over any unused amounts into the next year.
- HRAs may continue to reimburse former or retired employees for medical expenses.

How are HRAs different from HSAs?

Health savings accounts (HSAs) allow employees to save tax-deductible money for routine medical care. Because they share many of the same features and benefits, HRAs and HSAs may be easily confused, but they differ in many respects. Here are some of the significant differences between them:

- HSAs must be established in conjunction with high-deductible health plans; no such requirement applies to HRAs.
- HSAs may be established by individuals and employers; HRAs may only be established by employers.
- HSAs allow both individual and employer contributions; HRAs are funded solely by employer contributions.
- HSAs are owned by individuals and are portable; HRAs are owned by employers and are not portable.
- HSA funds can be invested and earn interest; HRA funds cannot.

How are HRAs different from FSAs?

Although HRAs and FSAs share certain attributes, they are significantly different. FSAs require you to make pre-tax contributions to an account, while HRAs prohibit this: Only employers can make contributions to an HRA.

Another important difference is that an HRA allows you to carry over unused funds from year to year. It is not a "use or lose it" arrangement.

For healthcare expenses covered under both a health FSA and an HRA, HRA funds must be exhausted before reimbursements can be made from the FSA unless the HRA plan document specifies that coverage under the HRA is available only after expenses exceeding the dollar amount of the FSA have been paid.

Impact of healthcare reform

Healthcare reform legislation passed in 2010 included a change in the definition of "qualified medical expenses" that impacted reimbursements and withdrawals under all types of tax-advantaged healthcare accounts (i.e., FSAs, HRAs, HSAs, and Archer MSAs). As of 2011, expenses incurred for over-the-counter (OTC) medications are no longer eligible for reimbursement from FSAs and HRAs or count as qualified expenses for purposes of HSAs and Archer MSAs. However, OTC medicines prescribed by a physician and insulin are still considered qualifying expenses.

The following table provides a summary of the various tax-advantaged health plans:

Comparison of various tax-advantaged health plans				
	Archer Medical Savings Accounts (MSAs)	Health Savings Accounts (HSAs)	Healthcare Flexible Spending Accounts (FSAs)	Health Reimbursement Arrangements (HRAs)
Who can contribute?	Eligible individual and employer, but not both. For a Medicare Advantage MSA, only Medicare can contribute.	Eligible individual or any other person, including an employer or a family member, on behalf of an eligible individual.	Eligible individual or employer.	Eligible employer only.
Must be combined with an HDHP?	Yes	Yes	No	No
Dollar limits (2019)	Two limits: 1. Annual deductible limit – 75% of annual deductible for a HDHP (65% if you have a self-only plan). 2. Income limit – not more than what you earned from the employer with the HDHP.	Maximum annual contributions for 2019 (All sources, whether made by you, your employer, or your family members.): Single – $3,500 Family – $7,000 (Age 55 or older – $1,000 Catch Up)	Salary reduction contributions can't be more than $2,700 for 2019 (or any lower amount set by the plan).	There is no limit on the amount the employer can contribute.
Other advantages	• Tax deduction for contributions even if you don't itemize deductions. • Interest or other earnings grow tax-free. • Distributions used for qualified medical expenses are tax-free. • Portable when you change employers; you may not make additional contributions unless you are otherwise eligible. • Contributions can be made up until April 15 of the following year. • Not a "use it or lose it" account.	• Distributions used for qualified medical expenses are tax-free. • Portable when you change employers. • Investment options are available. • Contributions can be made up until April 15 of the following year. • Not a "use it or lose it" account.	• Contributions made by employer can be excluded from gross income. • No employment or federal income taxes are deducted from the contributions. • Reimbursements may be tax-free if you pay qualified medical expenses.	• Contributions made by employer can be excluded from gross income. • No employment or federal income taxes on the amounts the employer contributes. • Reimbursements may be tax-free if you pay qualified medical expenses. • Not a "use it or lose it" account.

Comparison of various tax-advantaged health plans				
	Archer Medical Savings Accounts (MSAs)	Health Savings Accounts (HSAs)	Healthcare Flexible Spending Accounts (FSAs)	Health Reimbursement Arrangements (HRAs)
Other considerations	• Contributions must be made in cash. • Amounts withdrawn and not used for qualified medical expenses may be subject to an additional 20% penalty tax. • Amounts from a Medicare MSA used for non-qualified expenses will be taxed as part of your income and subject to an additional 20% tax penalty. • Must file and report on Form 8853 with your individual income tax return. • Be aware of deemed taxable distributions for certain prohibited transactions.	• Contributions must be made in cash. • After retirement, you cannot make contributions to an HSA. • You can contribute to both an HSA and a limited-purpose FSA or HRA. • You can contribute to both an HSA and a post-deductible health FSA or HRA. • You can make a qualified HSA funding distribution from a traditional IRA or Roth IRA (Cannot be made from an ongoing SEP IRA or SIMPLE IRA). Limited to one lifetime qualified HSA funding distribution. • Prior to age 65, amount withdrawn and not used for qualified medical expenses may be subject to an additional 20% penalty tax. • Must file and report on Form 8889 with your individual income tax return. • Be aware of deemed taxable distributions for certain prohibited transactions.	• No reporting requirements on your individual income tax return. • You must designate how much you want to contribute at the beginning of each plan year. • FSAs are generally "use-it-or-lose-it" plans. A plan may allow either a grace period of 2 ½ months after the end of the plan year or some plans may allow up to $500 to be carried over to the following plan year.	• No reporting requirements on your individual income tax return. • Not portable. Stays with employer.

Conclusion

With health care costs increasing every year, saving money on healthcare costs has become paramount. Any use of pre-tax dollars that have the potential to grow and be withdrawn tax-free for federal and state tax purposes if used for qualified medical expenses is a win-win. Any assistance that an employer can offer can help too. For example, employer contributions to a health savings account or to a health reimbursement arrangement can provide significant assistance with healthcare expenses.

Make sure you know what options are available to you to help save and pay for healthcare-related costs.

For more information on leveraging tax-favored health plans, please consult your Key Private Bank Advisor.

About the Author

As a senior financial planner with Key Private Bank, Tina offers her clients sophisticated financial planning advice and a comprehensive set of strategies to grow and preserve their wealth. She collaborates with her team's Relationship and Portfolio Managers, coordinates strategies with attorneys and accountants and follows up on a regular basis to ensure the plan is performing optimally. Tina received the 2016 Exceptional Service Award from the Cleveland Estate Planning Council and 2016 and 2018 Circle of Excellence Award by Key Private Bank.