



Leimberg's Think About It

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Taxation of Health Insurance: The Key Points You Need to Know

Every financial services professional needs to have a working knowledge of at least the key facts and essential rules of the taxation of health insurance and related expenses.

This **THINK ABOUT IT** is based on a recent release of the Congressional Research Service, which provides information and objective analysis to Congress, and on my book, **TOOLS AND TECHNIQUES OF EMPLOYEE BENEFITS AND RETIREMENT PLANNING**.

AN OVERVIEW AND CAVEAT

Please keep in mind that the following discussion is merely an overview. An in-depth treatment of the limitations, qualifications, or exceptions is beyond the scope of this commentary.

Although state tax laws parallel many of the federal tax rules discussed below, some states have income taxes that do not follow the federal rules.

Also note that there are similarities in the treatment of health/medical insurance premiums and/or benefits for individual as well as employment-based coverage as discussed below.

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DEDUCTION OF UNREIMBURSED MEDICAL EXPENSES

Taxpayers who itemize their deductions may deduct unreimbursed medical expenses (whether covered under an individual or employment-based health insurance plan) that exceed 7.5% of adjusted gross income (AGI).

Medical expenses include:

1. Health insurance premiums paid by the taxpayer. The employee's share of premiums, if any, for employment-based coverage.
2. Amounts paid for the "diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body."
3. Certain transportation and lodging expenditures, qualified long-term care costs, and long-term care insurance premiums that do not exceed certain amounts.
4. The medical expense deduction is rarely of use to most taxpayers, because the standard deduction is larger than the sum of their itemized deductions and few taxpayers have unreimbursed expenses significantly greater than 7.5% of their AGIs.

NO DEDUCTION FOR CERTAIN POLICIES

Premiums for certain types of individual insurance are not deductible, such as:

1. policies for loss of life, limb, and sight;
2. policies that pay guaranteed amounts each week for a stated number of weeks for hospitalization;
3. policies to provide payment for loss of earnings; and
4. the portion of automobile insurance premium that provides medical coverage for persons injured in, or by, the policyholder's car.

EXCLUSION OF BENEFITS

Benefits paid under accident and health insurance policies purchased by individuals are excluded from gross income – even if they exceed medical expenses.

Coverage and benefits under Medicare, Medicaid, and military and Veterans' health care programs are not taxable.

SPECIAL RULES FOR SELF-EMPLOYED INDIVIDUALS

Self-employed individuals include:

1. Sole proprietors (single owners of unincorporated businesses),
2. General partners,
3. Limited partners who receive guaranteed payments, and
4. Individuals who receive wages from S corporations in which they are more than 2% shareholders.

Self-employed taxpayers may deduct payments for health insurance in determining their adjusted gross income (AGI); that is, as an "above-the-line" deduction. This "above-the-line" deduction is not restricted to itemizers or subject to a floor, as is the medical expense deduction described above.

Although 100% of the insurance cost of a self-employed individual may be taken into consideration, the overall deduction is limited to

1. The net profit, and
2. Any other earned income from the business under which the plan is established, less
3. Deductions taken for certain retirement plans and for one-half of the self-employment tax.

Note: The deduction described above is not available for any month in which the taxpayer or the taxpayer's spouse is *eligible* to participate in a subsidized employment-based health plan (i.e., one in which the employer pays part of the cost).

The result of these restrictions is to prevent taxpayers with little net income from their business (which is not uncommon for a new business) from deducting much, if any, of their insurance payments. However, the portion that cannot be deducted under these rules may be treated as an itemized medical expense deduction.

Self-employed individuals may not deduct their health insurance costs in determining the self-employment taxes they pay.

EMPLOYER-PROVIDED HEALTH INSURANCE

KEY FACTS:

1. 60% or more of the non-institutionalized population under age 65 is insured through employment-based plans.
2. Large employers pay about 80% of the cost of employer-provided health insurance.
3. Four tax-advantaged accounts available to help pay health care expenses are:
 - a. Flexible Spending Accounts (FSAs),
 - b. Health Reimbursement Accounts (HRAs),
 - c. Health Savings Accounts (HSAs), and
 - d. Medical Savings Accounts (MSAs).

KEY TAX IMPLICATIONS:

1. Most employer-paid health insurance coverage is excluded from income and employment taxes.
2. Health coverage and benefits available through cafeteria plans are exempt.
3. Self-employed taxpayers may deduct 100% of health insurance costs even if they do not itemize deductions.

TAX IMPLICATIONS TO EMPLOYEES:

Generally, health insurance paid by an employer is:

1. Excluded from an employee's gross income in determining his or her income tax liability. The income and employment tax exclusions apply to both single and family coverage, which includes the employee's spouse and dependents.
2. Not considered in computing either the employee's or the employer's share of employment taxes (i.e., Social Security, Medicare, and unemployment taxes).

Generally, benefits are excluded from employee's gross income if they are:

1. Reimbursements for medical expenses, or
2. Payments for permanent physical injuries.

Benefits which are neither medical expense reimbursements nor payments for permanent physical injuries are taxable in proportion to the share of the insurance costs paid by the employer that were previously excluded from gross income.

Benefits are also taxable to the extent that taxpayers received a tax benefit from deducting expenses in a prior year (e.g., if a taxpayer claimed a medical expense deduction for 2005 expenditures and then received an insurance reimbursement in 2006).

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Benefits received by highly compensated employees under discriminatory "self-insured" plans are partly taxable. A self-insured plan is defined as one in which the employer has not shifted the risk to a third party, such as an insurance company, and has assumed the risk for health care plan costs.

DEDUCTION ALLOWED TO EMPLOYERS:

Premiums employers pay for insurance are deductible by employers as a business expense. Congress considers this deduction as "a calculation necessary for the proper measurement of the net income that is subject to taxation" rather than as a tax benefit.

CAFETERIA PLANS

Cafeteria plans (or "flexible benefit plans") are typically established by larger employers under which all participants are employees. Within limits, the employees may choose between receiving cash (typically additional take-home pay) and certain normally nontaxable benefits (such as employer-provided health insurance) of equal value without being taxed on the value of the benefits if they select the latter.

Cafeteria plans may be simple or complex. Simple plans might allow employees to choose between cash and one nontaxable benefit, such as health insurance. Whereas, complex plans might give employees a "pot of money" to allocate among health insurance and reimbursement accounts, dependent care assistance, disability income (long- and/or short-term), group term life insurance, commuter benefits, and cash as they see fit.

When a taxpayer has the "option" of taking cash, the tax result is generally that the doctrine of constructive receipt will apply; the cash that could have been taken becomes the amount reportable. However, when a cafeteria plan is involved, special tax law provisions provide an express exception to this rule – assuming the plan meets various reporting and nondiscrimination requirements of Code Section 125.

Nontaxable benefits received under a cafeteria plan are exempt from both income and employment taxes.

(For more, see Chapter 38 of **Tools and Techniques of Employee Benefit and Retirement Planning**.)

FLEXIBLE SPENDING ACCOUNTS (FSA)

Here are some key facts about FSAs:

FSAs are employer-established programs under Code Section 125 that reimburse employees for specified, incurred expenses. An FSA can be provided as a stand-alone plan or as part of a traditional cafeteria plan.

FSAs are funded through salary reductions elected by the participating employees each plan year.

The list of potential nontaxable benefits available from an FSA is large, the most common types are health FSAs, which provide for reimbursement of medical and dental expenses. Others may include benefits employers might not otherwise provide, such as dependent care.

(Note: FSAs cannot be used to purchase insurance.)

Health care FSAs must exhibit some of the risk-shifting and risk-distribution characteristics of insurance.

The full benefit amount (less any benefits paid) must be made available throughout the entire year, even if employees spread their contributions throughout the year. For each plan year, the participating employee must estimate the amount that will be required for covered expenses in the following year. Once made, this election cannot be changed (or revoked) during a coverage year, except for changes in family status.

Any funds left in the account at the end of the year are forfeited. In other words, amounts unused at the end of the year must be forfeited to the employer (the "use it or lose it" rule), although employers may allow a 2 1/2-month grace period following the end of the plan year for participants to submit expenses for reimbursement.

TAXATION OF FSAs:

Employee salary reductions applied to nontaxable benefits are not subject to income tax. FSA reimbursements funded through salary reduction agreements (the most common arrangement) are exempt from income and employment taxes under cafeteria plan provisions.

FSA reimbursements funded by *non-elective* employer contributions are exempt from taxation directly under provisions pertaining to employer-paid dependent care or health insurance.

Highly compensated employees may be taxed on FSA benefits if the plan is considered discriminatory.

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Key employees may lose the tax benefits of an FSA if their benefits, as a percentage of their compensation, are too large.

The employer's payroll subject to payroll taxes (FICA, FUTA, state unemployment taxes, and workers' compensation) is reduced by the amount of any employee salary reductions under an FSA.

(For more on FSAs, see Chapter 39 of **Tools and Techniques of Employee Benefit and Retirement Planning**.)

HEALTH REIMBURSEMENT ACCOUNTS (HRA)

Under a health reimbursement arrangement (previously called a medical expense reimbursement plan or MERP), an employer reimburses covered employees for specified medical (health and accident) expenses – not covered by insurance or otherwise reimbursable. These reimbursements are paid directly from corporate funds and are not paid by a third party insurer. Employers are not required by law to fund HRAs. No money is needed until employees draw on the allowable reimbursements and the employer can use a bookkeeping account.

Reimbursements can be limited to amounts previously contributed. Unused balances may be carried over indefinitely, though employers may limit the aggregate carry-overs.

TAXATION OF HRAs:

Reimbursements by employers of an employee's medical expenses are not subject to either income or employment taxes.

HRAs follow the same rules for the exclusion of benefits as the benefits paid from employment-based plans.

Favorable tax benefits will be denied to highly compensated employees if a self-insured plan is considered discriminatory.

(For more on HRAs, see Chapter 47 of **Tools and Techniques of Employee Benefit and Retirement Planning**.)

HEALTH SAVINGS ACCOUNTS (HSA)

HSAs, also known as Section 223 Plans, allow taxpayers to pay for un-reimbursed medical expenses (such as deductibles, co-payments, and services not covered by insurance) on a tax-advantaged basis. An employer can provide an HSA for employees, or individuals or organizations can set one up.

Eligible individuals can establish and fund HSAs when they have a qualifying high deductible health plan (HDHP) and no other health plan (with some exceptions).

TAXATION OF HSAs:

Contributions made by an individual are deductible "above the line" – and so are useful whether or not the taxpayer itemizes deductions.

Contributions made by an employer (either directly or under a Section 125 Cafeteria Plan) are deductible, but not taxable to the employee or subject to FICA or FUTA.

Distributions are tax-free to the extent they are used to pay for qualified medical expenses.

However, they are taxable and usually subject to a penalty if used for other expenses or to purchase health insurance, with some exceptions. Earnings on contributions to HSAs are tax-exempt, and, unlike FSAs, unused balances may accumulate without limit.

The annual HSA contribution limit in 2006 for individuals with self-only coverage is the lower of (a) \$2,700 or (b) 100% of the insurance deductible.

For family coverage in 2006, the annual contribution limit is the lowest of:

1. \$5,450,
2. 100% of the overall deductible, or
3. the embedded deductible (the deductible applying to one individual) multiplied by the number of covered family members.

For purposes of HSAs, a high deductible health plan (HDHP) – in the case of self-only coverage for 2006 – is defined as a health plan with an annual deductible of at least \$1,050 and the out-of-pocket limit must not exceed \$5,250; for family coverage, the deductible must be at least \$2,100 and the out-of-pocket limit must not exceed \$10,500.

Individuals who are at least 55 years old but not yet enrolled in Medicare may contribute an additional \$700. Employers, individuals, or both may make contributions.

Contributions may be made through salary reduction agreements, in which case they are treated as if made by employers.

(For more on HSAs, see Chapter 46 of **Tools and Techniques of Employee Benefit and Retirement Planning**.)

MEDICAL SAVINGS ACCOUNTS (MSA)

MSAs (officially Archer MSAs) are an older, more-restrictive version of HSAs limited to people who either are self-employed, or are covered by high deductible insurance plans established by small employers (with 50 or fewer employees). An MSA works in a similar way to an IRA, but is strictly for paying un-reimbursed medical expenses of covered employees and those of their spouses and dependants. The maximum limit on the number of MSAs was 750,000 (not counting accounts of owners who previously were uninsured, among others), although that number was never reached. No new Archer MSAs can be adopted after 2003, but existing plans were grandfathered. Many of these have probably now been rolled into HSAs.

MSAs should be distinguished from Medicare MSAs, which are discussed below under "Medicare."

Annual contributions to MSAs are limited. They can be made only when account owners have qualifying high deductible insurance, though the specific rules are different.

Contributions to MSAs can be made by individuals or employers, but not both; neither can they be made through salary-reduction agreements.

TAXATION OF MSAs:

MSA contributions are deductible (as an above-the-line deduction) if made by individuals.

MSA contributions, if made by employers, are exempt from both income and employment taxes.

Withdrawals are not taxed if used for qualified medical expenses under rules similar to those for HSAs.

Account earnings are tax-exempt. Unused balances may accumulate without limit.
(For more on MSAs, see Chapter 46 of **Tools and Techniques of Employee Benefit and Retirement Planning**.)

MILITARY HEALTH CARE

The U.S. Department of Defense (DOD) provides health care coverage (called Tricare) to active duty military personnel, military retirees, and their dependents.

Active duty personnel receive care generally without cost (aside from small per diem charges). Military retirees and their dependants may have deductibles, co-payments, and premiums. This will depend on where benefits are provided and the particular insurance plan that covers them.

TAXATION OF MILITARY HEALTH CARE:

Neither the cost of coverage nor benefits received is taxable to recipients.

VETERANS' HEALTH CARE

The U.S. Department of Veterans Affairs (VA) provides health care directly to veterans through hospitals, nursing homes, residential rehabilitation treatment centers, and community-based outpatient clinics.

In some cases, it pays for care provided by independent doctors and other health care professionals.

Eligibility for services is prioritized according to several factors, including the severity of disabilities, whether disabilities occurred during or after military service, certain military events (e.g., having been a prisoner of war), the period of service, and means testing.

TAXATION OF VETERANS' BENEFITS:

Coverage and benefits received under veterans' health care programs is not taxable.

MEDICARE

Medicare is a national health insurance program for people ages 65 and older, or who meet certain disability tests.

TAXATION OF MEDICARE:

Coverage under Medicare and the benefits for qualifying expenses are not taxable.

Medicare Part A provides insurance for hospitalization, skilled nursing facilities, post-hospitalization home health, and hospice care. Both workers and employers pay a tax, currently equal to 1.45% of covered wages, for this coverage.

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Individuals cannot take these tax payments into account as medical expenses for itemized deductions.

Employers may deduct what they pay as a business expense.

PART A: Workers and their spouses become entitled to Part A once the workers have paid employment taxes on covered wages for certain periods of time. They pay no additional premium to be enrolled. People ages 65 and older that are not entitled to Part A may voluntarily enroll by paying a monthly premium.

This premium may be taken into account for the itemized deduction for medical expenses, as may the deductibles and co-payments associated with Part A.

PART B: Medicare Part B (insurance for doctors' fees, hospital outpatient services, most home health, and other medical services) is financed by general tax revenues and monthly premiums paid by those who enroll. Usually the premiums are withheld from Social Security benefits.

These premiums may be taken into account for the itemized deduction for medical expenses, as may the deductibles and co-payments associated with Part B.

Medicare **Part D** provides insurance for prescription drugs. Part D is financed through general tax revenues and monthly premiums paid by enrollees.

Deductibles and co-payments associated with Medicare Part D may be taken into account for the itemized deduction for medical care.

No official guidance has been issued regarding the tax treatment of Part D premiums.

MEDICAID

Medicaid is a form of health insurance for the elderly, people who have disabilities, pregnant women, families with dependent children, and children who have low income and few assets. It also pays for long-term care for people meeting similar needs tests.

Each state designs and administers its own program. So there is variation (within broad federal guidelines) with respect to who is served, benefits and delivery systems, and cost-sharing and other patient requirements. Medicaid waivers allow states even more flexibility for certain populations.

TAXATION OF MEDICAID:

Neither the coverage nor benefits of Medicaid is taxable.

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