

Pre-tax Dollars in the barn, Why not in the house?

The cost of health care seems to be on a steep trajectory! It doesn't matter if you're treating a sick ewe or a sick child. The cost of prescription drugs, wormers and even fly spray seem to become more expensive every month. At least in the barn, we can deduct the "medical" expenses before we pay income tax on what might be left.

Now, you have the same option in the house. Though the concept has been available for a few years through Archer Medical Savings Accounts (MSA), the newer Health Savings Account (HSA) is rich with tax benefits worthy of your attention.

An Archer MSA and HSA both provide pre-tax dollars for medical expenses. An Archer MSA (expired on 12-31-2005 and only available if you already have one) could only be established by a small business employee or a self-employed individual. An HSA can be established by ANY individual covered by a High Deductible Health Plan (HDHP).

Generally, if you are covered under an HDHP, you are able to establish an HSA. If you have an HDHP, your agent has likely already made you aware of using an HSA. To be HSA eligible, very specific rules that relate to the annual deductible and to the annual out-of-pocket expense must be followed. Since they do change, I won't give specific numbers—your insurance agent should be well versed in the current rules and limits. When you opt for a high deductible, you are generally rewarded with a much lower monthly premium.

There are plans available that require a family to pay the high deductible for the family and then have 100% of all expenses paid. For example, if you have an HDHP with a family deductible of \$5,450 (the maximum family HDHP deductible that can be put into an HSA), you would pay \$5,450 as a family FIRST; after which, the insurer would pay 100% of covered medical expense. In this example, there are no co-pays. The HDHP deductibles and out-of-pocket expense limits are annually indexed to inflation.

HSA's are established as a tax-exempt trust or custodial account, typically through a bank, insurance company or third-party administrator. Often, the chosen insurance company has a close affiliation with a provider. Contributions can earn interest tax free, provided the funds are used for qualified medical expense. Withdrawals for non-medical expense carry a 10% penalty on the total withdrawal, plus the regular income tax. Remember, the HSA is funded with PRE-tax dollars. Even if you do not itemize, HSA deposits are deductible as an adjustment to income before you get to the adjusted gross income on the first page of the 1040.

So what is a qualified medical expense? Wow, the IRS publishes a long list—lab fees, prescription and NON-prescription drugs (aspirin), dental check-ups and treatment, eye glasses, ambulance service, hearing aids, deductibles and co-payments. Quite a list and this is not a comprehensive one! You *cannot* pay insurance premiums, qualified long-term care insurance, COBRA coverage or retiree health insurance. The one insurance premium allowed under the HSA rules is the purchase of a Medicare supplemental policy (Medigap).

The long list of eligible expenses also leads to some confusion. Some covered items like aspirin are NOT part of your insurance deductible. It takes good records to keep it straight. The confusion is worth it—an HSA allows your eye glasses and dental care to be paid with pre-tax dollars. If you contribute the 2006 maximum of \$5,450 to your HSA and are in the 28% tax bracket, you have an after tax equivalent of \$7,569.

An HSA has a few strong characteristics. First, you can roll over the excess. If you don't use the full amount this year, it can be rolled over and added to a new year's contribution. In time, you will have more cash ready when you need those hearing aids! Second, the account is portable. If you change insurance companies, the funds can be rolled over to the new provider with no tax consequence. Third, when you reach age 65, you cannot contribute to an HSA, however, whatever funds are still there can be used for the same qualified medical expense without tax consequence. Finally, when you die, your spouse can become the account holder and use the funds in the same fashion. The one long term draw back—if the beneficiary is not your spouse, the fair market value of the account will be included in the recipient's gross income that year.

Health Savings Accounts allow you to be in control of your medical dollars. With the right policy, you can know what your maximum out-of-pocket medical expense will be. If you control your visits to the doctor, you can even save money on a tax free basis. This article in no way has covered all of the bases—just tried to grab your attention to call your health insurance provider and ask questions. Health Savings Accounts appear to be great financial planning tool in an area where it has been difficult to contain costs in the past. Being a relatively new tool, “experience” is not readily available to be a “teacher,” however, the effort to gain experience appears to this financial planner, well worth the long term gain. Hopefully you can make your family's medical expense almost as tax deductible as it is for your flock in the barn!

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