

## **Tax-Favored Health Plans**

Farmers may want to consider one of three health insurance options:

- Self-Employed 100% Health Insurance Deduction,
- Medical Expense Reimbursement Plans, and
- Health Savings Accounts.

A short summary of each and some of the considerations may be useful in comparing what would work for your family and your employees. Other types of plans exist including cafeteria plans and Flexible Spending Accounts which are not covered in this discussion.

- Self-Employed 100% Health Insurance Deduction

Health Insurance for a self-employed person may be 100% deductible as an adjustment to income on the front of the Form 1040 so no state and federal income taxes are required to be paid on it. This includes health insurance for the owner, spouse, and dependents. The deduction is limited to the net earned income of the business that established the plan and only from that business. For a farmer with both a farm operation (Schedule F) and another side business (Schedule C), or with multiple Schedule F forms, the net earned income calculation can come from only one. The net income is further reduced by deductions for one-half the self-employment tax plus contributions to SEP, SIMPLE and Keogh retirement plans. Owners or spouses eligible for subsidized health plans by an employer cannot use this deduction.

A farmer still gets to pay self-employment tax on the amount paid for health insurance since it is not deducted on tax forms until after the SE tax is calculated. This deduction only covers health insurance premiums. Other medical costs are normally deductible only as itemized deductions after they exceed the 7.5% of adjusted gross income (AGI) threshold.

- Medical Expense Reimbursement Plans (§105)

This plan allows an employer to reimburse employees for qualified medical expenses which are not income to the employee and are fully deductible as an expense by the employer.

Qualifications:

Self-employed individuals are not eligible for this. However, if the business employs the spouse and the business provides family coverage for employees, then all family members (including the owner) may be covered. The plan may include expenses beyond medical insurance including deductibles, vision and dental coverage, prescription and some non-prescription medicines.

Requirements: The IRS may look at these three issues of a plan.

- 1) An actual employee-employer relationship should exist. This includes records of hours worked, reasonable pay rates, and regular and current pay (rather than a lump sum at the end of the year). If the pay gets deposited back into the business accounts, then it appears to be suspect. All normal employer/employee forms should be filed including W-2, W-3, Form 940 (unemployment, if applicable), and Form 943. An

- employment agreement with terms and conditions, which are followed, helps with this issue.
- 2) The actual plan must be administered properly. Has the plan been written and signed by both employer and employees? Reimbursement procedures should be clear and records of qualifying expenses must be kept to substantiate claims. Insurance for a spousal employee should be in that spouse's name, not the owner's name.
  - 3) All qualified employees must be eligible for the plan. Those with less than three years of service, under 25 years old, part-time or non-resident aliens may be excluded but eligibility requirements must be clear in the summary plan description.

These plans can be fairly complex and the advice of a professional is recommended.

Advantages: Lower federal, state and self-employment taxes since medical insurance premiums are a deductible expense on Schedule F. Other medical costs like insurance deductibles, eyeglasses, dental and prescription costs can be reimbursed. Also, a plan can be written to include over-the-counter medical expenses. Funding for this plan comes only from the employer who chooses the contribution limit. Employee or individual contributions are not allowed.

Other considerations:

The spouse's wages are subject to social security and medicare taxes as well as income taxes. Nondiscrimination rules apply so that all qualified employees must be able to participate.

- Health Savings Accounts

A health savings account (HSA) is a tax-exempt account that you (an employer, employee, or individual) set up with a trustee to pay or reimburse qualified medical expenses.

Benefits:

- 1) Claim a tax deduction for contributions made by you or someone other than your employer, even if you do not itemize deductions.
- 2) Contributions made by the employer may be excluded from your gross income and are not subject to payroll taxes.
- 3) Contributions remain in your account until you use them. Interest and earnings on the assets in the account are tax free. Your account remains yours even if you change employers.
- 4) Distributions are tax free if used for qualified medical expenses.

Eligibility for an individual:

- 1) Have a high deductible health plan (HDHP).
  - a. Self only: \$1,150 minimum annual deductible, \$5,500 maximum (2007)
  - b. Family: \$2,200 minimum annual deductible, \$11,000 maximum (2007)
  - c. An HDHP may provide certain preventive care benefits without a deductible or a deductible below the minimum annual deductible.
- 2) Have no other health coverage, generally. You are allowed other coverage for accidents, disability, dental care, vision care and/or long-term care.

- 3) You can still be an eligible individual even if your spouse has non-HDHP coverage provided you are not covered by that plan. Prescription drug plans are permitted as part of the HDHP or as a separate plan as long as it doesn't provide benefits until the minimum annual deductible is met.

### Contributions

Can be made by the employee and/or employer. For self-employed – anyone can contribute to your HSA but it must be in cash (not stock or property).

In 2007 contributions are permitted up to \$2,850 for an individual or \$5,650 for a family. Additional contributions up to \$800 more are allowed for age 55 or older. Beginning with the first month you are enrolled in medicare, you cannot contribute to your HSA.

If an employer contributes to HSAs for employees, comparable contributions (same amount or same percentage) must be made to all comparable participating employees except that additional contributions may be made for lower paid employees.

In prior years contributions were limited to the annual deductible and prorated if the HSA began after the beginning of the year. These limits no longer apply.

### Distributions

Qualified medical expenses for you, your spouse and dependents can be reimbursed from your HSA by the trustee. Examples of these expenses include doctor's fees, prescription and non-prescription medicines, and necessary hospital services not paid for by insurance. These distributions are tax-free unless withdrawn for some other reason. In that case the distribution would be subject to income tax plus a 10% additional tax.

Insurance premiums are generally not qualified medical expenses for your HSA. However, premiums for long-term health care coverage (subject to limits based on age), health care coverage while receiving unemployment, and some other limited situations may be qualified medical expenses.

Your records must show

- 1) The distributions were exclusively used to pay or reimburse qualified medical expenses.
- 2) The qualified medical expenses had not been previously paid or reimbursed from another source.
- 3) The medical expenses had not been taken as an itemized deduction in any year.

HSAs tend to be a better choice for the young or healthy because they can build up their account. Of course, a lower deductible health care plan is generally preferred by employees when it is highly subsidized by an employer. Many health insurance providers now offer HSAs. The employer contributions are not subject to social security, medicare or income taxes. The employee or individual contributions are deductible as an adjustment to income on the Form 1040 which comes from the Form 8889, Health Savings Accounts (HSAs). In some situations with an employer sponsored plan with salary reductions, the employee contributions may not be subject to social security and medicare taxes.