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MEDICAL SAVINGS ACCOUNTS – OVERLOOKED OPPORTUNITY?

— by Michael T. Maurer* and Neil E. Harl**

A Medical Savings Account (MSA) is a tax-exempt trust or custodial account established with a financial institution[1] to pay qualified medical expenses.[2] MSAs must be used in conjunction with high deductible healthcare insurance.[3] MSA funds are available to pay medical expenses not covered by the taxpayer's high deductible medical insurance. Amounts not used for medical expenses belong to the taxpayer[4] and are treated similarly to funds in an IRA. Like an IRA, contributions to an MSA are 100 percent tax deductible[5] and investment income earned by the MSA is tax deferred.[6]

Under the Health Insurance Portability and Accountability Act of 1996,[7] MSAs were made available to 750,000[8] taxpayers for a pilot period from 1997 through 2000.[9] The limitations placed on MSAs reflect a political compromise; opponents of MSAs were concerned that the tax advantages of MSAs would motivate healthier people to select high deductible health coverage and thereby cause insurance premiums for individuals choosing traditional low deductible health care policies to increase.[10] However, the anticipated rush to open MSAs has yet to materialize. The total number of MSA returns filed for 1997 was only 41,668.[11] Accordingly, the opportunity of opening an MSA remains available to a relatively large number of taxpayers who meet the eligibility requirements. Furthermore, once a taxpayer establishes an MSA, the taxpayer can continue to make MSA contributions and receive distributions after the pilot period ends if the taxpayer continues to meet the statutory eligibility requirements.[12]

Benefits. The benefits to individuals using MSAs include lower insurance premiums because of the high deductible, ability to pay medical expenses with pre-tax dollars, more control over healthcare choices, tax deferment on the income earned by the MSA, and ownership of the account balance.[13] A primary goal of an MSA account holder is to preserve the funds in the MSA so it is available for general purposes when the account holder retires or dies. The public policy underlying MSAs is to (1) create a financial incentive for individuals to control healthcare costs and (2) provide financial benefits to those who stay healthy.

Eligibility. To be eligible to open an MSA, an individual must either (1) work for a "small employer" that has established a "high-deductible health plan" or (2) be self-employed and have a "high-deductible health plan."[14] Generally, a "small employer" must have 50 or fewer employees.[15] Accordingly, many farmers, ranchers and other small business owners are eligible to open an MSA.

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A "high deductible health plan" must meet statutory criteria concerning (1) the amount of the annual deductible and (2) the maximum amount of annual out-of-pocket expenses paid by the taxpayer for covered benefits.[16] These amounts are larger for policies providing family coverage compared to policies providing individual coverage. For individual coverage in 1999, the annual deductible must be between $1,550 and $2,300; the annual deductible for family coverage must be between $3,050 and $4,600.[17] The maximum amount of out-of-pocket expense is $3,050 for individual coverage and $5,600 for family coverage.[18] It should not be difficult to obtain this type of insurance as many insurance companies[19] have tailored policies to fit the statutory requirements.

As an example of how the out-of-pocket maximum works, assume an individual has a $2,300 deductible with a 20 percent co-pay until the maximum amount is reached. That person pays the first $2,300 of covered medical costs plus 20 percent of the next $3,750[20] of covered medical expenses.[21] All further covered medical costs are covered 100 percent under the insurance policy.[22]

Another requirement of MSA eligibility is that the individual must not be covered by another health insurance plan.[23] However, this rule does not apply if other health plans only cover accidents, disability, dental care, vision care, long-term care, workers' compensation, tort liability, specific diseases or a fixed per diem amount for hospitalization.[24]

Contributions. Contributions to an MSA may be made either by the eligible individual or by the employer. However, if an employer makes contributions to an MSA, the account holder may not make contributions during the same year. For individual coverage, the annual contribution limit is 65 percent of the deductible.[25] Therefore, in 1999, the maximum contribution for someone with individual coverage is $1,495.[26] For family coverage, the annual contribution limit is 75 percent of the deductible.[27] Thus, the 1999 maximum MSA contribution for someone with family coverage under a high deductible health plan is $3,450.[28]

A further limitation on contributions restricts self-employed individuals to the income earned by the business.[29] Similarly, employees may not contribute more than the compensation earned from the employer.[30]

Employers are required to make comparable contributions for all participating employees or a penalty is imposed.[31] Generally, employers are required to contribute the same amount for each employee or the same percentage of each employee's deductible.

Contributions for a taxable year can be made in one or more payments at any time during the year or in the subsequent year prior to the deadline (without extensions) for filing the account holder's tax return.

Use of Funds. Depending upon the circumstances, distributions from an MSA may be tax free, subject only to income tax, or subject to income tax plus a 15 percent penalty tax.

Distributions for Medical Expenses. Distributions from an MSA for qualified medical, dental, vision and prescription drug expenses incurred by the individual, spouse, or dependents generally are not subject to income tax.[32] The phrase "qualified medical expenses" is defined in Section 213(d) of the Internal Revenue Code.[33] Generally, insurance premiums are not qualified medical expenses for MSA purposes. However, long-term care insurance, COBRA or other continuation coverage required by federal law or coverage while an individual receives unemployment compensation may be purchased with tax-free withdrawals from an MSA.

Other Distributions. If distributions are not used for qualified medical expenses, they are taxed as ordinary income.[34] In addition, a 15 percent penalty tax applies[35] unless the distribution is taken after death, disability or age 65.[36] The 15 percent penalty tax provision is similar to the penalty that applies to early distributions from an IRA or 401(k) account. For taxpayers in a lower income tax bracket after retirement or disability, distributions from an MSA are subject to less income tax than if taxed at the time of the contribution.

Employer Plans. Small employers who want their employees to be eligible to use an MSA must make available to the employees a high deductible health plan. Employers may choose to make contributions to employees' MSAs[37] or employees can be responsible for making their own contributions. Amounts contributed to employees' MSAs are deductible by the employer only for the tax year in which paid.[38] Also, employer contributions are not subject to employment taxes, such as FICA, FUTA or railroad retirement taxes. Employers must report contributions made to an employee's MSA on the employee's Form W-2. The MSA is owned by, and stays with, the employee through employment changes, even if the employer made the contributions.[39] For employers who do not make contributions to employees' MSAs, the cost of providing a high deductible healthcare plan is less than providing low deductible insurance. Some employers use the savings from the lower insurance premiums to fund contributions to the employees' MSAs.

Self Employed. Self-employed individuals may find the use of an MSA and a high deductible policy economically attractive compared to the use of traditional low deductible insurance. A self-employed taxpayer with low deductible insurance is allowed a tax deduction for (1) 60 percent of healthcare insurance premiums,[40] and (2) out-of-pocket medical costs that exceed 7.5 percent of adjusted gross income. The 7.5 percent threshold is relatively high and is reached only with a catastrophic healthcare bill. In contrast, a self-employed taxpayer with an MSA may deduct 60 percent of healthcare insurance premiums and 100 percent of MSA contributions. Therefore, a taxpayer with an MSA need only use after-tax dollars for medical expenses when the MSA balance is insufficient to cover out-of-pocket expenses. In addition, MSA funds not used for medical expenses can accumulate tax-free and be withdrawn without penalty after retirement or disability.[41]

Filing Requirements. To claim a deduction for contributions made to an MSA, a taxpayer must file a Form 1040[42] and attach a Form 8853. The trustee or custodian of the MSA sends the taxpayer a Form 5498-MSA showing the amounts contributed during the year. With respect to distributions, the taxpayer must report them on Form 8853 whether or not they are used for qualified medical expenses. The trustee or custodian of the MSA reports any distributions to the account holder and the IRS on Form 1099-MSA.

Investment of Funds. Some MSA trustees allow the account holder to invest funds that exceed a particular level in mutual funds. For example, a trustee might allow account holders with over $2,000 in their MSA to invest in mutual funds so long as a minimum balance of $500 is maintained in an interest bearing account with the trustee. The minimum balance is the first source of funds used to reimburse medical expenses and then mutual funds are redeemed. As a convenience for the account holder, some trustees issue the account holder a debit card to use when paying covered medical expenses.[43]

Death of Account Holder. When the account holder dies, what happens to an MSA depends upon who is designated as the beneficiary. If a spouse is the designated beneficiary, then it will be treated as the spouse's own MSA. If someone other than a spouse is designated as the beneficiary, the account ceases being an MSA on the date of death and the fair market value of the MSA becomes taxable income to the beneficiary. If no beneficiary is designated, the fair market value of the MSA will be included on the decedent's final income tax return.[44]

Conclusion. MSAs provide several advantages to taxpayers, particularly those who historically have medical expenses less than the deductible on their health insurance coverage. While Congress subsequently may expand or extend the use of MSAs, self-employed taxpayers and small employers should not assume MSAs will continue to be available after 2000 when the pilot project expires. Therefore, to avoid missing the opportunities presented, eligible taxpayers should not delay in weighing the benefits offered by MSAs against the risks of using high deductible health insurance and determining whether or not to establish an MSA.

FOOTNOTES

1 The trustee may be a bank, an insurance company, or any other person approved by the IRS. I.R.C. § 220(d)(1)(B). Persons already approved by the IRS to be trustees or custodians of IRAs are automatically approved to be MSA trustees or custodians. IRS Notice 96-53, I.R.B. 1996-51, 5-6. Question and Answer No. 10.

2 I.R.C. § 220(d)(1). See generally, I.R.C. §§ 106, 220 and IRS Pub. 969, "Medical Savings Accounts." A free copy of Pub. 969 may be obtained from the IRS by calling 1-800-TAX-FORM (1-800-829-3676) or by downloading it from www.irs.ustreas.gov/prod/forms_pubs/index.html.

3 The criteria a health insurance policy must meet to be a "high deductible health plan" are contained in I.R.C. § 220(c)(2)(A). See notes 15-18 and accompanying text, *infra*.

4 I.R.C. § 220(d)(1)(E) states an individual's interest "in the balance in his account is nonforfeitable." Unlike certain flexible spending arrangements contained in cafeteria plans, one does not "use or lose" an MSA balance.

5 I.R.C. § 220(a) provides a deduction for amount paid by eligible individuals to an MSA. I.R.C. § 106(b) provides that contributions made by employers to an eligible employee's MSA are not included in the employee's gross income.

6 I.R.C. § 220(e).

7 Pub.L. No. 104-191, Sec. 301, 110 Stat. 1936 (1996).

8 The specifics of the limitation are contained in I.R.C. § 220(i).

9 After 2000, established MSAs will be allowed to continue, but Congress must pass additional legislation to allow new MSAs to be created after expiration of the pilot period.

10 When signing the bill into law on August 21, 1996, President Clinton raised this concern.

11 Ann. 98-88, I.R.B. 1998-42.

12 IRS Notice 96-53, I.R.B. 1996-51, 7. Question and Answer No. 25.

13 MSAs are portable and the balance of the account is owned by the account holder, even if the employer made the contributions. See n. 4, *supra*.

14 I.R.C. § 220(b) and (c)(1).

15 I.R.C. § 220(c)(4) defines a small employer as having an average of 50 or fewer employees during either of the last two calendar years; it also contains special rules for new and for growing employers.

16 I.R.C. § 220(c)(2).

17 Rev. Proc. 98-61, I.R.B. 1998-52, 18. See I.R.C. § 220(g) concerning inflation adjustments to be made after the 1998 tax year to the amounts specified in I.R.C. § 220(c)(2).

18 I.R.C. § 220(c)(2)(A)(iii). The base amounts of $3,000 and $5,500 have been adjusted for inflation.

19 A search of the Internet using the search engine at http://www.altavista.com and the phrase "medical savings accounts" generated over 2,300 hits, many of which are sites of companies offering health plans or trustee services. Also, a GAO report found that "qualifying plans were widely available." "GAO Surveys Insurers On MSA Sales," *Employee Benefit Plan Review*, March 1999, p. 53.

20 Twenty percent of $3,750 is $750. When added to the deductible of $2,300, the individual has paid a total of $3,050.

21 To the extent of funds in the MSA, pre-tax funds can be used to pay the deductible and co-pay.

22 Coverage under the policy, as with all insurance, is subject to policy terms and limitations.

23 If an individual had other health coverage or was not covered under a high deductible healthcare plan in the month in which the qualified expense was incurred, MSA funds may be used tax free only if no contributions (other than rollovers) were made to any MSA of the individual for the year.

24 Notice 96-53, I.R.B. 1996-51, 5. Question and Answer No. 7.

25 I.R.C. § 220(b)(2)(A). The annual limitation is computed as an aggregate of monthly limitations. The amount of the allowable contribution is reduced one-twelfth for each month that the covered person was not eligible. For example, a self-employed individual who purchases a self-only, high deductible policy on July 31, 1999, may make an MSA contribution of up to 5/12ths of 65 percent of the annual deductible.

26 This is based on the health care plan having the maximum allowable deductible of $2,300. For plans with lower deductibles, the maximum contribution allowed will be less. For example, if the deductible is at the bottom of the eligible range, i.e., $1,550, the maximum contribution will be $1,007.50

27 I.R.C. § 220(b)(2)(B).

28 Based on the maximum allowable deductible of $4,600. For plans with the deductible at the bottom of the eligible range, i.e., $3,050, the maximum contribution will be $2,287.50.

29 I.R.C. § 220(b)(4)(B).

30 I.R.C. § 220(b)(4)(A).

31 I.R.C. §§ 106(b)(7), 4980E.

32 I.R.C. § 220(f)(1).

[33] IRS Pub. 502, "Medical and Dental Expenses", contains detailed information on eligible expenses. A copy of Publication 502 may be obtained by using the procedure outlined in note 2, *supra*.

[34] I.R.C. § 220(f)(2).

[35] I.R.C. § 220(f)(4)(A).

[36] I.R.C. § 220(f)(4)(B), (C).

[37] Employers must make comparable contributions (same amount or same percentage of annual deductible) for comparable participating employees. Employees are comparable if they are covered by the high deductible health plan and eligible to establish an MSA, have the same category of coverage (self-only or family), and have the same category of employment (either part-time or full-time).

[38] I.R.C. § 106(b)(3).

[39] See note 4 and accompanying text, *supra*.

[40] The applicable percentage is 60 percent for taxable years beginning in calendar years 1999 through 2001. I.R.C. § 162(l)(1)(B).

[41] Withdrawals for medical expenses incurred after age 65 are still tax-free.

[42] A Form 1040A or Form 1040EZ can not be used. An individual need not itemize deductions to take a deduction for contributions made to an MSA.

[43] The statement of account activity on the debit card assists the account holder in maintaining records of the medical expenses paid from the MSA.

[44] See Pub. 969, n. 2 *supra*.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

EXEMPTIONS

HOMESTEAD. The debtors, husband and wife, were farmers until financial difficulties forced them to quit farming. In February 1998, the husband moved to Kansas where he found employment. The wife remained in Illinois at the residence until a contract of sale was reached for the residence. The wife moved to Kansas in May 1998. The debtors filed for bankruptcy in Illinois in July 1998 and claimed the residence as exempt under Illinois law. The debtors had no intention of moving back to the residence or to Illinois after the bankruptcy case was filed but only rented residences in Kansas. The debtors maintained the residence even after moving. The residence transaction closed after the filing of the petition and the debtor changed the exemption to the proceeds of the sale. The court noted that the husband did not intend to stay in Kansas if the employment did not last. The court held that the mere moving out of a residence was not sufficient to indicate abandonment of the residence, especially where there was an impending sale. The court noted that the delay in closing the sale was not the fault of the debtors. The court held that the debtors could claim the exemption because the debtors had not established a new owned residence prior to filing for bankruptcy. ***In re* Wagenbach, 232 B.R. 112 (Bankr. C.D. Ill. 1999)**.

PROCEEDS OF SALE OF EXEMPT PROPERTY. The debtors claimed their homestead as exempt and no objection was filed. The residence was sold and the net proceeds were ordered given to the Chapter 13 trustee. The debtors sought turnover of the proceeds as exempt property but the Bankruptcy Court held that the proceeds were to be held by the trustee until the Chapter 13 plan was completed and no chance of a dismissal remained. The Bankruptcy Court reasoned that the retention of the proceeds until the completion of the plan would preserve the funds for creditors in the case of an early dismissal of the case. The appellate court reversed, holding that Section 522(c) was clear that exempt property was no longer part of the bankruptcy estate and was available for the debtors' use without control by the bankruptcy court or trustee. ***In re* Gamble, 168 F.3d 442 (11th Cir. 1999), *rev'g unrep. D. Ct. dec. aff'g*, 208 B.R. 598 (Bankr. S.D. Ga. 1997)**.

CHAPTER 12-*ALM* § 13.03[8].*

DISMISSAL. The debtor operated a livestock and small grain farm and during the two year prior to filing for Chapter 12 had suffered large losses. In the last year before filing, the debtor had started planting alfalfa but was unable to plant a large crop because of wet conditions on much of the debtor's land. That land had been too wet to plant for many years. The debtor's plan projected income for the years of the plan but the court found that the debtor was unable to provide sufficient evidence that the operation of the farm would change significantly to explain how a farm which had a history of losses would suddenly start producing income. The court held that the plan could not be confirmed, that the debtor could not propose a confirmable plan, and that the case would be dismissed. ***In re* Tofsrud, 230 B.R. 862 (Bankr. D. N.D. 1999)**.

FEDERAL TAXATION-*ALM* § 13.03[7].*

AUTOMATIC STAY. The debtor filed for Chapter 7 in April 1996 and listed an expected refund from 1995 in the schedule of assets. In May 1996, the IRS applied the refund to the debtor's taxes for 1990, 1991 and 1992 and remitted to the debtor only the balance after those taxes were fully paid. The debtor received a discharge in July 1996 which discharged the 1990 and 1991 taxes only. The debtor sought recovery of the full refund, arguing that the offset was improper and violated the automatic stay. The court held that, under Section 522(c), the IRS was authorized to offset only the nondischargeable taxes and the court ordered recovery of the 1990 and 1991 tax payments from the refund. Although the parties and the court agreed that the offset violated the automatic stay, the only damages proved by the debtor were the amounts offset for the 1990 and 1991 taxes; therefore, the debtor was not awarded any additional damages. ***In re* Jones, 230 B.R. 875 (M.D. Ala. 1997), *aff'g*, 212 B.R. 680 (Bankr. M.D. Ala. 1997)**.

DISCHARGE. The IRS filed a claim for taxes owed from 1985 and the debtor sought to discharge those taxes. The IRS records showed that the IRS had made several attempts to notify the debtor of a tax deficiency for 1985 based on no tax return filed or

**Agricultural Law Manual* (ALM).