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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

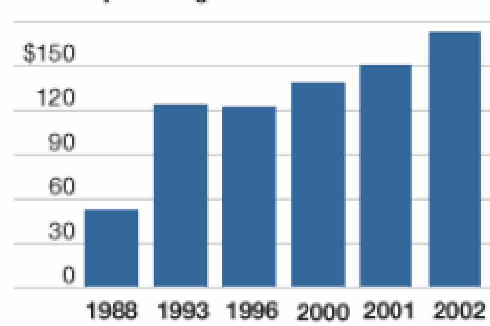
- Since September 2003, employees are allowed to pay for over-the-counter prescriptions with their Flexible Spending Accounts.
- The maximum benefit for a worker retiring in March 2003 at Social Security's *full retirement age* of 65 and 2 months is $1,741 per month

Funding Medical Expenses with Pretax $

Health care is a key issue in the upcoming presidential election. More specifically, the cost of health care and who pays for it is hotly debated. In the United States, private employers began paying significant health care benefits about forty years ago. In 1960, individuals paid directly for 50 percent of their health care. Today they pay for only 15 percent. The other 85 percent is paid by third parties, generally employers, insurance companies or the government. What began as a way to attract and keep good employees has become a burden.

Since 1997, employers have increased spending on health care benefits 57%. At the same time, companies have shifted more and more of the financial burden of health care to their workers. Employee co-payments have increased dramatically in the past 15 years. Here's an illustration.

Average monthly worker contribution for family coverage



Sources: Mercer Human Resource Consulting; Kaiser Family Foundation

Apart from receiving subsidies, employees may be able to fund health care expenses in tax-advantaged accounts. Under Section 125 of the IRS code, an employee is allowed to pay for his/her group health premiums, other qualified insurance premiums, and unreimbursed medical costs, with tax-deductible funds.

Pretax savings plans of this nature are most commonly referred to as Flexible Spending Accounts (FSAs). Each annual enrollment period, the employee establishes a payroll deduction schedule to fund health care expenses not covered by his employer. The IRS imposes no limit on the amount that may be contributed to an FSA to fund health care.

The catch is that the FSA is a "use it or lose it" account. Funds not used by the end of the year are forfeited. Studies have shown that the average employee leaves $100 unspent in these accounts each year. Moreover, many folks spend their remaining balances on items of questionable value near the end of their enrollment period. It is not surprising, then, that less that one in four employees that have access to an FSA actually opt to fund it.

The Medicare reform bill signed in December also included a provision for Health Savings Accounts (HSA). While President Bush mentioned them in his State of Union speech in January, they are little known as yet. Their popularity should increase within a short period of time.

The HSA is a tax-free account that must be paired with high-deductible health insurance. The deductibles must be from $1000 to $2600 for a single individual and from $2000 to $5150 for a family. The patient may contribute an amount equal to the policy's deductible each year to fund health care

Funding Medical Expenses (continued)

expenses not covered. Sole proprietors, partners, and employees alike may fund an HSA if their health plan accommodates.

HSA Funds can be disbursed for a wide range of purposes. They can be spent on doctors' appointments, prescription drugs, long-term care insurance premiums, COBRA premiums and health insurance premiums for those receiving unemployment benefits. Medicare beneficiaries can use HSA money to pay managed care and standard Medicare premiums.

Unlike Flexible Spending Accounts, funds contributed to a Health Savings Account carry over form year to year. These are portable accounts that move with the patient and are not tied to the employer. After an HSA account holder retires, he or she can still use the funds to cover medical expenses without incurring a tax liability . Other withdrawals after age 65 are taxed as ordinary income.

"With the substantial increase in co-pays for physical exams and prescription drugs, the next logical step is the elimination of any employer subsidy for routine health care"

Today most folks are not eligible as their group health plan either offers first dollar coverage or a lower deductible that is required for an HSA. However, high deductible group policies are looking more and more attractive to employers. With the substantial increase in co-pays for physical exams and prescription drugs, the next logical step is the elimination of any employer subsidy for routine health care. Even before the HSA provisions of the Medicare Bill passed, a significant number of employers were considering high deductible coverage for 2004.

Firm Size (number of workers)	% considering high deductible coverage in 2004
3-199	27%
200-999	28%
1000 – 4999	29%
5000+	41%

The advent of HSAs is a double-edged sword. The positive side is that patients will be able to set aside substantial amounts of pretax dollars for health care each year. The drawback is that HSAs will be paired with group coverage that no longer provides partial reimbursement for first dollar medical expenses.

To date, there are at least two major medical insurance providers that have adopted HSA-complaint policies, Aetna and Fortis. Individual and group policies are available. Another major player, Blue Cross of Texas, may have a plan available as early as July of this year. With health care costs increasing so dramatically, it will be important for patients to take advantage of the tax shelters available to leverage their spending on health care.

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Funding Dependent Care with Pretax $

Flexible Spending Accounts may also be used to fund dependent care expenses. The dependent care and health care accounts are separate. Children under the age of 13 or adults who are claimed as dependents qualify. Health care costs as well as schooling above the first grade are not eligible. The IRS limits the contributions to $5000 annually. Most families have a very good idea how much they will need to spend on child care and, unfortunately, $5000 is not a binding constraint. No need to worry about waste.

For management and most employees, FSAs are the most efficient way to pay for child care. Lower wage earners might be better served by claiming child care credits. Smaller firms with group health plans may find that the tax savings of employees more than compensates for the administrative costs of an FSA.