Federal Tax Considerations For Accident & Health Insurance

Different types of health insurance policies are subject to a different degree of taxation. This section will continue the discussion of tax issues as they pertain to health insurance, specifically the tax treatment of premiums and proceeds. By the end of this section, you should be able to compare the taxation of personally owned health insurance policies with similar policies provided by an employer. You will also learn about business disability insurance and reimbursement or savings accounts available in group coverage.

TERMS TO KNOW

Adjusted gross income — gross income (all income from whatever sources) minus adjustments to income
Defined-benefit plans — the employer specifies an amount of benefits promised to the employee
Defined-contribution plans — focus on contributions rather than on the benefits they will pay out
IRS — Internal Revenue Service: a U.S. Government agency responsible for collecting of taxes, and enforcement of the Internal Revenue Code
Tax deductible — a qualified expense that may reduce the amount of income subject to taxation
Tax exempt — not subject to taxation
Taxable — subject to taxation

A. Employer Group Health Insurance

1. Disability Income (STD, LTD)

Premiums paid by the employer for disability income insurance for its employees are deductible as a business expense and are not considered as taxable income to the employee.

Benefits received by an employee that are attributable to employer contributions are fully taxable to the employee as income.

When the employer and employee share in disability insurance premium contributions, the employee’s contribution is not deductible; however, benefits received by the employee that are attributable to the employee's portion of the contribution are not taxable as income. The taxation of income received by the employee would depend on the type of a group plan:

- **Noncontributory** – The employ**er** pays the entire cost of the disability

insurance premium, so the income benefits are included in the employee's gross income and taxed as ordinary income.
- **Fully contributory** – The employ**ee** pays the entire cost of the disability insurance premium, so the income benefits are received income tax free by the employee.
- **Partially contributory** – The cost of disability insurance is paid partially by the employ**er** and partially by the employ**ee**. The portion paid by the employee is received income tax free and the portion paid by the employer is included in the employee's gross income and taxed as ordinary income.

For example, if an employee contributes 40% of the premium and receives a benefit of $1,000, only $600 (60% = employer contribution) of the benefit payment will be taxed to the employee as income, while $400 (40% = employee contribution) will be received tax free.

Know This! Disability insurance premiums are deductible as business expense; benefits are taxable income for employee.

Short-term disability (STD) group plans usually have a benefit period of less than 2 years. It is common in this type of disability income plans to place a maximum dollar amount on the benefit that will be provided regardless of earnings, and to have an elimination period (except for disability resulting from accidents).

Long-term disability (LTD) group plans usually pay benefits for 2 years or longer.

Benefits Subject to FICA

Benefits paid to disabled employees that are attributable to the employer's contribution are subject to Federal Insurance Contributions Act (FICA) withholding for Social Security purposes. Any portion of the benefit paid for and deducted by the employer will be considered taxable income to the employee.

2. Medical and Dental Expense

For **group medical and dental expense insurance**, any premium paid by the employer is deductible as a business expense. However, any premiums provided by the employee are only deductible to the extent that the employee premium, when added to all other unreimbursed medical expenses, exceed a certain percentage of the insured's adjusted gross income, for individuals who itemize their deductions.

Most people who itemize their deductions can claim **deductions** for unreimbursed medical expenses (those that are not covered by health insurance) that exceed **7.5%** of their adjusted gross income (AGI).

Group medical and dental expense benefits are received income tax free by the employee.

Know This! Premiums paid by an employer are tax deductible as the employer's business expense.

3. Long-term Care Insurance

The following general rules apply to taxation of long-term care policies:

- Premiums may be deductible;
- Daily benefits from the LTC policy are received income tax free, as long as they do not exceed the daily cost of long-term care; and
- Benefits paid in excess of the cost of care received are taxed as ordinary income.

B. Business Disability Insurance

1. Key Person Disability Income

Key person disability income *premiums* are **not deductible** to the business, but the *benefits* are received income **tax free** by the business.

2. Buy-sell Policy

Disability buy-sell insurance is typically written to cover partners or corporate officers of a closely held business. The policy provides funds for the business organization to purchase the business interest of a disabled partner. In a disability buy-sell policy, whether a cross purchase or entity, the *premiums* are **not deductible** to the business, but the *benefits* are received income **tax free** by the business.

C. Consumer Driven Plans

1. Health Savings Account

Health savings accounts (HSAs) are designed to help individuals save for qualified health expenses that they, their spouse, or their dependents incur. An individual who is covered by a high deductible health plan can make a tax-deductible contribution to an HSA, and use it to pay for out-of-pocket medical expenses. Contributions by an employer are not included in the individual's taxable income.

Health Savings Accounts (HSAs) feature tax-deferred growth, and enable the insured to pay for medical expenses with pre-tax income. Excess funds can be carried over to the next year. Regardless of how income is earned, any money deposited into an HSA is considered an "above-the-line" deduction, giving a 100% write-off against adjusted gross income.

Health Savings Accounts provide a broad range of tax-free withdrawals including

- Doctors, dentists and hospitals;
- Artificial limbs;
- Drugs;
- Eyeglasses and contacts;
- Chiropractic;
- Laboratory expenses;
- Nursing home costs;
- Physical therapy;

- Psychoanalysis;
- X-rays; and
- Nursing home insurance premiums.

2. Health Reimbursement Account

Health Reimbursement Accounts (HRAs) consist of funds set aside by employers to reimburse employees for qualified medical expenses, such as deductibles or coinsurance amounts. Employers qualify for preferential tax treatment of funds placed in an HRA in the same way that they qualify for tax advantages by funding an insurance plan. Employers can deduct the cost of a health reimbursement account as a business expense.

The following are key characteristics of HRAs:

- They are contribution healthcare plans, not defined benefit plans;
- Not a taxable employee benefit;
- Employers' contributions are tax deductible;
- Employees can roll over unused balances at the end of the year;
- Employers do not need to advance claims payments to employees or healthcare providers during the early months of the plan year;
- Provided with employer dollars, not employee salary reductions;
- Permit the employer to reduce health plan costs by coupling the HRA with a high-deductible (and usually lower-cost) health plan; and
- Balance the group purchasing power of larger employers and smaller employers.

In **Health Reimbursement Accounts (HRAs)**, the employer's contribution is tax deductible in the year in which the reimbursement is made to the employee. The employee is not taxed on receipt of the benefit. Benefits must be paid solely to the employee for medical care expenses for the employee, the employee's spouse or dependents. If funds are distributed for other than medical care expenses, the benefit is considered to be taxable income to the employee.

3. Flexible Spending Accounts (FSAs)

A **Flexible Spending Account** (FSA) is a form of cafeteria plan benefit funded by salary reduction and employer contributions. The employees are allowed to deposit a certain amount of their paycheck into an account before paying income taxes. Then, during the year, the employee can be directly reimbursed from this account for eligible health care and dependent care expenses. FSA benefits are subject to annual maximum and "use-or-lose" rule. This plan does not provide a cumulative benefit beyond the plan year.

There are 2 types of Flexible Spending Accounts: a Health Care Account for out-of-pocket health care expenses, and a Dependent Care Account (subject to annual contribution limits) to help pay for dependent's care expenses which makes it possible for an employee and their spouse to continue to work.

An FSA is exempt from federal income taxes, Social Security (FICA) taxes and, in most cases, state income taxes, saving 1/3 or more in taxes. If the plan favors highly compensated employees, the benefits for the highly compensated employees are not exempt from federal income taxes.

Know This! FSAs may be used to pay medical and dental expenses for employees and their dependents.

Child and dependent care expenses must be for the care of one or more qualifying persons:

- A dependent who was under age 13 when the care was provided and who can be claimed as an exemption on the employee's Federal Income Tax return;
- A spouse who was physically or mentally not able to care for himself or herself; or
- A dependent who was physically or mentally not able to care for himself or herself and who can be claimed as an exemption (as long as the person is earning gross income less than an IRS-specified amount).

Persons who cannot dress, clean, or feed themselves because of physical or mental problems are considered not able to care for themselves. Also, persons who must have constant attention to prevent them from injuring themselves or others are considered not able to care for themselves.

The insured may change benefits during open enrollment. After that period, generally, no other changes can be made during the plan year. However, the insured might be able to make a change under one of the following circumstances, referred to as *qualified life event* changes:

1. Marital status;
2. Number of dependents;
3. One of dependents becomes eligible for or no longer satisfies the coverage requirements under the Medical Reimbursement plan for unmarried dependents due to attained age, student status, or any similar circumstances;
4. The insured, the insured's spouse's or qualified dependent's employment status that affects eligibility under the plan (at least a 31-day break in employment status to qualify as a change in status);
5. Change in dependent care provider; or
6. Family medical leave.

The IRS limits the annual contribution for Dependent Care Accounts to a specified amount that gets adjusted annually for cost of living. This is a family limit, meaning that even if both parents have access to flexible care accounts, their combined contributions cannot exceed the amount.

Tax Considerations for Health Insurance

	PREMIUMS	BENEFITS
Individual Disability Income	Not deductible	Not taxable
Group Disability Income	Deductible for employer	Taxable
Individual Medical	Not deductible*	Not taxable
Group Medical	Deductible for employer	Not taxable
Individual Long-Term Care	Not deductible*	Not taxable
Group Long-Term Care	Deductible for employer	Not taxable

Individual Medicare Supplement	Not deductible*	Not taxable
Group Medicare Supplement	Deductible for employer	Not taxable
Buy-Sell	Not deductible	Not taxable
Key Person	Not deductible	Not taxable
Business Overhead Expense (BOE)	Deductible for employer	Taxable
MSAs	Deductible	Not taxable when used for medical expenses Taxable when taken out at end of year
FSAs	Not deductible	Not taxable
HRAs	Deductible	Not taxable
HSAs	Deductible	Not taxable when used for medical expenses Taxable, plus 20% penalty under 65 for nonmedical use; no penalty over 65

* Unless combined premiums and unreimbursed medical expenses exceed 10% of adjusted gross income (or 7.5% for individuals age 65 or older), and subject to the tax-qualified limitations.

Please note that not all plans are discussed in every state. Refer to your text to learn which plans apply in your state.

D. Chapter Recap

This chapter explained taxation of various health insurance policies. Let's recap some of the major points:

TAX TREATMENT OF PREMIUMS AND PROCEEDS

Personally-Owned Health Insurance	• Premium payments nondeductible • Benefits received tax free
Employer-Provided Health Insurance	• Premium payments made by employer deductible as a business expense • Benefits received by employee taxable to employee as income • Types of employer health plans: - *Noncontributory* - employer pays entire cost; benefits part of employee's gross income and taxed income - *Fully contributory* - employee pays entire cost; benefits received tax free by employee - *Partially contributory* - cost shared by employer and employee; portion paid by employee is received tax free and portion paid by employer is part of employee's gross income and taxed as ordinary income • *Medical and dental expense* - employer premiums are deductible; premium by the employee is not deductible • *Long-term care* - premiums are deductible; daily benefits that do not exceed costs are tax free; excess costs are taxed • *Accidental death and dismemberment* - policies are deductible to employer; benefits are tax free
Coverage for Sole Proprietors and Partners	• Deduct 100% of medical expense cost

	• Provided to self-employed and families • May not exceed taxpayer's earned income
Business Disability	• Key Person: - Premium not tax deductible to business - Benefits tax free by business • Buy-sell agreement: - Premiums not deductible to business - Benefits tax free by business
Consumer-driven Plans	• HSAs - tax-deferred growth; excess funds can be carried over to the next year • HRAs - contribution plans; employee's contribution tax deductible • FSAs - salary reduction and employer contribution; annual maximum and use-or-lose rule