CHAPTER SEVEN

Out-of-Pocket Healthcare: Turning Everyday Expenses into Tax Savings

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Healthcare is a major expense for many people, and its costs continue to rise even among people who receive little care throughout the year. The cost of insurance premiums has risen significantly over the past decade. One study from Kaiser shows that premiums have increased by 131 percent since 1999. In addition to premiums, the cost of treatment is going up as well, and some insurance policies fail to cover all of the treatments required. With the cost of healthcare increasing faster than the growth of income, many Americans are feeling this expense deep in their wallets.

Fortunately, there are a few ways to reduce some of the financial burden caused by exorbitant healthcare costs. As the government attempts to rein in the rising costs of healthcare through its Affordable Care Act, individual taxpayers can also take advantage of a smart tax strategy to minimize the cost of medical expenses. By understanding
what tax opportunities exist for deducting your medical costs, you can find ways to pay for healthcare with pretax dollars, which will help you keep more of your own money in your pocket.

As with any proactive tax strategy, the key to maximizing medical deductions is to find ways to deduct money that you’re already spending. By writing off these necessary costs on your taxes, you can shave money off your annual tax bill and free up funds that would otherwise have been sent to the IRS. Coupling these strategies with other aspects of your proactive tax plan will keep your tax bill as low as possible.

**Healthcare Deductions**

Every taxpayer is eligible to deduct a portion of his or her healthcare expenses. This itemized deduction can help cover non-reimbursed medical expenses for things like insurance premiums, deductibles, and coinsurance payments. In order to qualify for the deduction, however, your expenses must first exceed 10 percent of your Adjusted Gross Income; only expenses over that figure are deductible.

In other words, if you have an adjusted gross income of $100,000, you cannot deduct any medical expenses under $10,000. Costs over $10,000 can be deducted. Obviously, most taxpayers will not pay enough for medical care to claim this deduction every year, but they may qualify in years with medical emergencies or other unusually high costs. In these cases, it’s important that you always remember this deduction so that you can get your taxes adjusted appropriately.

The healthcare deduction can absolutely be helpful for many taxpayers, but it’s not the only way to save money on your taxes. If you are a small business owner, you can see substantial tax savings by utilizing a medical expense reimbursement plan, or MERP. Even if you don’t qualify for a MERP, you may still get a valuable tax break by utilizing a health savings account (HSA).
Medical Expense Reimbursement Plans

Medical expense reimbursement plans are a powerful tool for businesses looking to save money on their taxes while offering medical coverage to their employees. Rather than purchasing a group insurance plan for the company’s employees, a MERP allows the employer to reimburse the employees only for the expenses actually incurred throughout the year. In this way, employees have the opportunity to choose whatever insurance policy they wish rather than being limited to an employer-provided plan. Best of all, MERPs are 100 percent tax deductible for the employer, so every cent paid out to employees can be deducted. This creates a win-win situation for both the employer and the employee, and it’s one of the most effective ways to provide high quality medical care to employees without tremendous overhead.

If you own a business and are providing health insurance to your employees, you should look into a MERP as an affordable and flexible option. Aside from reimbursing the cost of health insurance premiums, you can also reimburse and deduct many other qualifying medical expenses:

- Insurance premiums for major medical, Medicare and Medigap (a Medicare Supplement).
- Coinsurance, copays and deductibles.
- Prescription and over-the-counter medications when prescribed by a doctor.
- Chiropractic, dental and vision expenses.
- Fertility treatments.
- LASIK surgery.
- Special schools and therapy.

Essentially any treatment prescribed by a doctor can be covered by a MERP, including unexpected expenses like hot tubs installed for therapeutic reasons. Additionally, a MERP will cover medical expenses for an employee’s spouse and dependents. Because MERPs can cover entire families, they create an additional opportunity for many small business owners. If you are the
owner of a small business, you can cover your own medical expenses by establishing a MERP for yourself or your spouse when one of you is a bona fide employee of the company. This allows you to deduct 100 percent of the medical expenses you are already paying out of pocket.

How to Establish a MERP for Your Small Business

In order to receive benefits under a medical expense reimbursement plan, an individual must be a legitimate employee of the company. This means that you cannot create a MERP for yourself as a sole proprietor or partner. You can, however, hire your spouse and pay him or her in medical benefits. Because spousal medical expenses are covered by a MERP, your spouse’s reimbursements can be used for your own healthcare costs. In effect, this allows you to fully deduct your own medical expenses while staying entirely within the letter of the law.

The way you establish a MERP will vary somewhat depending on the type of business you own. Some business designations lend themselves more naturally toward this than others. Here are your options:

- If you run the business as a sole proprietorship, you can hire your spouse as an employee.
- If you have a partnership, you can hire your spouse as an employee as long as that spouse is a limited partner or does not hold an ownership interest in the business.
- In a C corporation, you can hire yourself as an employee of the company and establish a MERP for yourself that way.
- If you own an S corporation, however, you cannot establish a MERP for any employee with more than 2 percent of the business’s ownership.

As you can see, an S corporation is the least tax advantageous corporate structure for utilizing a MERP. However, you can still establish a MERP if you open a secondary business with a different designation. You can discuss this option with your Certified Tax Coach to see whether it will work for your business.
Depending on your business type, you may be able to split your business into two parts and designate the second one under a tax designation that will allow a MERP for yourself or your spouse. For example, if you’re a doctor who also publishes papers or speaks at conventions, you might be able to classify these secondary activities as a separate business rather than leaving them as part of your S corporation activities. This doesn’t have to be a daunting process, and you may find other tax benefits from dividing your business activities in this way.

**MERP Limitations**

Although establishing a MERP for your spouse can be a very smart tax decision, it’s not something to attempt without the guidance of a tax professional. You will need to be careful to set up the MERP correctly to avoid audits and other potential problems with the IRS.

First, you will need to carefully document your spouse’s work in order to prove that he or she is an actual employee of your business. It will not work to designate your spouse as an employee in name only; you will need to prove the services your spouse provides are essential to the business and warrant the medical expenses you pay through the MERP.

For example, you might hire your spouse to do your bookkeeping for you, or to act as your assistant by answering phone calls and fielding emails. These are legitimate business tasks that can qualify your spouse as an employee. In fact, these are the types of activities that your spouse may already be doing to help with your business without even being officially hired.

To document this work, you will want to keep track of how many hours of work the employee completes and what activities were done during that time. Because it’s possible to pay your employee in benefits alone rather than wages, you do not need to establish a payroll or have W-2 for the work. You do, however, need to justify why the benefits are fair compensation for the work the employee has done. If your spouse does only a few hours of work for
you each year but receives thousands in medical expense reimburse-
ments, you may run into trouble with the IRS.

Aside from keeping careful records of your spouse’s work, you
will need to pay attention to a few other rules regarding the main-
tenance of a MERP. These rules are especially important in busi-
nesses with multiple employees:

• Your plan must cover all employees. In other words, you can-
  not hire your spouse and pay for his medical expenses while
  not paying medical expenses for your other employees. You
  can, however, exclude part time employees who work fewer
  than 35 hours per week, employees under the age of 25 and
  any employee who has worked for you for fewer than three
  years.

• If you own multiple companies, you must provide similar
  benefits to the employees of both. For example, if you have
  a business with 50 employees and a secondary business with
  just your family members, you cannot extend medical ben-
  efits to your family without offering the same benefits to the
  employees of your larger company.

• If your business is affiliated with another business and receives
  more than 50 percent of its profit from that business, the two
  businesses will be treated as one entity as far as MERPs are
  concerned.

When you set up the medical expense reimbursement plan, it
helps to write out a detailed plan document and summary plan de-
scription. This document will explain the type of benefits you will
offer and the value of those benefits. You can check with your tax
professional for guidance on drafting this document.

As you can see, a MERP is a powerful way to manage the cost of
healthcare and provide valuable benefits to your employees. These
health plans can get complicated, however, and not every taxpayer
will qualify for one. If you do not own your own business or are
otherwise unable to take advantage of a MERP, you may wish to
look for another way to reduce your health care related tax burden.
Health Savings Accounts

A health savings account, or HSA, is an excellent tool for setting aside money to cover medical expenses. Anyone can qualify for an HSA, including business owners and employees. You do, however, need to be enrolled in a qualifying insurance plan with a high deductible. Once that plan has been established, you simply need to set up a health savings account at the bank of your choice.

The funds you deposit are tax deductible, and the withdrawals from the account are not taxed. This allows you to pay for medical expenses with tax-free dollars, which saves more of your earnings for other costs. An HSA can be used for several purposes:

- Copayments, coinsurance and deductibles
- Prescription drugs
- Certain necessary over-the-counter drugs
- Other qualifying medical expenses

Your contributions to the HSA are capped at $3,300 for an individual policy or $6,550 for a family policy. Taxpayers over age 55 can pay an additional $1,000 into the policy each year as a catch-up. These contributions can roll over to future years, which allow you to grow your available funds over several years and use them for emergency expenses.

In this way, an HSA is ideal for a healthy worker: After a year or two of consistent tax-deductible contributions, all out-of-pocket deductibles and coinsurance can be paid from the HSA. If you’re not in a position to pay high medical expenses each year, an HSA is a smart way to grow your healthcare savings.

Using an HSA in Conjunction With a MERP

An HSA is not as flexible as a MERP, but it’s a valuable tax planning tool all the same. In fact, you can utilize an HSA in conjunction with a MERP for maximum health insurance savings. Here is a practical example:

Let’s say that a family has a taxable income of $100,000 before any medical expenses are deducted. The family pays $2,500 annually
in insurance premiums for a high deductible insurance policy. In addition, they use funds placed in an HSA to cover $6,000 worth of co-pays, deductibles and prescription drugs throughout the year.

Because they used the HSA, they can save on regular income tax. Assuming a tax rate of 20 percent, this amounts to a savings of $1,600 in taxes through using pre-tax dollars out of the HSA. If this same family were to use a MERP, however, they could increase that tax savings by 85 percent. This is because a MERP reduces FICA as well as regular employment tax. By combining their MERP and HSA, this family can dramatically reduce its tax burden.

Remember that you can also combine an HSA with your standard itemized deduction if your medical expenses for a given year happen to go over the 10 percent threshold established by the IRS. For example, if you are involved in a serious auto accident that results in substantial hospitalization, surgery or other costly treatments, it’s possible that your healthcare costs can exceed the balance of your HSA before reaching the insurance company’s out-of-pocket maximum. In this case, you can claim a deduction for any medical expense that will not be reimbursed once the expenses total more than 10 percent of your total AGI.

Other Healthcare Deductions

Aside from establishing a medical expense reimbursement plan, business owners can take advantage of other tax breaks to reduce their total tax burden when they provide health insurance. The small business health insurance tax credit was established to encourage small businesses to provide their employees with insurance in conjunction with the insurance mandate created by the Affordable Care Act. If you choose to purchase a group health insurance policy for your employees rather than a MERP, you can take advantage of this tax credit.

Small businesses with fewer than 25 full-time employees can qualify for a powerful tax credit to offset the cost of providing health insurance. In order to qualify, the average wage for your employees
must be below $50,000, and you must pay at least half of the health-care cost for your employees.

As of 2013, qualifying small businesses can enjoy a 35 percent tax credit; non-profit employers can claim a 25 percent tax credit. In 2014 and beyond, this credit will increase to 50 percent and 35 percent respectively.

If you are unable to use the full tax credit in any given year, you can roll it forward to future tax years. You can also amend your previous years’ taxes to apply the credit to your returns. This tax credit is frequently overlooked, so it’s a good idea to check your previous tax returns to verify that your tax preparer applied this credit. If not, it might be time to look for a new tax professional.

When considering your insurance options for your employees, look carefully at the difference between setting up a MERP and a group policy. Both options will give you powerful tax incentives, but your employees may have a strong preference for one choice over another. If you do choose to implement a MERP rather than a group plan, just remember the above-mentioned limitations on discrimination: Whatever benefits you offer to some of your employees must be extended to all of them.

**Affordable Care Act Tax Credits**

Under the Affordable Care Act, often called “Obamacare,” individuals are required to either purchase health insurance or pay a tax penalty. In order to offset the cost of healthcare under this plan, the government offers tax credits. (The lower an individual’s income, the higher the tax credit.) These credits begin to phase out at higher incomes depending on the taxpayer’s family size.

Unlike other tax credits, the credits offered by the ACA are not given as refunds at the end of the tax year. Instead, they are offered at the beginning of the year and are applied directly to the insurance policy. In effect, these credits work to reduce the cost of insurance premiums. However, they do not apply toward any out-of-pocket healthcare expenses.

In order to get the best value for your dollar, it makes sense to purchase a high-deductible insurance policy and use any government
tax credit you may qualify for with your income. You can then establish an HSA to cover the remainder of your out-of-pocket healthcare expenses. If you have a low enough income to qualify for a higher tax credit, you may prefer to purchase a policy with a lower deductible. It’s worth investigating your options to make the best choice for you and your family.

The Power of a Proactive Tax Strategy

The rising cost of healthcare is something outside of our control. Although the government can attempt to keep costs low through individual mandates and healthcare reforms, there are no guarantees about what will happen to insurance premiums and other medical expenses in the future. A smart tax strategy, however, can help you save money and provide some security to your family.

The key to proactive tax planning is to work with a Certified Tax Coach to find ways to deduct the expenses you are already paying. There is no point in taking a tax deduction if it requires you to pay more for goods or services, especially if you don’t actually need them. By partnering with a Certified Tax Coach, you can identify the major expenses in your budget and find a way to write those expenses off on your taxes. A bit of creative accounting can make a huge difference in your tax bill and help put more money in your pocket.
Chapter Seven

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Diane Gardner, the Entrepreneur’s Choice for Your Financial Future, is a native of Idaho. She has been working in the accounting field with small businesses since 1982. She is the founder of Adept Business Solutions and Tax Pro Solutions which meet the needs of her clients by providing full service accounting and tax planning services.

Diane is a graduate of San Jose State University where she majored in accounting. She is an Enrolled Agent (EA) which allows her to prepare income tax returns in all 50 states. Diane is also a QuickBooks Pro advisor, an Accredited Tax Preparer (ATP) and a Certified Tax Coach (CTC). Certified Tax Coaches are an elite group of professionals who focus on helping businesses and individuals pay the least amount of tax that is legally possible.

Diane’s goal is to be sure business owners pay the least amount of tax they can legally pay. This is accomplished through proactive tax planning. Her clients generally realize an average tax savings between $5,000 and $50,000 per year. She is saving businesses, one tax return at a time!

Diane is currently working on her fifth book, *Growing Your Business in the New Economy*, which should be released summer of 2014. This book is filled with proven strategies that all business owners can utilize to help them not only grow their businesses, but to increase profits too.

Diane is married, and has a daughter and one grandchild. She enjoys reading, camping, picnics in the woods with her husband, Dutch oven cooking, and spending time with her family.

Diane is active in her church and serves on the board of the Twin Lakes Friends Camp. She is also active in the Rathdrum Chamber of Commerce where she chairs the Economic Development Committee, the Spirit Lake Chamber of Commerce where she holds the office of Treasurer, and the Coeur d’Alene Chamber of Commerce.

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