

INSURANCE PRODUCTS

A limited number of medical savings accounts can now be funded with tax-deductible dollars as part of a demonstration project. A look at the program.

Experimental MSAs Offer Useful Approach for the Self-Employed

By Peter Katt

In this column, I cover an insurance-related product that is somewhat outside the traditional purview of my columns. Nonetheless, it concerns an area that is of considerable interest to most self-employed—healthcare and the new experimental medical savings account (MSA) program.

Medical savings accounts were created as a demonstration project under the Health Insurance Portability & Accountability Act of 1996. Starting this year, self-employed individuals can contribute tax-deductible money to a medical savings account to pay for medical expenses combined with a major medical insurance policy. Employers with less than 50 employees can also fund medical savings accounts for their employees. Details about each appear below.

Our government has limited the number of MSA participants to the first 750,000. Proponents herald medical savings accounts as a way of greatly increasing individual control over medi-

cal care and cost decisions while opponents believe medical savings accounts will only benefit well-to-do healthy individuals with no benefit to others, leading opponents to favor a more centralized system.

Reasons for Reform

Wage controls following World War II caused employers to develop more creative ways to increase employee compensation as a way of competing for the best talent. One of these ways was providing healthcare insurance as an employee benefit. Over time, benefits became extremely generous (especially in lowering out-of-pocket employee costs) and the tax code was structured to treat health insurance costs very favorably. Then along came Medicare and Medicaid. Within several decades patients and medical care providers became disconnected from the financial aspects of medical care, as it came to be considered an entitle-

ment with no real limits on the amount of care available. Concurrent with this invisible financing and the illusion of limitless healthcare was an explosion of very expensive medical technology.

As aggregate private and government medical costs soared out of control, the current healthcare crisis was born.

At the core of the healthcare crisis is the fact that healthcare costs paid by employers and the government (taxpayers) have evolved into a financing plan rather than adhering to the principles of traditional insurance.

Healthcare financing refers to a system that pays even first-dollar healthcare costs (in other words, very low deductibles) on a collective basis via employer or government funding. Such a system creates its own set of incentives for patients and providers. The only way to substantially reduce the cost of such a system is to lower payments to providers, which will have an adverse effect on the quality of services provided, and to ration the amount of healthcare available to patients.

On the other hand, traditional insurance is intended to provide protection against large unforeseen medical care costs by collecting a relatively small sum from each insured, each of whom has about the same chance of incurring large medical costs. Therefore, medical insurance would not cover routine medical care costs (up to specified dollar amount), but only large ones that might otherwise cause significant financial hardship on families. By way of analogy, homeowners insurance doesn't cover yard work, house cleaning, painting, remodeling, etc., but instead covers the home's replacement cost in the event of a catastrophic occurrence such as damage caused by fires and tornadoes. The amount of time and resources devoted to home maintenance is therefore an individual decision.

Employer-provided healthcare premiums are fully tax-deductible. Out-of-pocket costs that employees have to pay before insurance coverage begins are an aftertax expense to the employee. Therefore, the economic incentives have favored the evolution of this

Peter Katt, CFP, LIC, is sole proprietor of Katt & Co., a fee-only life insurance adviser located in Kalamazoo, Michigan (616/372-3497). His book, "The Life Insurance Fiasco: How to Avoid It," is available through the author.

health financing system. But it is first-dollar coverage that has significantly caused healthcare costs to skyrocket because employees have no medical cost-containment incentives.

In response to this situation, some companies, notably Forbes magazine and Golden Rule Insurance Company, instituted their own versions of medical savings accounts, but without any special tax advantages. Essentially, these companies set up a fund employees would use to directly pay healthcare costs up to a certain limit, such as \$1,000. To the extent the specified amount wasn't used in a given year, the employee received a cash bonus of up to twice the amount not used for medical bills annually. Amounts used to fund deductible and co-pay costs, and cash bonuses, were included in the employees' income and taxable to them, while deductible by the employer as compensation. Companies using these non-tax-deductible medical savings accounts have reported experiencing significant savings in their combined healthcare costs because employees were provided with an incentive to be cost-conscious, which has driven down their premiums.

Self-Employed MSAs

A self-employed medical savings account is purchased from an insurance company. (For information about medical savings accounts and companies offering them you might contact Council for Affordable Health Insurance, 703/836-6200.) The MSA insurance plan typically has three components: the medical savings account; an out-of-pocket cost; and a major medical insurance policy, typically with \$2.0 million lifetime coverage per covered person. An individual with one or more dependents can make a maximum tax-deductible contribution to a medical savings account each year of \$3,375, which is 75% of the maximum amount (\$4,500) that can be used each year to pay medical bills from the MSA. Typically, the MSA plan will have a total deductible amount of \$4,500 before major medical coverage kicks in.

Let's look at an example: Bob is self-employed. He purchases an MSA plan and makes his first \$3,375 tax-deductible MSA contribution, plus the annual premium for major medical insurance for which he is entitled to take 40% as a deduction from his income. Bob and his family have medical bills of \$5,000 the first year: \$3,375 is paid from the MSA, the next \$1,125 is paid by Bob personally without a tax deduction (totaling \$4,500, which is his deductible amount), and the remaining \$500 is paid by the insurance company. The next year Bob again makes a tax-deductible contribution of \$3,375 to his medical savings account plus his insurance premium. During the second year his family has only \$1,000 of medical bills. All \$1,000 is paid from the medical savings account, leaving a balance of \$2,375 (this ignores the interest the medical savings account earns). The third year Bob again contributes his tax-deductible \$3,375 and pays the premium, bringing the MSA total to \$5,750. During the third year Bob's family has medical bills of \$6,500. Since Bob's deductible is \$4,500, this is the amount paid out of his medical savings account with the remaining \$2,000 covered by his major medical insurance plan, leaving an MSA balance of \$2,000 going into the fourth year. If included in the medical bills of \$6,500 were services not covered by the major medical insurance plan, but allowed as MSA expenses (such as dental), these bills could be paid from the medical savings account also.

The MSA plan is not a financing plan, it truly is insurance because the first \$4,500 of medical costs each year are paid from Bob's medical savings account or are paid out-of-pocket. Bob's ability to deduct from income his MSA contributions levels the playing field with healthcare premiums paid by employers.

Amounts remaining in Bob's medical savings account at the end of each year are rolled over to subsequent years, but continue to be subject to the \$4,500 medical payments annual limit. Withdrawals for anything but the payment of approved medical bills are subject

to ordinary income taxes and penalties before age 65 except for the payment of long-term care insurance premiums. After age 65, withdrawals are subject to ordinary income taxes without any penalties.

Interestingly, retired investors under age 65 who have enough self-employed income to cover the MSA funding and 40% of the premium cost (the amount that can be deducted from income) can obtain the tax advantages of using an MSA plan and, as I understand it, it may be coordinated with Medicare.

Employer-Provided MSAs

Employers with 50 or fewer employees may also institute an MSA insurance plan. These work like self-employed MSA insurance plans. That is, employers will make the tax-deductible contributions to each individual employee's medical savings account, with a major medical plan paying costs above the medical savings account and any additional deductible or co-pay requirements. Whether employer-provided medical savings accounts will be perceived by employees as an improvement or whether employers will benefit from better cost containment depends on what kind of healthcare coverage was previously provided and how the MSA insurance plan is communicated to employees. In fact, non-tax-deductible medical savings accounts discussed earlier in this column offered by such companies as Forbes magazine and Golden Rule Insurance Company may be perceived as superior to the new tax-deductible employer-provided medical savings accounts because receiving a cash bonus of unused medical funds each year is an immediate employee incentive, whereas the new MSA plan incentives are less obvious and longer-term. Perhaps creative employers will be able to devise a hybrid that can incorporate immediate cost-containment incentives of the non-deductible medical savings account within the new tax-deductible medical savings accounts. (Remember that the new medical savings accounts are only available for employers with 50 or fewer

employees.)

Conclusion

Medical savings accounts are a radical improvement for the self-employed. Tax-deductible medical savings accounts for employers may be disappointing without some improvements or creative employer improvisation;

non-tax-deductible medical savings accounts for employers should continue to achieve cost containment because they have significant incentives.

It will be interesting to see how the MSA experiment fares. If it survives, the medical savings account could be improved to such an extent that it could be used by millions of Americans instead of Medicare, thereby greatly in-

creasing the solvency prospects for Medicare: MSA users would still pay Medicare payroll taxes, but voluntarily not use it. This could come about if MSA funding were allowed to increase, say, to \$10,000 a year; insurance companies sold an integrated MSA plan lasting a lifetime; and MSA cash values not used could be left to heirs. And that would be a significant benefit to all. 

Learn About Mutual Funds While You Cruise the Alaskan Shore

Sign up now for
AAII's Seminar Cruise Through
Alaska's Beautiful Inside Passage July 21-28, 1997.

In the exciting atmosphere of seven days touring the longest sheltered inlet in the world, you can learn the concepts and techniques needed to successfully invest in mutual funds. Two 3½ hour teaching sessions on board leave you plenty of time to enjoy the scenic vistas and the ship's luxury accommodations.

Your Cruise Ship

MS Veendam

Holland America Line's luxury ship with comfortable and spacious staterooms and a full complement of facilities and activities for your pleasure.

Ports of Call

Juneau	Ketchikan
Skagway	Vancouver
Glacier Bay	



Holland America Line
A TRADITION OF EXCELLENCE®

The strategies involved in analyzing, selecting, and monitoring mutual funds will be taught by Jack Rader, adjunct professor in the finance department at the University of South Florida's College of Business Administration and executive director of the Financial Management Association. He will cover all aspects of mutual fund investing from interpreting fund prospectuses to managing a portfolio of funds. Essential questions that will be answered for you in the course of the presentations include:

- How important are sales commissions and fund charges and how do I identify them?
- How do I interpret net asset value changes and fund distributions?
- Are there differences in the taxation of mutual funds?
- How important is risk when selecting a mutual fund and how can I judge risk?
- How do I sort through the thousands of mutual funds to find those I might want to study?
- What are the crucial factors when picking a mutual fund?
- When can I tell if my mutual fund investments are doing poorly?
- How do I go about creating a portfolio of mutual funds that will meet my financial goals?
- When should I change or rebalance my mutual fund portfolio as markets change or my goals change?

Your host for this unique cruise seminar will be Holland America Line's newest luxury cruise ship, the MS Veendam. This ship offers the latest in amenities, service, and international cuisine at an affordable price. Entertainment and activities range from orchestras or nightclubs with dancing to games of chance. Health facilities include a spa/gym, jogging track, saunas, and steam rooms.

Take advantage of the special group rate offered to AAI members and their immediate family for this unique combination first-class cruise and mutual funds seminar.

For a complete brochure and to register, call Special Event Cruises at 1-800-326-0373

Stateroom selection is on a first-come, first-served basis. Single persons can be matched with passengers of the same gender to share a stateroom for economy.

