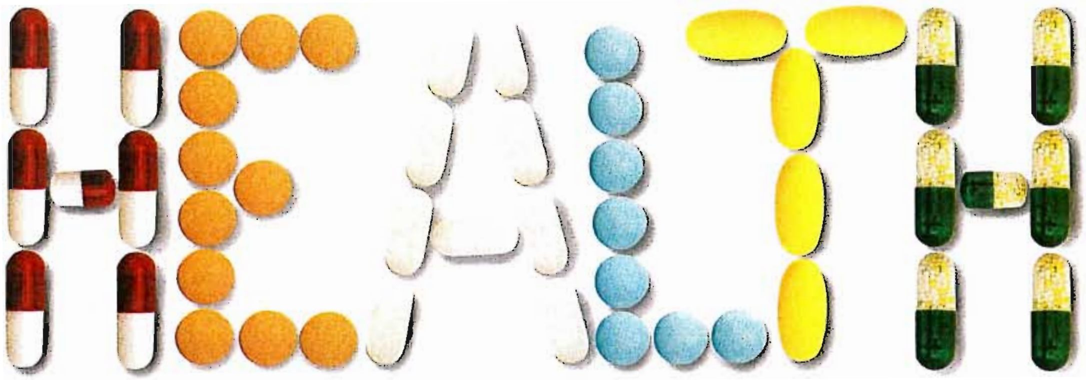
Business point

HEALTHY



PLAN DEDUCTIONS

The tax benefits of your health coverage can be just what the doctor ordered.

As health insurance and medical costs continue to increase, many producers will look at ways to manage these expenses. It's always a good idea to review your health insurance plan, but maybe it's also time to "evaluate" the tax implications of your health coverage. We suggest using the after-tax cost to evaluate comparisons.

Before discussing any possible tax savings, let's review the tax treatment for a sole proprietor. As a self-employed individual, your health insurance premiums are 100 percent deductible for federal tax purposes. State tax-deduction rates vary. If you're eligible to participate in a subsidized health plan, you can't claim the self-employment health insurance deduction.

Any other out-of-pocket qualified medical costs (doctor, dentist, etc.) are reduced by 7.5 percent of your adjusted gross income (from your tax return) before they count toward your Schedule A deductions. Hence, unless you itemize, qualified medical costs offer no tax savings.

To help evaluate the after-tax cost, let's examine a fictional family, the Johnsons:

- John Johnson is a married, sole-proprietor farmer living in Iowa.
- 2006 income is $50,000 (all self-employed income from farming).
- Health insurance premiums for John and family are $8,000.
- Out-of-pocket qualified medical expenses are $3,000.

The accompanying table demonstrates the after-tax calculations for the Johnsons' situation. They're in the 15 percent federal tax bracket; their deduction is 100 percent at a 7 percent Iowa tax bracket.

The after-tax cost for the Johnsons' health insurance and medical expense is $9,240. This is the total cost ($11,000) minus the federal tax savings ($1,200) minus the state tax savings ($560).

Tax-saving options

Section 105 Medical Reimbursement Plans: IRC Section 105(b). These plans are growing popular with sole proprietors who want to provide benefits to their employees and their families. Typically the only employee is the operator's spouse. In this situation, the operator (employer) would provide health insurance (including dental, vision, qualified long-term care and cancer insurance) and out-of-pocket reimbursement to the spouse (employee) and the family (including the operator). The key tax-savings benefit is that the health insurance premiums and out-of-pocket medical costs are 100 percent a business expense.

To demonstrate the tax savings, let's look at the Johnsons again. All the facts are the same except that John has hired his wife, Jane, and adopted a 105 medical reimbursement plan. The table below demonstrates the tax savings of their situation using the 105 medical reimbursement plan.

The after-tax cost for the Johnsons' health insurance and medical expense is $6,906. This is the total cost ($11,000) minus the Federal tax savings ($1,650) minus the self-employment tax savings ($1,674) minus the State of Iowa tax savings ($770).

To receive this tax savings using a Section 105 Medical Reimbursement Plan, it's essential the employee (spouse) is a "bona fide" employee of the business. To solidify this relationship, adopt a "Section 105 Plan" and follow the guidelines.

Tax professionals may administer their own plan or use a benefit company as the administrator. These plans typically cost between $125 to $200 per year. Your tax consultant can help you set up a plan and review the process with you.

If you establish a plan before the end of the year, you can deduct health insurance premiums back to Jan. 1 of that year. However, you can only deduct medical expenses after the plan is set up. Plans now allow for a "carry-over feature" for unused medical reimbursements as defined by the employer's stated maximum reimbursement amount.

Below are several points to help you decide if a 105 plan is for you. Your plan administrator should provide a complete checklist to help you comply.

- Pay your spouse reasonable total compensation and make regular cash wage payments. (Total compensation is the combination of cash wages and benefits.)
- Write an "employee contract" listing compensation, duties and maximum dollars for medical reimbursement.
- Keep accurate records, including hours worked and duties performed.
- Complete all IRS Forms such as: W-3 Form (annually), W-2 Form (annually), 941/943 Forms (quarterly or other frequency depending on specifics), I-9 Forms (one time), Form 940 for employees other than spouses. (Your state may require additional forms.)
- Deposit the spouse's paycheck into a separate personal account — not the business account.
- Complete claim forms for all reimbursed medical expenses.
- Pay Social Security tax on employee wages (this may reduce the employer's Social Security earnings).
- Plans must adhere to nondiscriminatory rules established by the Department of Labor's Employee Retirement Income Security Act.
- All employees are eligible to participate. However, the employer may offer the plan to employees within specific limits, such as minimum hours of work per week, number of months worked per year and others. Your plan documentation should specify these limits.

JOHNSONS' THEORETICAL HEALTH-CARE COST

EXAMPLE A	Cost	Federal tax savings	Self-employment savings	State (IA) savings	After-tax final cost
Insurance premium	$8,000	$1,200	$0	$560	
Qualified medical expenses	$3,000	$0	$0	$0	
Totals	$11,000	$1,200	$0	$560	$9,240

EXAMPLE B	Cost	Federal tax savings	Self-employment savings	State (IA) savings	After-tax final cost
Insurance premium	$8,000	$1,200	$1,224	$560	
Qualified medical expenses	$3,000	$450	$450	$210	
Totals	$11,000	$1,650	$1,674	$770	$6,906

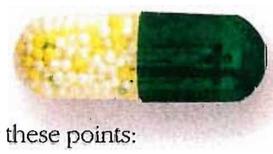
Source: Kent Vickre, Iowa Farm Business Association

Health Savings Account. The Health Savings Account (HSA) is growing popular as an alternative to "traditional health insurance." An HSA allows you to make tax-deductible contributions then later withdraw this money to pay for qualified medical expenses.

Requirements to qualify for an HAS are:

- You must be covered under a High Deductible Health Plan (HDHP).
- You cannot have any other health coverage (with exceptions for specific things such as disability, dental care, vision care).
- You cannot be enrolled in Medicare.
- You cannot be claimed as a dependent on someone else's tax return.

The amount of the HSA contribution is limited to the lesser of the health plan annual deductible or the IRS set limits. To claim your tax deduction, you must file Form 8889 with your individual tax return. You're also required to have a "qualified trustee" to administer your HSA account. Most financial institutions will provide this service.



Since the insurance costs vary, you will need to calculate your own "after-tax cost." Consider these points:

- Your HDHP premium has the same tax treatment as regular health insurance. Thus, the HDHP could be used in conjunction with other benefit plans.
- With the HSA, your out-of-pocket medical costs will be 100 percent tax deductible whether you itemize or not.
- All HSA account withdrawals and earnings are tax free as long as you use withdrawals for qualified medical expenses. ■

Editor's note: Kent Vickre and Chuck Cagley author a tax and finance column for each issue of Pioneer GrowingPoint® *magazine. Vickre is state coordinator of the Iowa Farm Business Association. Cagley is state coordinator of Illinois Farm Business Farm Management. They address issues that influence agribusiness success.*