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Voices Stop deducting medical expenses. Here's what to do instead

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In today's age of lost tax deductions many accountants are looking for new tax deductions they can offer their clients to offset the ones their clients have lost.

One available, yet little known, deduction is a medical expense account that allows a client to deduct various medical expenses when retired. Here are some questions and answers about medical expense accounts that you can use to inform your clients who are wondering about how to deduct their medical expenses in the wake of the Tax Cuts and Jobs Act:

What is a medical expense account under Section 401(h) of the tax code?

A medical expense account under Code Section 401(h) is an account within a defined benefit pension plan, or a money purchase plan. It's similar to a health savings account, but with higher contribution limits.

When can I expect a 401(h) benefit to be available to me?

401(h) benefits are only available when you retire. There is no 401(h) benefit available prior to retirement.

What can 401(h) benefits pay for?

Post-retirement 401(h) benefits are made available to reimburse post-retirement medical expenses not otherwise covered by insurance or governmental programs. This includes co-pays, deductibles, health insurance premiums, long-term care premiums, long-term care needs including facilities and at-home care, doctor bills, dental bills, hospital bills, cosmetic surgery, cost of medical equipment, weight loss programs and much more.

Can the 401(h) benefits be used for retirement?

No. The plan documents must make it impossible for the medical benefits account to be used for, or diverted to, any purpose other than providing medical benefits under the plan.

Can the 401(h) benefits be used for my family?

Yes. Any qualified medical expense that you, your spouse or your dependents incur can be paid tax-free from the 401(h) account.

What are the qualification requirements and can employers discriminate?

No, you may not discriminate. All full-time employees, those working 20 hours per week or more, will need to receive a small 401(h) benefit.

Is there a vesting schedule for a 401(h) account?

Unlike a 401(k) or a defined benefit account, an employee is only 100 percent vested upon retirement from the employer. Employees who leaves before they retire are 0 percent vested in the 401(h) account. Money that is forfeited by the other employees will be applied to reduce future contributions to the 401(h) account.

How much can be contributed to a 401(h) account?

Since a 401(h) account is part of a defined benefit plan, contributions are made to the defined benefit plan and the employer must, at the time it makes a contribution, designate a portion of the contribution that will fund the medical benefits. The contributions to fund medical benefits must be reasonable and ascertainable.

Because clients are funding both retirement and medical plans, contributions to a defined benefit plan with a 401(h) are much larger than a traditional defined benefit plan. The maximum contribution to a defined benefit plan with a 401(h) for a 40-year-old with $164,000 of income is $600,000.

Why should I have a 401(h) account in my defined benefit plan?

The Employee Benefit Research Institute recently released a report on the savings Medicare beneficiaries need for health expenses. The report shows that a 65-year-old couple needs $400,000 to pay for Medigap premiums, Medicare Part B premiums, Medicare Part D premiums, long-term care needs including facilities and at-home care, and out-of-pocket drug expenses during Retirement. All of these expenses can be paid for with the money in the 401(h) account. Contributions to a 401(h) account are tax-deductible and the money grows tax-free. When the money is withdrawn, it is tax-free as long as the money is used for qualified medical expenses.

Who else has a plan design like the 401(h)?

The following companies, along with others, offer a defined benefit plan with a 401(h) benefit for their retirees:

• AARP And Retired Persons Services Inc.

• Citigroup Inc.

• Nationwide Mutual Insurance Company

• The Farmers Automobile Insurance Association

• The Hartford Financial Services Group Inc.

• The Prudential Insurance Company Of America

• Wachovia Corporation

• Wells Fargo & Co.

Companies with a 401(h) feature in their defined benefit plan must use the code 1e on the Form 5500.

Can I add a 401(h) account to my existing defined benefit plan or 401(k)?

Yes, you can. Your current plan would need to be amended to incorporate the proper language. When added to a 401(k) or profit sharing plan, some of the rules change, but the money can still be withdrawn tax free.

What happens if i don't use all of the money in my 401(h) account?

The unused portion of the 401(h) account goes back to the employer, and the employer pays income tax on the unused potion. Unlike a defined benefit plan, there is no penalty or fine for unused 401(h) money that is reverted to the employer.

Why not just deduct medical expenses instead of contributing to a 401(h)?

401(h) accounts allow people to bypass the 7.5 percent threshold for medical expenses. Needless to say, people in higher income brackets often have difficulty meeting this threshold. Unlike the itemized medical deduction, 401(h) contributions are available regardless of whether you itemize any deductions and whether you incur enough medical expenses to qualify for the medical expenses itemized deduction.

What is the savings vehicle for a 401(h) account?

Traditionally life insurance is used as the funding vehicle for a 401(h) account, although any brokerage account can be used. When a retirement plan without a 401(h) feature terminates, the taxpayer can either terminate any life insurance in the plan and take the cash value or switch the owner of the policy from the retirement plan to the taxpayer. This creates a taxable event for the taxpayer. The taxpayer can also buy the policy from the plan if the taxpayer has the cash on hand. A 401(h) allows the taxpayer to use the cash value of the policy without paying taxes or having to come up with enough cash to buy the policy from the plan. If the taxpayer does not use the cash value of the life insurance for medical expenses, the taxpayer still has the death benefit of the life insurance.

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