



Tax Tips You Can Use Sept 2006

Medical Expense Deductions- A Personal Perspective Part 1

By Kathleen Crawford, EA

The article this month and next is about medical expense deductions. I wrote about medical expenses this time last year, but that article was very theoretical. These two articles are intended to be practical. The article this month is about the “big picture” of financing medical expenses and how that affects the medical deductions. The article next month is about what expenses are deductible.

As most of my clients know, I fell at home on an icy step and broke my right leg in February of 2006. Many Jacksonville neighbors saw me in various stages of hobbling to and from Jacksonville Physical Therapy. One would not think of a broken leg as a catastrophic medical situation, but the bills for my accident have already exceeded \$40,000.00. That would be catastrophic without medical insurance.

My family has an insurance policy using the new special program called the “Health Savings Account”(HSA). This program has tax advantages similar to an IRA. To qualify for this account, one must sign up for an HSA plan or high deductible insurance plan. Our insurance plan requires a \$3500.00 annual deductible. For most years, we never exceed the deductible. We can contribute up to our deductible amount (\$3500) into a special Health Savings Account and, at tax time, that amount is deducted from our income just like an IRA. We then use money from that account to pay for medical expenses. That makes the medical expenses untaxed dollars. I had only \$1000.00 in my account in February. To pay my medical bills, I used the HSA money to pay the first \$1000.00 of bills and then started spending money from my regular accounts. After I met the deductible, my insurance started to pay the bills.

The items that I can include in my medical expense deduction are the premiums for my health insurance and the moneys that I paid out of pocket except the money I used from my HSA account. That money is untaxed money, so I can't deduct it. In my case, I add up the insurance premiums of \$3000.00, my deductible of \$3500.00 minus the \$1000.00 of untaxed HSA money. The money paid by the insurance company is not a deduction for me because I did not pay it.

Medical Expenses are an itemized deduction. That means that they are listed on Schedule A of the federal tax return. However, they are not directly added to the other deductions. The law requires that 7.5% of your Adjusted Gross Income (AGI) (last line on page 1 of the 1040) be subtracted from your medical expenses before any deductions can be taken. If you have an AGI of \$10,000.00, you must subtract \$750.00 from your expenses and the remainder is added to your other itemized deductions.

In my example, I have \$6500.00 of expenses minus the \$1000.00 from the HSA or \$5500.00 of medical expenses. Then, I subtract the 7.5% of my AGI or \$750.00. My deductible expenses for Schedule A are \$4750.00. Where do I find the money to pay my expenses?

One place to look is my retirement account. There is a penalty of 10% if you make an early withdrawal from your IRA, unless you meet an exception to the rules. One of the few exceptions is medical expense that is over 7.5% of your AGI. For my example, that is \$4750.00. I can take \$4750.00 out of my IRA to help pay for my medical bills. I will have to pay income tax on that money because it was deducted from my income when I contributed it to the IRA. But I won't have to pay the 10% penalty.

This may seem very technical, but most actual situations are more complicated than this streamlined example. Even if you have insurance, not everything is covered. Next month I will discuss what expenses, not covered by insurance, are deductible.

The fine print is that this article is for information only. Please call Kathy or a tax professional for questions about your individual tax situation. The Jacksonville Tax Lady can be reached at 541-899-7926 or at 610 North Fifth Street.

