



112 S. West Street
Suite 400
Alexandria, VA
22314

Phone:
(703) 836-6200

Fax:
(703) 836-6550

e-mail:
cahi2@aol.com

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CAHI Policy Brief:

What Is Section 213(d) of the Internal Revenue Code And How Does It Relate To MSAs?

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Introduction

A Medical Savings Account (MSA) is a savings account used to pay health care expenses that works in combination with a high-deductible health insurance policy. An individual or employer, on behalf of themselves or an employee, purchases a high-deductible health insurance policy which usually costs significantly less than a low-deductible policy. For example, a \$3,000 annual deductible policy typically costs less than half what a \$500 deductible policy costs. The high-deductible policy still protects the insured from catastrophic illness, prolonged hospitalization, or a particularly unhealthy year. In addition to the high-deductible policy, the individual, or the employer on behalf of an employee, establishes an MSA with a designated trustee – usually a bank or insurance company. Into this account is placed funds to pay the medical expenses incurred by the insured and his or her family.

When qualified medical expenses² for any year exceed the deductible and total out-of-pocket maximum, the insurance company will usually pay the remaining medical expenses during the year. If any balance remains in the MSA at the end of the year, the funds roll over and are available for the next year, thereby prefunding future medical expenses. Additionally, the annual investment gains in the MSA account roll over into the account for the next year.

Central to how an MSA works is Section 213(d) of the Internal Revenue Code. This section of the tax code outlines what a qualified medical expense is. When an individual withdraws money from his or her MSA, it has to be a qualified medical expense under this section in order not to be taxed on the amount of the withdrawal.

What does §213 (d) really mean?³

CAHI researched Section 213(d) of the Internal Revenue Code and the follow pages list the allowable and disallowed medical expenses. The following are taken from the Internal Revenue Service Publication 502 and other sources. To find out how this section of the Internal Revenue Code applies to you, please consult your tax advisor.

* *The principle author of this Policy Brief is Victoria Craig Bunce, CAHI's Research and Policy Director.*

Checklist of Deductible Medical Expenses

abdominal supports	heating devices (if therapeutic)
abortion (legal)	hospital bills and meals
acupuncture	hydrotherapy
air conditioner (when necessary for breathing)	inclinor
alcoholism treatment	insulin treatments
ambulance	invalid chair
Anesthetist	lab tests and fees
arch supports	lead paint removal
artificial limbs	legal fees (required to authorize health treatment)
autoette (but not to/from work)	lodging (away from home for outpatient care)
back supports	metabolism tests
birth control pills and other contraceptive devices (by prescription)	neurologist
blood tests and transfusions	nursing home and services (including board and meals)
braces	obstetrician
Braille Books & Magazines (extra cost only)	oculist
cardiographs	operating room costs
chiropractor	ophthamologist
Christian Science Practitioner	optician
contact lenses	optometrist
cosmetic surgery (unless related to accident, birth defect or disease)	oral surgery
convalescent home (medical)	organ transplant (including donor's expenses)
cost / maintenance of health-related home im- provements	orthopedic shoes
crutches	orthopedist
dental x-rays	osteopath
dentures	oxygen and oxygen equipment
dermatologist	pediatrician
diagnostic fees	physician
diathermy	physiotherapist
drug addition therapy	podiatrist
drugs by prescription	postnatal treatments
elastic hosiery (by prescription)	practical nurse for medical services
exercise equipment (by prescription)	premiums for free-choice medical plan
eyeglasses	premiums for group clinical care plan
fees paid to health institute prescribed by doctor	premiums for group hospital plan
FICA and FUTA tax paid for medical care service	premiums for health policy including long-term care insurance
fluoridation unit	premiums for hospitalization
guide dog	premiums for medical care (paid & separately stated on school tuition bill)
gum treatment	premiums for medical service cooperatives
gynecologist	premiums for voluntary federal Medicare insur- ance
healing services	prenatal care
hearing aids and batteries	

prescription medicines	splints
prosthesis	sterilization
psychiatrist	surgeon and surgery
psychoanalyst	telephone/TV for impaired
psychologist	therapy equipment
psychotherapy	transplants
radium therapy	transportation expenses (relative to health care)
reclining chair (prescribed)	tuition for child with learning disability
registered nurses	ultra-violet ray treatment
sickroom supplies	vaccines
special auto equipment for the handicapped	vasectomy
special mattresses	vitamins (prescribed)
special school or home costs for the physically and mentally impaired	wheelchair
spinal fluid tests	whirlpool bath (by prescription)
	x-rays

Checklist of Nondeductible Medical Expenses

advance payment for services rendered next year	nonprescription medication
athletic club membership	premiums for life insurance, income protection, disability, loss of limbs, sight or similar bene- fits
car insurance premium (medical portion)	Scientology counseling
boarding school fees and child care	social activities
bottled water	special foods or beverages
commuting expenses of a disabled person	specially designed car for the handicapped other than an autoette or special equipment
cosmetic surgery and procedures	stop-smoking programs
cosmetics, hygiene products and similar items	swimming pool
diaper service	travel for general health improvement
domestic help	tuition and travel expenses to send a problem child to a particular school
funeral, cremation or burial expense	weight loss programs
health programs offered by resort hotels, health clubs, and gyms	
illegal operations and treatments	
illegally procured drugs	
maternity clothes	

Actual Internal Revenue Code §213 Medical, Dental, Etc., Expenses

(a) Allowance of deduction

There shall be allowed as a deduction the expenses paid during taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent (as defined in §152), to the extent that such expenses exceed 7.5 percent of adjusted gross income.

(b) Limitation with respect to medicine and drugs

An amount paid during the taxable year for medicine or a drug shall be taken into account under subsection (a) only if such medicine or drug is a prescribed drug or is insulin.

(c) Special rule for decedents

(1) Treatment of expenses paid after death

For purposes of subsection (a), expenses for the medical care of the taxpayer that are paid out of his estate during the one-year period beginning with the day after the date of his death shall be treated as paid by the taxpayer at the time incurred.

(2) Limitation

Paragraph (1) shall not apply if the amount paid is allowable under §2053 as a deduction in computing the taxable estate of the decedent, but this paragraph shall not apply if (within the time and in the manner and form prescribed by the Secretary) there is filed –

(A) a statement that such amount has not been allowed as a deduction under §2053, and

(B) a waiver of the right to have such amount allowed at any time as a deduction under §2053.

(d) Definitions

For purposes of this section –

(1) The term “medical care” means amounts paid –

(A) for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.

(B) for transportation primarily for and essential to medical care referred to in subparagraph (A), or

(C) for insurance (including amounts paid as premiums under part B of title XVIII of the Social Security Act, relating to supplementary medical insurance for the aged) covering medical care referred to in subparagraphs (A) and (B).

(2) Amounts paid for certain lodging away from home treated as paid for medical care.

Amounts paid for lodging (not lavish or extravagant under any circumstances) while away from home primarily for and essential to medical care referred to in paragraph (1) (A) shall be treated as amounts paid for medical care if –

(A) the medical care referred to in paragraph (1) (A) is provided by a physician in a licensed hospital (or in a medical care facility which is related to, or the equivalent of, a licensed hospital), and

(B) there is no significant element of personal pleasure, recreation, or vacation time in the travel away from home. The amount taken into account under the preceding sentence shall not exceed \$50 for each night for each individual.

(3) Prescribed Drug

The term “prescribed drug” means a drug or biological that requires a prescription of a physician for its use by an individual.

(4) Physician

The term “physician” has the meaning given to such term by §1861(r) of the Social Security Act (42 U.S.C. 1395x(r)).

(5) Special rule in the case of child of divorced parents, etc.

Any child to whom §152(e) applies shall be treated as a dependent of both parents for purposes of this section.

(6) In the case of an insurance contract under which amounts are payable for other than medical care referred to in subparagraphs (A) and (B) of paragraph (1) –

(A) no amount shall be treated as paid for insurance to which paragraph (1) (c) applies unless the charge for such insurance is either separately stated in the contract, or furnished to the policyholder by the insurance company in a separate statement,

(B) the amount taken into account as the amount paid for such insurance shall not exceed such charge, and

(C) no amount shall be treated as paid for insurance if the amount specified in the contract (or furnished to the policyholder by the insurance company in a separate statement) as the charge for such insurance is unreasonably large in relation to the total charges under the contract.

(7) Subject to the limitations of paragraph (6) premiums paid during the taxable year by a taxpayer before he attains the age of 65 for insurance covering medical care (within the meaning of subparagraphs (A) and (B) of paragraph (1)) for the taxpayer, his spouse, or a dependent after the taxpayer attains the age of 65 shall be treated as expenses paid during the taxable year for insurance which constitutes medical care if premiums for such insurance are payable (on a level payment basis) under the contract for a period of 10 years or more until the year in which the taxpayer attains the age of 65 (but in no case for a period of less than 5 years).

(8) The determination of whether an individual is married at a any time during the taxable year shall be made in accordance with the provisions of §6013 (d) (relating to determination of status of husband and wife).

(9) Cosmetic surgery in general –

(A) The term “medical care” does not include cosmetic surgery or other similar procedures, unless the surgery or procedure is necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or disfiguring disease.

(B) Cosmetic surgery defined – for purposes of this paragraph, the term “cosmetic surgery” means any procedure which is directed at improving the patient’s appearance and does not meaningfully promote the proper function of the body or treat illness or disease.

Endnotes

¹ Golden Rule Insurance Company offers the following example of a traditional plan versus MSA. Please note that this comparison is for a self-employed, non-smoking family of four living in Dallas, Texas.

	Traditional Plan*	MSA Plan**
Annual Premium	\$5,028.48	\$2,327.64
MSA deposit (100% tax deductible)	Not available	2,250.00
Pre-tax deductible on premium (40%)	2,011.39	931.10
Taxable income (60% of premium)	3,017.09	1,396.54
Taxes paid (assuming 28% tax bracket)	1,173.31	543.10
Total annual cost	\$6,201.79	\$5,120.74***
* The traditional plan has a \$500 deductible, and 80/20 coinsurance to \$5,000.		
** The MSA plan has a \$3,000 deductible.		
*** Overall savings realized by choosing the MSA is \$1,081.05. (The total annual cost is equal to the annual premium, plus the MSA deposit, plus taxes paid.		
<i>SOURCE: Golden Rule Insurance Company, Indianapolis, Indiana.</i>		

² Qualified medical expenses as defined under §213(d) of the Internal Revenue Code.

³ Please see the following sources: MSA Central: <http://www.msacentral.com/thelist.html>. Also, Greg Scandlen's "Patient Power Report", Volume 1, Number 3, April 19, 1996.