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Tax-Advantaged Accounts for Health Care Expenses: Side-by-Side Comparison

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Summary

The conference agreement on the Medicare prescription drug bill (H.R. 1) includes new tax-advantaged accounts for health care expenses called health savings accounts (HSAs). These accounts had been included in the original House-passed bill, but they were not in the Senate amendment. Other tax-advantaged accounts in the original House-passed bill, health savings security accounts (HSSAs), were not included in the conference agreement.

The new accounts in conference agreement might be considered an expanded form of Archer medical savings accounts (MSAs) that are authorized under current law. Both HSAs and MSAs ought to be distinguished from two other health care accounts authorized also under current law, health care flexible spending accounts (FSAs) and health reimbursement accounts (HRAs). While the four accounts have some features and objectives in common, they differ in important respects. Keeping the accounts straight can be difficult, especially when they are discussed informally using alternative names.

This report provides brief summaries and background information about the four accounts and then compares them with respect to characteristics such as eligibility, contribution limits, and use of funds. The report will be updated to reflect legislative developments and may be expanded to include additional topics and perspectives.

Brief Summaries and Background

Three of the accounts discussed in this report are permitted under current law. Health care **flexible spending accounts (FSAs)** are employer-established arrangements that reimburse employees for medical and dental expenses not covered by insurance or otherwise reimbursable. They usually are funded through salary reduction agreements under which employees receive less pay (for example, $100 a month) in exchange for equivalent contributions to their accounts (in this case, $1,200 for the year). The entire annual amount must be made available to employees at the beginning of the year. Employees choose how much to put into their accounts, which can vary from year to year; however, they must forfeit unused balances at the end of the year. Contributions are not subject to either income or employment taxes (i.e., Social Security and Medicare taxes), unlike the pay employees otherwise would have received.

FSAs funded by salary reductions are governed by Section 125 of the Internal Revenue Code, which allows contributions to be exempt from taxes despite the fact that employees have the choice to receive taxable wages.[1] However, most rules regarding FSAs are not spelled out in the Code; rather, they were included in proposed regulations that the Internal Revenue Service (IRS) issued in 1984 and 1989. Final rules regarding permissible mid-year election changes were issued in 2000 and 2001. FSAs are available to more than one-fifth of private-sector workers and nearly half of government workers (including federal employees), though participation rates are substantially lower.[2]

Health reimbursement accounts (HRAs) are also employer-established arrangements to reimburse employees for medical and dental expenses not covered by insurance or otherwise reimbursable. As is the case with FSAs, contributions are not subject to either income or employment taxes. In contrast, however, contributions cannot be made through salary reduction agreements; only employers may contribute. Also unlike FSAs, reimbursements can be limited to amounts previously contributed. Unused balances may be carried over indefinitely, though employers may limit the aggregate carryovers.

HRAs are governed by Section 105 of the Internal Revenue Code, which allows health plan benefits used for medical care to be exempt from taxes, and Section 106 of the Code, which allows employer contributions to those plans to be tax-exempt. Rules regarding HRAs are spelled out in IRS revenue rulings and notices issued in 2002.[3] Since HRAs are relatively new, few people have these accounts.

Archer medical savings accounts (MSAs) are personal savings accounts for medical expenses not covered by insurance or otherwise reimbursable. MSAs can be established and contributions made only when the account owners have high deductible insurance and no other coverage, with some exceptions. (For the deductible amounts required for MSAs and the other accounts in this report, see the side-by-side comparison that follows.) In addition, the account owners must be either self-employed or employees covered by a high deductible plan established by their small employer (50 or fewer employees, on average). Contributions made by employers are exempt from income and employment taxes, while contributions by the account owners (allowed only if the employer does not contribute) are deductible. Contributions are limited to a percentage

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[1] Section 125 thus provides an express exception to the constructive receipt rule, which requires taxation of what is normally nontaxable income when taxpayers have the choice of receiving taxable income or nontaxable income.

[2] FSA rules are available at 49 *Federal Register* 19321 and 50733, 54 *FR* 9460, 65 *FR* 15548 and 66 *FR* 1837. Also see IRS revenue ruling 2003-102. For data on the use of FSAs, see CRS Report 96-500, *Flexible Spending Accounts and Medical Savings Accounts: A Comparison*, by Bob Lyke and Chris L. Peterson.

[3] Revenue Ruling 2002-41 and Notice 2002-45.

of the health insurance deductible. MSA earnings are tax-exempt, as are withdrawals for medical expenses. Nonqualified distributions (i.e., those not used for health care) are taxable and generally subject to an additional 15% penalty. Unused balances may be carried over from year to year.

MSAs are governed by Section 220 of the Internal Revenue Code, which allows exceptions to what would otherwise be considered taxable employment income and personal savings. They were first authorized by the Health Insurance Portability and Accountability Act of 1996 (P.L. 104-191). That legislation also limited the number of accounts, though by mid-2002 only about 100,000 had been established, far below the ceiling of 750,000. Later amendments extended the deadline for establishing new accounts to December 31, 2003.

The **health savings accounts (HSAs)** included in the conference agreement on the Medicare prescription drug bill (H.R. 1) might be considered expanded versions of current MSAs. (The conference agreement passed the House on November 22 and the Senate on November 25.) Like those accounts, HSAs could be established and contributions made only when account owners have high deductible insurance and no other coverage, with some exceptions. However, the legislation would allow deductibles lower than those required for MSAs, and it would permit larger contributions. Additional contributions could be made by individuals who are at least 55 years of age but not yet eligible for Medicare. Eligibility would no longer be restricted to people who are self-employed or work for small employers, and contributions could be made both by employers and account owners. Similar rules would apply to withdrawals for medical expenses and nonqualified distributions, with some exceptions. There would be no statutory cap on the number of HSA accounts.

HSAs were included in H.R. 1 as passed by the House in June, 2003; they were not in the Senate amendment. The House bill also included health savings security accounts (HSSAs), which would have allowed even more individuals and families to save for health care expenses on a tax-preferred basis. The Senate bill did not have HSSA provisions, and they were omitted from the conference agreement.[4]

H.R. 1 also would have allowed up to $500 in FSA balances unused at the end of the year to be carried over or transferred to a qualified retirement plan, a deferred compensation plan, an HSA, or an HSSA. This provision was not included in the conference agreement.

Side-by-Side Comparison

The side-by side comparison on the following pages shows the principal features of FSAs, HRAs, and MSAs and the proposed HSAs. Rules are expressed in general terms, and not all details are shown. For additional information, readers might refer to IRS guidance and the legislative language of H.R. 1.

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[4] HSSAa are described in earlier versions of this report, available from the authors.

Summary of General Features of FSAs, HRAs and MSAs, and Proposed HSAs and HSSAs, 2003

	Health care flexible spending accounts (FSAs)	Health reimbursement accounts (HRAs)	Medical savings accounts (Archer MSAs)	Health savings accounts (HSAs) in H.R. 1 conference agreement
Eligibility	Employees whose employers offer this benefit. Former employees may be included. Employers not restricted by size.	Employees whose employers offer this benefit. Former employees may be included. Employers not restricted by size.	Individuals with qualifying health insurance who are either employees of a small employer (50 or fewer workers) with a high deductible plan or self-employed. Ineligible individuals may keep previously established accounts but cannot make contributions.	Individuals with qualifying health insurance. Ineligible individuals may keep previously established accounts but cannot make contributions.
Definition of qualifying health insurance	No health insurance requirements.	No health insurance requirements, although HRAs are usually combined with high deductible health insurance.	**Self-only deductible** must be at least $1,700 and not more than $2,600, with an out-of-pocket maximum for covered benefits of not more than $3,450; **family deductible** must be at least $3,450 and not more than $5,150, with an out-of-pocket maximum of not more than $6,300 (2004 amounts).	**Self-only deductible** must be at least $1,000; the **family deductible** must be at least $2,000. The required out-of-pocket expenses for covered benefits cannot exceed $5,000 for **self-only coverage** and $10,000 for **family coverage**.
Contributions	By employer, employee, or both. Usually funded by employee through salary reduction agreement.	Only by employer.	By employer or account owner, but not both.	By employer, the account owner, or both.
Annual contribution limits	None required, though employers usually impose a limit.	None required. Employers usually set their contributions below the annual deductible of the accompanying health insurance.	65% of the deductible for **self-only coverage** and 75% of the deductible for **family coverage.**	The lesser of 100% of the deductible or $2,600 for **self-only coverage** and 100% of the deductible or $5,150 for **family coverage** (2004 amounts). Individuals who are at least 55 years of age but not yet eligible for Medicare can contribute an additional $500 in 2004, increasing to $1,000 more in 2009 and thereafter.

	Health care flexible spending accounts (FSAs)	Health reimbursement accounts (HRAs)	Medical savings accounts (Archer MSAs)	Health savings accounts (HSAs) in H.R. 1 conference agreement
Qualifying expenses	Most unreimbursed medical expenses, though employers may impose additional limitations. May not be used for long-term care or health insurance premiums.	Most unreimbursed medical expenses, though employers may impose additional limitations. May be used for long-term care and health insurance premiums, if the employer allows.	Most unreimbursed medical expenses. May be used for premiums for long-term care insurance, COBRA, and health insurance for those receiving unemployment compensation under federal or state law.	Most unreimbursed medical expenses. May be used for premiums for long-term care insurance, COBRA, health insurance for those receiving unemployment compensation under federal or state law, and health insurance (other than Medigap policies) for individuals who are 65 years of age and older.
Allowable non-medical withdrawals	None	None	Permitted, subject to income tax and 15% penalty except in cases of disability, death, or attaining age 65.	Permitted, subject to income tax and 10% penalty except in cases of disability, death, or attaining age 65.
Carryover of unused funds	None allowed. Balances remaining at year's end are forfeited to employer.	Permitted, although some employers limit amount that can be carried over.	Full amount may be carried over indefinitely.	Full amount may be carried over indefinitely.
Portability	Balances generally forfeited at termination, although COBRA extensions sometimes apply.	At discretion of employer, though subject to COBRA provisions.	Portable.	Portable.