

# CRS Report for Congress

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

Bob Lyke  
Specialist in Social Legislation  
Domestic Social Policy Division

Chris L. Peterson  
Analyst in Social Legislation  
Domestic Social Policy Division

### Summary

Health Savings Accounts (HSAs) are the newest addition in the array of tax-advantaged accounts people can use to pay for unreimbursed medical expenses such as deductibles, copayments, and services not covered by health insurance. The new accounts, which became available January 1, 2004, might be considered an expanded form of Archer Medical Savings Accounts (MSAs), which have been available since 1997. HSAs and MSAs differ in important respects from the two other health care accounts permitted under current law, health care Flexible Spending Accounts (FSAs) and Health Reimbursement Accounts (HRAs). However, the four accounts have some features and objectives in common. 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

Four types of tax-advantaged accounts are permitted under current law for people to pay for unreimbursed medical expenses such as deductibles, copayments and services not covered by health insurance: health care Flexible Spending Accounts, Health Reimbursement Accounts, Archer Medical Savings Accounts and, the newest addition, Health Savings Accounts. Brief summaries and background information on the four accounts follows.

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.<sup>1</sup> 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.<sup>2</sup>

**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.<sup>3</sup>

**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

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<sup>1</sup> 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.

<sup>2</sup> 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.

<sup>3</sup> Revenue Ruling 2002-41 and Notice 2002-45.

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 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. Although no new MSAs may be created, with some exceptions, current holders of MSAs can maintain their accounts and, provided they have a qualifying high-deductible health insurance plan, can continue to make contributions to the MSA. However, MSA owners can now have Health Savings Accounts, and their MSA balances can be rolled over into the new accounts.

**Health Savings Accounts (HSAs)** might be considered expanded versions of current MSAs. Like those accounts, HSAs can be established and contributions made only when account owners have high-deductible insurance and no other coverage, with some exceptions. However, lower deductibles are allowed for HSAs than for MSAs. HSAs also permit larger contributions. Additional contributions can be made by individuals who are at least 55 years of age but not enrolled in Medicare. Eligibility is 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. In fact, any person may make contributions to an HSA on behalf of an eligible individual. Similar rules apply to withdrawals for medical expenses and nonqualified distributions, with some exceptions. There is no statutory cap on the number of HSA accounts.<sup>4</sup>

HSAs were authorized by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, which was signed into law by the President on December 8, 2003 (P.L. 108-173). HSAs became available January 1, 2004.

## Side-by-Side Comparison

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

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<sup>4</sup> Refer to CRS Report RL32467, *Health Savings Accounts*, by Bob Lyke, Chris L. Peterson and Neela Ranade for more detailed description and analysis of HSAs. The technical guidance for HSAs is available from the Department of Treasury's website at [<http://www.treas.gov/offices/public-affairs/hsa/technical-guidance/>].

### Summary of General Features of FSAs, HRAs, MSAs, and HSAs, 2004

	Health Care Flexible Spending Accounts (FSAs)	Health Reimbursement Accounts (HRAs)	Medical Savings Accounts (Archer MSAs)	Health Savings Accounts (HSAs)
<i>Eligibility</i>	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.
<i>Definition of qualifying health insurance</i>	No health insurance requirements.	No health insurance requirements, although HRAs are usually combined with high deductible health insurance.	<b>Self-only deductible</b> 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; <b>family deductible</b> must be at least \$3,450 and not more than \$5,150, with an out-of-pocket maximum of not more than \$6,300.	<b>Self-only deductible</b> must be at least \$1,000; the <b>family deductible</b> must be at least \$2,000. The required out-of-pocket expenses for covered benefits cannot exceed \$5,000 for <b>self-only coverage</b> and \$10,000 for <b>family coverage</b> .
<i>Contributions</i>	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 any person on behalf of an eligible individual.
<i>Annual contribution limits</i>	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 <b>self-only coverage</b> and 75% of the deductible for <b>family coverage</b> .	The lesser of 100% of the deductible or \$2,600 for <b>self-only coverage</b> . For <b>family coverage</b> , the least of the following: 100% of the overall family deductible, the “embedded” per-person deductible times the number of family members, or \$5,150. Individuals who are at least 55 years of age but not enrolled in Medicare can contribute an additional \$500 in 2004, increasing to \$1,000 more in 2009 and thereafter.

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	<b>Health Care Flexible Spending Accounts (FSAs)</b>	<b>Health Reimbursement Accounts (HRAs)</b>	<b>Medical Savings Accounts (Archer MSAs)</b>	<b>Health Savings Accounts (HSAs)</b>
<i>Qualifying expenses</i>	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.
<i>Allowable non-medical withdrawals</i>	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.
<i>Carryover of unused funds</i>	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.
<i>Portability</i>	Balances generally forfeited at termination, although COBRA extensions sometimes apply.	At discretion of employer, though subject to COBRA provisions.	Portable.	Portable.