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

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Summary

The House-passed Medicare prescription drug bill, H.R. 1, includes two new tax-advantaged accounts for health care expenses, health savings accounts (HSAs) and health savings security accounts (HSSAs). The Medicare prescription drug bill that passed the Senate, S. 1, does not have comparable provisions. Whether the accounts will be included in the final bill is to be considered by the conference committee.

The accounts in the House bill are widely referred to as "medical savings accounts" since they provide tax advantages to encourage people to save for future medical expenses. However, both accounts can be distinguished from Archer medical savings accounts (MSAs) authorized under current law, as they can from health care flexible spending accounts (FSAs) and health reimbursement accounts (HRAs) that some employers now offer. While the five 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 five 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. 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 (for example, 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. 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 unreimbursed medical expenses. 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 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.

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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. 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.

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 House-passed Medicare prescription drug bill (H.R. 1) might be considered an expanded replacement for current MSAs. Like those accounts, HSAs could be established and contributions made only when the account owners have high deductible insurance and no other coverage, with some exceptions. However, the legislation would allow deductibles lower than those under MSAs and would permit contributions up to the full deductible amount. 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.

The **health savings security accounts (HSSAs)** included in H.R. 1 could be more widespread than HSAs.[4] HSSAs could be established and contributions made by account owners who are uninsured or who have a minimum deductible health plan. They could make a tax-deductible contribution of up to $2,000 each year if they have self-only coverage or are uninsured with no dependents, and up to $4,000 each year if they have family coverage or are uninsured with dependents and file a joint return. Larger contributions could be made by owners age 55 and over. Contributions would be reduced and then eliminated for higher income owners. Rules similar to MSAs would apply to withdrawals for medical expenses and nonqualified distributions.

Both HSAs and HSSAs were included in H.R. 2596, which was introduced on June 25, 2003, and passed by the House the next day. Immediately after passage, its provisions were appended to H.R. 1, the House-passed Medicare prescription drug bill, as provided in H. Res. 299. The Senate-passed Medicare prescription drug bill, S.1, does not include accounts comparable to HSAs and HSSAs.

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 and HSSAs. Rules are expressed in general terms, and not all details are shown. For additional information, readers might refer to the legislative language and IRS guidance.

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[4] The estimated revenue loss for HSSAs is $163.4 billion for fiscal years 2004 through 2013, while the estimated revenue loss estimated for HSAs for the same period is $5.7 billion. Joint Committee on Taxation, JCX-65-03, June 26, 2003.

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)	Health savings security accounts (HSSAs)
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) 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.	Individuals with qualifying health insurance or with no health insurance, provided their adjusted gross income is less than thresholds specified below. 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.[a]	**Self-only deductible** must be between $1,700 and $2,500, with an out-of-pocket maximum of not more than $3,350; **family deductible** must be between $3,350 and $5,050, with an out-of-pocket maximum of not more than $6,150. (2003 amounts)	**Self-only deductible** must be between $1,000 and $2,500 with an out-of-pocket maximum of not more than $3,350; **family deductible** must be between $2,000 and $5,050 with an out-of-pocket maximum of not more than $6,150.[a] (2004 amounts calculated by Joint Committee on Taxation)	**Self-only deductible** must be at least $500; **family deductible** must be at least $1,000.[a] (2004 amounts) No out-of-pocket maximum requirement.
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.	By employer, account owner and/or a member of the account owner's family.

	Health care flexible spending accounts (FSAs)	Health reimbursement accounts (HRAs)	Medical savings accounts (Archer MSAs)	Health savings accounts (HSAs)	Health savings security accounts (HSSAs)
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 deductible for self-only plan, 75% for family policy.	100% of the deductible.	**$2,000 annually** for individuals who have self-only coverage or who are uninsured and without dependents, provided their adjusted gross income does not exceed $75,000 ($150,000 for joint returns); **$4,000 annually** for individuals with family coverage or who are uninsured and have dependents or file a joint return, provided their adjusted gross income does not exceed $150,000. **Additional contributions** allowed for those age 55 and over.[b]
Qualifying expenses	Most unreimbursed medical expenses, though employers may impose additional limitations. May not be used for long-term care or health insurance premiums.[c]	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, 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, health insurance for those 65 and older, and qualifying health insurance toward which neither the account owner's spouse nor employer contributes.
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 15% penalty except in cases of disability, death, or attaining age 65.	Permitted, subject to income tax and 15% penalty except in cases of disability, death, or attaining age 65.

	Health care flexible spending accounts (FSAs)	Health reimbursement accounts (HRAs)	Medical savings accounts (Archer MSAs)	Health savings accounts (HSAs)	Health savings security accounts (HSSAs)
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.	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.	Yes	Yes	Yes
FSA and MSA changes proposed in H.R. 1	Up to $500 of unused balances may be carried over or transferred to a qualified retirement plan, deferred compensation plan, an HSA, or an HSSA (subject to plan limits).	(Not applicable)	MSA funds may be transferred to an HSA or an HSSA (subject to plan limits).	(Not applicable)	(Not applicable)

[a] A plan may pay for preventive benefits without requiring the enrollee to pay the deductible and still be considered a high deductible plan.

[b] Individuals 55 and over may contribute additional sums, limited to $500 more in 2004, $600 more in 2005, $700 more in 2006, $800 more in 2007, $900 more in 2008, and $1,000 more in 2009 and thereafter. For individuals who have self-only coverage or who are uninsured and without dependents, the $2,000 limit and allowable additional sums are proportionally reduced to $0 as their adjusted gross income increases from $75,000 to $85,000 ($150,000 to $170,000 for joint returns). For individuals who have family coverage or who are uninsured and have dependents or file a joint return, the $4,000 limit and allowable additional sums are proportionally reduced to $0 as their adjusted gross income increases from $150,000 to $170,000. Aggregate contribution limits are also reduced by amounts contributed to an MSA, HSA, or the HSSA of another person. Contributions of $200 may be made as aggregate contribution limits are calculated to be greater than $0 but less than $200.

[c] Although FSAs may not be used to pay health insurance premiums, employees eligible for FSAs are also usually eligible for premium conversion plans which allow their contributions for employer-sponsored health insurance to be paid on a pre-tax basis.