America's Health Insurance Plans

Health Care Spending Accounts:

What You Need to Know About HSAs, HRAs, FSAs, and MSAs

- Health savings accounts (HSAs) with high-deductible health plans (HDHPs)
- Health reimbursement arrangements (HRAs)
- Health flexible spending arrangements (FSAs)
- Archer medical savings accounts (MSAs)

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The following information is based on guidance issued by the U.S. Treasury Department and the Internal Revenue Service (IRS) as of June 2005. It is not intended to serve as tax or legal advice. Please seek the advice of counsel or consult a tax advisor if you have any questions about your specific circumstances.

Introduction

In today's health care market, employers and consumers are looking for lower-cost health coverage, more control over their health care dollars, and broad choice among doctors and hospitals. Consumer health spending accounts are one of many product options that respond to these needs.

The major types of health care spending accounts are:

- **Health savings accounts (HSAs) with high-deductible health plans (HDHPs)** ***see p. 2***
- **Health reimbursement arrangements (HRAs)** ***see p. 4***
- **Health flexible spending arrangements (FSAs)** ***see p. 6***
- **Archer medical savings accounts (MSAs)** ***see p. 7***

All of these products have federal tax advantages, and they allow consumers to save money for health care. Each has a different design and is subject to a unique set of federal rules. This guide answers frequently asked questions about account-based health care products.

Frequently Asked Questions

HSAs

What is an HSA?

A health savings account is a new way of saving money to pay for current and future medical expenses on a tax-free basis. HSAs were created by the Medicare Modernization Act signed in December 2003.

Who is eligible to set up an HSA?

To set up and contribute to an HSA, an individual must:

- Be covered by a high-deductible health plan that meets federal requirements.
- Not have other health insurance. (Individuals with certain limited benefit policies such as accident-only, dental, vision, workers' compensation, disability, or long-term care coverage may still be eligible for an HSA.)
- Not be enrolled in Medicare. Medicare beneficiaries cannot contribute to an HSA. They may, however, spend money contributed to an HSA prior to their enrollment in Medicare.
- Not be claimed as a dependent on someone else's tax return.

Where can individuals open HSAs?

If an individual's employer does not offer an HSA, the individual can set up an HSA with:

- A health insurance plan. A growing number of health insurance plans offer high-deductible health plans and administer HSAs.
- A bank or credit union or another organization that has been approved by the IRS to serve as an HSA trustee. *(These entities can only open up the health savings account. They do not provide high-deductible health plan coverage.)*

What is a high-deductible health plan, according to the rules governing HSAs?

A health plan with:

- An annual deductible of at least:
  - $1,000 for self-only coverage.
  - $2,000 for family coverage.
- Limits on annual out-of-pocket expenses (deductibles, co-insurance, and copayments), which may not exceed:
  - $5,100 for self-only coverage.
  - $10,200 for family coverage.

These are the requirements for 2005; the dollar amounts are indexed annually for inflation.

What are the federal tax benefits of HSAs?

- Individuals can deduct from their federal income taxes the amount of their HSA contributions, whether or not they itemize.
- Employer contributions to an HSA on an individual's behalf are not counted as taxable income.
- If someone else makes an HSA contribution on an individual's behalf, only the individual can deduct the contribution.
- Individuals can withdraw funds from an HSA tax-free to pay qualified medical expenses.
- All earnings on HSAs are tax-free.
- Employer contributions are not subject to withholding for purposes of the Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), or the Railroad Retirement Tax Act.

Does preventive care count toward the deductible of the high-deductible health plan associated with an HSA?

The IRS has ruled that a high-deductible health plan may cover certain types of preventive care without a deductible or with a lower deductible than the annual deductible applicable to all other services. According to IRS guidance, the types of services that may be considered preventive care include:

- Routine prenatal and well-child care.
- Immunizations for children and adults.
- Periodic health evaluations, including tests and diagnostic procedures ordered with routine examinations such as annual physicals.
- Smoking cessation programs.
- Obesity weight-loss programs.
- Screening services (e.g., mammography, Pap testing, screening for glaucoma, tuberculosis).
- Limited categories of medications, including:
  (1) Medications used as part of procedures to provide any of the preventive services listed above;
  (2) Medications to prevent a disease or condition when a

person has risk factors but no symptoms of the disease or condition (e.g., cholesterol-lowering medication to help prevent heart disease for people with high cholesterol); and

(3) Medication to prevent recurrence of a disease from which a person has recovered (e.g., ACE inhibitors by individuals who previously had a heart attack or stroke);

(4) Treatment that is incidental or ancillary to a preventive care service or screening, where it would be unreasonable or impractical to perform another procedure to treat the condition (e.g., removal of polyps during a diagnostic colonoscopy).

The exceptions for preventive care do not include any service, benefit, or medication to treat an existing illness, injury, or condition.

Who can contribute to HSA?

- An employee.
- An employer on behalf of an employee.
- A self-employed individual.
- Individuals without job-based health insurance.
- Any person, such as a family member, on behalf of an eligible individual.

How much can be contributed to an HSA?

Each year, total contributions to an HSA cannot exceed the deductible of the high-deductible health plan, but in any event not more than $2,650 annually for individuals and $5,250 annually for families (adjusted annually for inflation). Individuals between the ages of 55 and 65 can make additional "catch-up" annual contributions of $600 (adjusted annually for inflation). Individuals are responsible for ensuring that their annual HSA contributions do not exceed the maximum allowed by law.

Employers can arrange for employees to contribute to HSAs through salary reduction. Employers contributing to HSAs are not required to make their entire contribution available at the beginning of the year. Once an employer contributes to an HSA, the funds become the employee's property. Employers are not allowed to take back unused HSA contributions.

Who controls the use of funds in HSAs?

The individual controls use of funds in HSAs and can decide when and how much to contribute (up to the allowable maximums). Individuals also can decide which custodian or trustee will hold the account, whether to invest any of the money in the account, and which investments to make.

What kinds of expenses can be paid with HSAs?

Individuals can withdraw HSA funds tax-free to pay qualified medical expenses, as defined by the IRS. These include, but are not limited to:

- Doctors' office visits.
- Hospital care.
- Dental care.
- Vision care.
- Prescription drugs.
- Over-the-counter medications.
- Copayments.
- Deductibles.
- Coinsurance.

Visit the link below for a list of qualified medical expenses as defined by the IRS:
http://www.irs.gov/publications/p502/ar02.html#d0e201.

Can HSA funds be used to pay health insurance premiums?

Individuals can use HSAs to pay for the following types of health coverage:

- COBRA continuation coverage.
- Health coverage purchased while an individual is receiving unemployment compensation.
- Qualified long-term care insurance.
- When age 65 or older, premiums for any health insurance except Medicare supplemental policies (also known as Medigap).

What happens if HSA funds are used for items other than qualified medical expenses or premiums?

Any amounts from an HSA that are used for items other than qualified medical expenses or premiums are subject to federal income tax plus a 10% excise tax. The 10% tax is not paid if the individual is age 65 or older or if the distribution from the account is made after the death or disability of the individual. However, the amount still is considered income.

Can HSA funds be used to pay health expenses incurred by a spouse or a dependent?

Yes, HSA funds can be withdrawn tax-free for the qualified medical expenses for a spouse or dependent, even if they are not covered by the high-deductible health plan.

What happens if there is money left in the HSA at the end of the year?

- Individuals can keep unused funds in their HSA accounts from one year to the next.
- Individuals can use HSA funds to pay qualified expenses from a previous year, as long as they were incurred after the HSA was established.

Can employees take HSAs with them when they retire or change jobs?

Yes. Individuals can take HSA funds with them when they retire or change jobs and can designate a beneficiary to receive the funds upon their death.

Can HSAs be used in conjunction with FSAs or HRAs?

In general, no. During any time that an employer or employee is contributing to an HSA, the individual cannot have any health coverage other than a high-deductible health plan.

Limited exceptions are allowed:

- Because individuals with HSAs can have limited health benefits such as dental and vision care, an employee with a limited FSA or HRA that covers only those expenses would still be eligible for an HSA.
- Individuals with HSAs can have FSAs or HRAs that pay for medical expenses only after the HDHP deductible has been met.
- Active employees can contribute to HSAs while covered by an HRA that pays only post-retirement medical expenses.
- An employee with HRA coverage can make HSA contributions if he or she suspends the HRA coverage.

When did HSAs first become available?

HSAs entered the market in January 2004.

How many people have HSAs?

AHIP's member survey found that as of March 2005, 1,031,000 people were covered by HSA/HDHP products. This is more than double the number reported in AHIP's September 2004 survey.

Are HSAs appealing mainly to young people?

HSA/HDHP products seem to appeal equally to all ages. AHIP's March 2005 member survey found that in the individual insurance market,

- 27% of people choosing HSAs were age 50-64;
- 24% were age 40-49;
- 26% were age 20-39;
- and 22% were under age 20.

In the small-group insurance market (firms with 2-50 employees), the age distribution was similar, and 43% of people covered by HSAs/HDHPs were age 40 or older.

Are HSAs covering individuals who previously were uninsured?

AHIP's March 2005 member survey found that 37% of people who bought HSA/HDHPs in the individual market were previously uninsured. In addition, 27% of small companies offering HSAs to employees previously had offered no coverage.

HRAs

What is an HRA?

HRAs are individual health reimbursement arrangements that employers can establish to pay employees' medical expenses.

Who is eligible to set up and contribute to an HRA?

HRAs must be set up by an employer on behalf of its employees (self-employed individuals are not eligible for an HRA), and only the employer can contribute to an HRA.

Who controls the use of funds in HRAs?

Employers decide how much money to put in HRAs, and employees can withdraw HRA funds for expenses allowed under the employer's HRA plan documents. The IRS allows employers to establish HRAs with unfunded "credits" rather than with hard-dollar amounts. This arrangement is similar to a line of credit, against which employee expenses are paid with employer funds when and if they occur. Employers can determine whether employees have access to the entire annual HRA contribution at any time during the year, or whether they can access only a portion of the funds at any given time.

How much can be contributed to an HRA?

There is no limit on the amount of money an employer may contribute to an HRA.

What are the federal tax benefits of HRAs?

Employer contributions to an HRA are not treated as taxable income to the employee, and employees can spend the funds tax-free.

In addition, employers are entitled to deduct the amount of their contribution. If they fund the account with hard dollars, they can take an immediate deduction. However, if the account is funded on a "notional" basis like a line of credit, the employer can take the deduction only when the amounts are actually paid out.

Can HRAs be offered in conjunction with a health insurance plan?

HRAs often are established with a high-deductible health plan for employees. However, they can be paired with any type of health plan or used as a stand-alone account. In addition, HRAs can be offered in conjunction with a health flexible spending arrangement. Employers decide what other types of products to offer with the HRA.

What kinds of expenses can be paid with HRAs?

The IRS allows HRA funds to be used for any item that qualifies as a medical expense under the Internal Revenue Code (except long-term care services). However, it is up to employers to determine whether employees can use HRAs for any of these items or only for medical expenses covered under the employer's health benefit plan. If the employer offers an HRA in conjunction with an HDHP, the employer can decide whether to cover preventive care without requiring employees to meet the HDHP deductible.

Can HRA funds be used to pay health insurance premiums?

IRS rules allow use of HRA funds for health insurance premiums, long-term care coverage, and qualified medical expenses not covered under another health plan, but it is up to individual employers to decide whether their employees can use the funds for these purposes.

Can HRA funds be used to pay health expenses incurred by a spouse or dependent?

Under IRS rules, employers have the option of allowing employees to use HRAs for expenses of spouses and dependents of current and former employees.

What happens if there is money left in an HRA at the end of a year?

IRS rules allow employers to determine whether employees can carry over all or a portion of unused HRA funds from year to year. Employers are not allowed to "refund" any part of an HRA balance to employees.

Can employees take HRAs with them when they retire or change jobs?

IRS rules allow employers to specify in their HRA plan terms whether HRA balances will be forfeited if an employee leaves the job or changes health plans. However, former employees who buy COBRA continuation coverage can retain access to the HRA and any health plan offered with it. As long as former employees pay COBRA premiums during the COBRA coverage period, they are entitled not only to unused balances from the HRA but also to the same annual employer contribution to the HRA as that provided to current active employees.

When did HRAs first become available?

In 2000, a small number of insurers began offering HRAs. Large employers began introducing HRAs in 2001, and they became more prevalent after June 2002, when the IRS issued a ruling to clarify their treatment in the tax code.

How many people have HRAs?

According to data gathered by Atlantic Information Services, as of January 2005, approximately 2.6 million people were covered by HRAs.

Are HRAs appealing mainly to young people?

Several recent studies found no significant age differences between individuals with HRAs and those with other types of health coverage (Christianson et al., 2004; Tollen et al., 2004).

Health Flexible Spending Arrangements

What is a health FSA?

Health flexible spending arrangements are benefit plans set up by employers that allow employees to set aside pre-tax money on an annual basis to pay for qualified medical expenses (as defined by the IRS) incurred during that year.

Who is eligible to set up and contribute to a health FSA?

Health flexible spending arrangements can be set up only by employers (self-employed individuals cannot establish FSAs). Employees contribute to health FSAs by having money withheld from their paychecks on a pre-tax basis, and employers have the option of contributing.

What are the federal tax benefits of health FSAs?

Employees do not pay federal income tax on the amount of salary contributed to an FSA or on the amount an employer may contribute. Pre-tax salary reduction for FSAs reduces the wages on which Social Security and Medicare taxes are paid. In addition, employees do not pay taxes on funds withdrawn from FSAs for qualified medical expenses.

How much money can be contributed to a health FSA?

There is no limit on the amount of funds that employers and employees can contribute to health FSAs. However, the employer's FSA plan documents must specify a maximum dollar amount or percent of salary that can be contributed to the FSA. Each year, employees designate the amount of money they will contribute to the account in the following year.

Who controls the use of funds in health FSAs?

Employees choosing health FSAs have a portion of their FSA contribution withheld from their paycheck each pay period. IRS rules specify that at any point during the year, regardless of how much has been withheld from their paychecks, employees can access the entire amount designated for the year.

Can employees change the amount of their health FSA contribution during the year?

In general, no. Employees can only contribute the amount they originally designated for the year. However, the amount of an annual health FSA contribution can be changed or revoked if there is a change in family status (e.g., birth or adoption of a child) or in employment status, as specified in the employer's FSA plan documents.

Can health FSAs be offered in conjunction with a health insurance plan?

Yes. Health FSAs can be offered in conjunction with any type of health insurance plan or other employer-provided benefits, or they can be offered on a standalone basis. As explained previously, health FSAs generally cannot be established with HSAs.

What kinds of expenses can be paid with health FSAs?

Employees can use health FSA funds for qualified medical expenses, including preventive care, as defined by the IRS and specified in the employer's FSA plan documents, as long as those expenses are not otherwise covered by health insurance.

Can health FSA funds be used to pay health insurance premiums?

No. Health FSA funds cannot be used for:

- health insurance premiums;
- long-term care coverage or expenses; or
- amounts covered under another health plan.

Can health FSA funds be used to pay health expenses incurred by a spouse or dependent?

Yes. Health FSA funds may be used for qualified medical expenses of a spouse or dependent.

What happens if there is money left in a health FSA at the end of the year?

Health FSAs are subject to a use-it-or-lose it rule, which recently was modified by the Treasury Department. Until recently, the rule specified that any funds that the employee had not spent by the end of the plan year would be forfeited and returned to the employer. However, in May 2005, the Treasury Department modified the rule, allowing employers to give employees a two-and-a-half month grace period immediately following the end of a plan year to use up funds for the year. Thus if the plan year ends December 31, employers may give employees until March 15 to use their health FSA funds from the previous year.

Can employees take health FSAs with them when they retire or change jobs?

No, and employers are not allowed to refund health FSA health balances to employees when they leave. Under certain limited circumstances, health FSAs may be subject to COBRA requirements.

When did health FSAs first become available?

Health FSAs have been available for many years; they were authorized by the Revenue Act of 1978.

How many people have health FSAs?

According to the Employers Council on Flexible Compensation, an estimated 20 million employees are enrolled in health FSAs.

Archer MSAs

What is an Archer MSA?

Archer MSAs are individual medical savings accounts authorized by the Health Insurance Portability and Accountability Act (HIPAA) of 1996.

Who is eligible to set up and contribute to an Archer MSA?

Individuals who are either self-employed or small business employees and their spouses are eligible to set up an Archer MSA. Individuals with an Archer MSA must be covered by a qualified high-deductible health plan. Under the rules governing Archer MSAs, either the employer or the employee may contribute, but both cannot contribute in the same year.

What are the federal tax benefits of Archer MSAs?

Employee contributions to Archer MSAs are tax deductible, even if the individual does not itemize. Employer contributions are excluded from gross income and not subject to employment taxes, and interest on Archer MSA accounts accrues tax-free. In addition, individuals can withdraw Archer MSA funds tax-free if they are used for qualified medical expenses.

How much can be contributed to an Archer MSA?

Archer MSAs must be paired with a high-deductible health plan, and contributions are limited to 65% of the amount of the high-deductible health plan deductible for self-only coverage and 75% for family coverage. Individuals cannot contribute more than they earned for the year from the employer through which they have the HDHP. If they are self-employed, they cannot contribute more than their net self-employment income (income minus expenses).

What is a high-deductible health plan under the rules governing MSAs?

Deductibles for HDHPs paired with MSAs must be between $1,750 and $2,650 for individual coverage in 2005 and between $3,500 and $5,250 for family coverage. The limits on what consumers can pay out-of-pocket for health expenses are $3,500 for individuals and $6,450 for families in 2005. Dollar amounts are indexed annually for inflation.

Does preventive care count toward the deductible of the high-deductible health plan associated with an Archer MSA?

Yes. Treasury Department rules allow HDHP deductibles to be waived for certain types of preventive care.

Who controls the use of funds in Archer MSAs?

Individuals control use of funds in Archer MSAs and can make withdrawals for qualified medical expenses as defined by the IRS. As with HSAs, individuals can decide when and how much to contribute to Archer MSAs (up to the allowable maximums). Individuals also can decide which company can hold the account. Contributions to Archer MSAs must be in cash; stock or other property cannot be contributed.

Can Archer MSAs be offered in conjunction with a health insurance plan?

Yes. Like HSAs, Archer MSAs must be used with a high-deductible health plan. To qualify for an Archer MSA, individuals generally cannot have health coverage other than the HDHP. However, the following additional types of coverage are allowed:

- Workers' compensation insurance.
- Insurance to cover liabilities from torts or use or ownership of property.
- Coverage for a specific disease or illness.
- Per-diem coverage for a hospital stay.
- Coverage for accidents, disability, dental care, vision care, or long-term care.

Individuals enrolled in Medicare cannot contribute to an Archer MSA. However, they can still receive tax-free distributions from a previously established MSA to pay qualified medical expenses.

What kinds of expenses can be paid with Archer MSAs?

To be withdrawn on a tax-free basis, funds must be used for qualified medical expenses, as defined by the IRS, or for certain health insurance premiums.

Can Archer MSA funds be used to pay health insurance premiums?

Yes. Individuals can use Archer MSA funds to pay health insurance premiums while receiving unemployment benefits or while receiving COBRA continuation benefits. In addition, Archer MSA funds can be used to pay premiums for qualified long-term care coverage.

Can Archer MSA funds be used to pay health expenses incurred by a spouse or dependent?

Yes.

What happens if there is money left in an Archer MSA at the end of a year?

As with HSAs, individuals can roll over their Archer MSA funds from year to year indefinitely throughout their lives. And upon a participant's death, unspent Archer MSA funds can be passed on to a surviving spouse without federal tax liability. Individuals also have the right to roll over Archer MSA funds into an HSA.

Can employees take Archer MSAs with them when they retire or change jobs?

Yes. Like HSAs, Archer MSAs are portable, so that individuals can take their MSA funds with them when they retire or change jobs. However, individuals in this situation cannot make additional contributions to the Archer MSA unless they would otherwise be eligible.

Are Archer MSAs being phased out?

Archer MSAs were created as a time-limited demonstration project. Congress has extended the demonstration several times, and currently Archer MSAs are scheduled to phase out on December 31, 2005. After that date, individuals can no longer open new Archer MSAs but can contribute to existing Archer MSAs and can use funds from existing Archer MSAs to pay qualified medical expenses.

How many people have Archer MSAs?

The number of people enrolled in Archer MSAs is much lower than the 750,000 allowed under HIPAA. In 2003, it was estimated that fewer than 80,000 taxpayers were participating in the demonstration (BNA, 2003). Analysts have attributed the relatively low enrollment to the complexity of the MSA product and restrictions on the scope of the MSA demonstration (e.g., limiting eligibility to the self-employed and small businesses and the phaseout).

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