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Solutions for Today's Health Policy Challenges

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MSAs Are Not FSAs Are Not HRAs

With the alarming increases in health care costs, employers are looking to consumer-driven health plans to help rein in expenditures. Such consumer plans include Medical Savings Accounts (MSAs), Health Reimbursement Arrangements (HRAs), Flexible Spending Accounts (FSAs), and even defined-contribution plans that give employees a fixed amount of money with which to purchase a health policy.

Unfortunately, many consumers and employers are confused about which approach is best. The *Washington Post* recently ran a story proclaiming that the American Postal Workers Union was giving its employees a "Medical Spending Account" option. However, a full reading of the story made it clear that postal workers were getting an HRA option, not an MSA. Indeed, establishing a tax-free MSA would be illegal under current federal MSA legislation.

The Council for Affordable Health Insurance (CAHI) has prepared this analysis in an effort to help clear up the confusion.

Medical Savings Accounts. MSAs are health plans that combine a high-deductible health insurance policy with a savings account. The high-deductible policy protects the insured from the cost of a catastrophic illness, prolonged hospitalization or a particularly unhealthy year. The savings account is controlled by the insured and is intended to pay routine health care expenses.

Deposits to federally qualified MSAs (often referred to as Archer MSAs) are tax free. MSA money not spent by year's end may be rolled over to the next year and grow with interest or be withdrawn. Those who withdraw MSA money for purposes other than health care expenses must pay the taxes they avoided plus a 15 percent penalty.

Congress authorized federally qualified MSAs under the Health Insurance Portability and Accountability Act of 1996 (HIPAA). At the same time, it imposed on Archer MSAs a number of restrictions that reduce their workability and appeal. For example, only the self-employed and employees working for small businesses can have a tax-free MSA. And employers or employees can contribute money to their MSA, but not both.

Flexible Spending Accounts. Congress authorized FSAs under the Revenue Act of 1978. FSAs allow employees to contribute some of their own salary to an account to pay for health care expenses or their share of health insurance premiums. Like Archer MSAs, contributions to an FSA are exempt from both income and payroll taxes. However, under the tax code,

only employers can set up this program for their employees, thus excluding the self-employed and millions of employees who are prohibited from creating their own accounts.

But the biggest downside of FSAs is the use-it-or-lose-it provision. While employees contribute the money, employers get to keep any unspent balance at year's end. Because it is difficult for a family to predict its annual medical expenses, employees often overfund their accounts and by December find themselves spending on unnecessary or frivolous health care so they will not have to forfeit the remaining money to their employers.

Health Reimbursement Arrangements. HRAs are the newest form of consumer-driven health plans. In June 2002, the IRS authorized them and published guidance regarding their tax treatment.

Notice that it is not called a Health Reimbursement "Account" (a common mistake) but "Arrangement." HRAs allow the employee to use the employer's money solely for medical expenses. The funds are owned by the employer, not by the employee, and they may not be withdrawn for nonmedical expenditures. If withdrawals are permitted for nonmedical expenses, the plan will be disqualified for all employees, and they will owe taxes on all amounts paid out of the HRA, *including all prior medical reimbursements*. Unspent HRA balances may accumulate from year to year, and employers may or may not allow departing employees access to the balances after they have left the company. However, the vast majority of employers are not making the funds available.

It's All about Incentives. One of the main differences between the FSA, HRA and MSA is the financial incentive to be a value-conscious health care consumer. HRA and FSA funds do not accrue to the employee and therefore offer the employee little incentive to control spending. Indeed, the only way to gain value from the money is to spend it. Thus it is possible that HRAs could *increase* health care spending rather than reduce it as any consumer-driven plan should.

These problems could be fixed, however. Congress could change the FSA's use-it-or-lose-it rule to a use-it-or-save-it provision. It could give employees an ownership right to their HRA funds. Better yet, it could eliminate the restrictions on Archer MSAs so that all employers and employees have access to a wide range of MSA plans.

For a side-by-side comparison of the pros and cons of MSAs, FSAs and HRAs, please see the reverse.

**Medical Savings Accounts (MSAs), Flexible Spending Accounts (FSAs)
& Health Reimbursement Arrangements (HRAs)
Side-By-Side**

| | MSA | FSA | HRA |
|---|--|---|---|
| Who “owns” it? | Individual/Employee. | Individual/Employee. | Employer. |
| Who funds it? | Employer or employee (but not both), or self-employed individual. | Typically funded by employee. | Employer only (self-employed precluded). |
| How is it funded? | Money is deposited directly into the account. | A set amount of pretax wages designated by the employee is deposited directly into an account. | Employer reimburses employee when presented with a valid receipt. |
| Is it a personal account? | Yes. | Yes. | It is an “Arrangement,” not an “Account.” |
| What type of corresponding health plan is allowed? | Only high deductible. | Any type of health plan arrangement. | Any type of health plan arrangement. |
| Does interest accrue? | Interest can be accrued tax free in qualified MSAs. | Interest not accrued. | Interest not accrued or addressed in IRS regulations. |
| Is it portable? | Rollover is allowed — individual owns MSA, takes it when leaving employment. | Unused funds must be spent by year’s end (or by termination of employment before year’s end), otherwise individual loses money. | HRAs cannot be rolled over to a new employer. An employer is under no obligation to continue the arrangement after employee departure, however an employer may chose to continue reimbursing a former employee’s expenses from the HRA. |
| Can funds be used for non-medical expenses? | Funds used for non-medical expenses are taxed as income and incur a 15% penalty. After age 65 there is no penalty. | No, health portion of FSA only used for expenses defined under §213(d) of IRC. | No, only expenses defined under §213(d) of IRC. |
| What is the tax treatment? | Qualified MSAs are tax free as long as funds are spent on medical care defined under §213(d). | Contributions to FSA are tax free and so reduce annual taxable income. | Reimbursements to employee are tax free as long as they are used on qualified health care purchases. |

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