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Solutions for Today's Health Policy Challenges

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HSAs, FSAs, HRAs *Which Consumer-Driven Health Care Option Should You Choose?*

With the alarming increases in health care costs, employers are looking to consumer-driven health plans to help rein in expenditures. Consumer-driven health plans (CDHPs) — which include plans with higher deductibles paired with Health Savings Accounts (HSAs), Health Reimbursement Arrangements (HRAs), and Flexible Spending Accounts (FSAs), as well as defined-contribution plans — give individuals more choices and more control over the money being used to purchase health care. These plans encourage consumers to be value-conscious shoppers in the health care marketplace.

Why Consumer-Driven Health Plans? Interest in and satisfaction with consumer-driven health plans has increased significantly over the years. Unfortunately, many consumers and employers are still confused about the differences between the various plans and accounts and which option would be best for them. The Council for Affordable Health Insurance (CAHI) first prepared this analysis in 2002 and has updated it annually in an effort to help people make informed choices about consumer driven health plans. Further, this version includes changes required by the Patient Protection and Affordable Care Act (PPACA). For a more in-depth look at PPACA changes and Health Savings Accounts, please see CAHI's *Issues and Answers: Answering Your Questions about Health Savings Accounts*.

Longest Running Consumer-Driven Study Shows Consumers Accessed More Preventive Care and Saved Money at the Same Time. Aetna has conducted the longest-running review of consumer driven health plans in the industry, with more than two million Aetna members. The most recent study found that employers that replaced their traditional health benefits plans with Aetna's consumer driven plans (consisting of HSAs and HRAs), saved \$21.5 million over a five-year period for every 10,000 members. The study showed that members of consumer driven plans accessed more preventive care and screenings than people with traditional Preferred Provider Organization (PPO) plans.

While companies that switched completely to Aetna HealthFund plans reaped the highest cost savings, those that offered Aetna HealthFund HRA and HSA plans as one option still experienced savings of \$9 million over five years for every 10,000 members enrolled in all health plan options.

Health Savings Accounts (HSA). A Health Savings Account is a special, tax-free account that must be coupled with an HSA-qualified high deductible health insurance policy. The insurance protects the insured person from the cost of a catastrophic illness, prolonged hospitalization or a particularly unhealthy year. The savings account is controlled and owned by the insured person and is intended to pay small and routine health care expenses. The HSA has set annual contribution limits (including "catch-up" contributions for people over age 55), and both the employer and individual may contribute to the HSA (but all money in the account is still owned by the insured person). A recent survey by America's Health Insurance Plans shows that HSA plans have grown to more than 11.4 million people covered in 2011.

PPACA changes: Starting January 1, 2011, the tax on withdrawals for non-medical expenses increased from 10 percent to 20 percent. In addition, a prescription is required for tax-free reimbursement of over-the-counter (OTC) medicines.

Flexible Spending Accounts (FSA). IRS Section 125 permits employers to create a "cafeteria" plan — a plan that allows employees to reduce their salary (and therefore income and payroll tax liability) by paying for certain benefits on a pre-tax basis. Cafeteria plans are used to pay for such things as insurance premiums, adoption expenses, child-care expenses, and (under a flexible spending account) medical expenses. Only employers can set up this program for their employees, so the self-employed and employees of firms that choose not to create a cafeteria plan are out of luck. To avoid IRS penalties, FSA funds may only be withdrawn for qualified medical expenditures. The biggest downside of FSAs is the requirement

that both employer and employee are at risk. Employees voluntarily deduct/contribute the money from their wages and employers get to keep any unspent balance at year's end. Similarly, employers may be responsible for covering employee's outstanding balances when the employee's expenses exceed their contributions if the employee leaves their job for any reason. These risks create problems for both the employer and employee. Many employers limit the pre-funding of medical expenses to avoid their risks. Employees may find it is difficult to predict annual medical expenses, and employees may overfund their accounts. Too often this situation results in employees spending their funds on unnecessary or frivolous health care so they will not have to forfeit the remaining money. Other employees decline to participate or contribute less than they might for fear of losing the funds at the end of the year.

PPACA changes: Starting January 1, 2011, a prescription is required for tax-free reimbursement of OTC medicines. Beginning January 1, 2013 salary reduction contributions to the health portion of an FSA is limited to \$2,500 per year (adjusted annually for inflation). There is no change to the dependent care FSA.

Health Reimbursement Arrangements. In June 2002, the IRS authorized HRAs and published guidance regarding their tax treatment. HRAs offer employers few restrictions and, as a result, attracted a lot of interest from employers looking at consumer driven options (HSAs were not yet available). Notice that it is not called a Health Reimbursement "Account" (a common mistake) but "Arrangement." HRAs are amounts pledged by employers that employees may use tax-free to reimburse medical expenses or premiums. Like with FSAs, the funds are owned and controlled by the employer, not by the employee, and they may not be withdrawn for non-medical expenditures. If withdrawals are permitted for non-medical 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. The employer decides whether unspent HRA balances may accumulate from year to year, or the balances may expire at the end of each year. Employers may or may not allow departing employees access to the balances after they have left the company. With some exceptions, the large majority of employers are not making the funds available.

PPACA Change: Starting January 1, 2011, a prescription is required for tax-free reimbursement of OTC medicines.

It's All about Incentives. One of the main differences between the FSA, HRA and HSA is the financial incentive to be a value-conscious health care consumer. In the case of the FSA and HRA, the account is not owned by the employee and is in most cases "use or lose" money; therefore, there is little incentive to save any money as it reverts back to the employer at year end. FSA funds do not accrue to the employee and therefore offer the employee little incentive to control spending — especially at the end of the year. Indeed, the only way to gain value from the money is to spend it. When HRAs work like FSAs, they usually increase health care spending rather than reduce it, as any consumer driven plan should.

These problems could be fixed, however. Congress did authorize a one-time rollover of unused FSA funds to an HSA (same for HRA funds). Congress could go further than a one-time allowance and change the FSA's use-it-or-lose-it rule to a use-it-or-save-it provision. Congress also could give employees an ownership right to their HRA funds. However, as more and more individuals and employers move to the HSA option — which they surely will do since the advantages to having an HSA greatly outweigh those of FSAs and HRAs for most people — the political pressure and need to amend FSAs and HRAs may diminish. Those who want a consumer driven option will simply choose an HSA.

For a side-by-side comparison of HRAs, FSAs and HSAs, please see the following table. For a complete analysis of the HSA law and changes under PPACA, please see CAHI's *Issues and Answers: Answering Your Questions about Health Savings Accounts*.

	Health Savings Accounts (HSAs)	Health Care Flexible Spending Accounts (FSAs)	Health Reimbursement Arrangements (HRAs)
Who may have this type of health care account?	Any adult that has coverage under an HSA-qualified plan and is not covered by any other health insurance (including Medicare) that makes the individual ineligible. Dependent children may not have their own HSAs.	Any employee that works for an employer that offers an FSA, subject to the employer's eligibility rules.	Any employee that works for an employer that offers an HRA, subject to the employer's eligibility rules.
What type of corresponding health plan allowed or required?	An individual must be covered under an HSA-qualified plan (also known as a "High Deductible Health Plan"). Individuals may not have other insurance that is not HSA-qualified except for certain types such as dental, vision, long-term care, etc.	FSAs are allowed regardless of type of health plan (including no health plan). Individuals may also have other types of insurance coverage and medical benefit plans.	HRAs are allowed with any type of health plan (including no health plan). Individuals may also have other types of insurance coverage and medical benefit plans.
Compatible with other health accounts?	HRAs and FSAs may make individuals ineligible for an HSA. However, certain types of HRAs and FSAs (known as "limited purpose" and "post-deductible" plans) will not impact HSA eligibility.	HRAs and HSAs do not impact an employee's ability to have an FSA.	FSAs and HSAs do not impact an employee's ability to have an HRA.
Who funds the account?	Employers, employees, and other individuals.	Employees, although employers may also.	Employers only.
How is the account funded?	Contributions made by employers, employees or other individuals must be made in cash to a bank account that is owned by the employee.	Employees elect to have money taken from their wages through payroll deduction. The employer collects the money and holds onto the funds until claims for reimbursement are made. The employer may also add funds to each employee's "account." However, there is no bank account that is owned by the employee.	Account is "notional" so employers do not actually make contributions. The employer must be prepared to pay up to the amount promised but does not have to make cash deposits. So there is no bank account that is owned by the employee. This is partly why it is an "arrangement" and not an "account."
Tax treatment of funding	Employer contributions are deductible as a business expense to the company and are tax-free to the employee. Employee contributions made through payroll deduction are not taxed as wages. Contributions made outside of work are deductible against federal and (in most cases) state income taxes.	Employee contributions through payroll deduction are not taxed as wages. Expenses reimbursed through the FSA are tax-free to the employee. The employer deducts as a business expense any amounts contributed by the company.	Account is "notional" so funding is not required. However, the employer agrees to reimburse up to a specified amount of expenses submitted for reimbursement. Expenses reimbursed through the HRA are tax-free to the employee. The employer deducts as a business expense only amounts actually reimbursed from employees' HRAs.
Limits on funding	Determined by IRS based on a formula set in law. Amounts increase annually based on inflation. Limits for 2011 are \$3,050 for individuals and \$6,150 for families.	Determined by employer. Effective January 1, 2013, contributions will be limited to \$2,500 per employee (adjusted annually for inflation). Employers can set lower limits.	Determined by employer.

	Health Savings Accounts (HSAs)	Health Care Flexible Spending Accounts (FSAs)	Health Reimbursement Arrangements (HRAs)
Catch up contributions for older workers	Individuals age 55 or older may make annual catch-up contributions of \$1,000.	Not applicable.	Employer may make additional amounts available to older workers, subject to non-discrimination rules.
What expenses may be reimbursed?	Qualified medical expenses, as defined by the IRS, may be reimbursed tax-free. Withdrawals for other purposes must be included in income and subject to a 20 percent penalty. No penalty applies at age 65 or if disabled.	Qualified medical expenses only, as defined by the IRS. Violation makes all reimbursements by the plan taxable. Employer may further limit reimbursable expenses.	Qualified medical expenses only, as defined by the IRS. Violation makes all reimbursements by the plan taxable. Employer may further limit reimbursable expenses.
Whose expenses may be reimbursed?	Individual/employee, their spouse, and dependents (children and/or qualifying relatives). Employers cannot add limitations.	Employee, their spouse, dependents (children and/or qualifying relatives), and children who have not reached age 27 by the end of the calendar year. However, employers can limit to certain persons (e.g., employees only).	Employee, their spouse, dependents (children and/or qualifying relatives), and children who have not reached age 27 by the end of the calendar year. However, employers can limit to certain persons (e.g., employees only)
How are expenses substantiated?	Individuals must keep receipts to substantiate tax-free withdrawals. Individual self-reports substantiated and non-substantiated withdrawals on income tax return.	Employers generally require valid receipts or use of approved debit or stored value cards.	Employers generally require valid receipts or use of approved debit or stored value cards.
Can funds grow through earnings or interest?	Interest and earnings can accrue tax-free in HSAs.	Employers generally use earnings on funds to offset plan expenses.	No, although employers can make additional deposits that mimic interest.
Can funds be invested?	Yes. HSA funds can be invested in the same types of investments as IRAs, including stocks, bonds, mutual funds, CDs, etc.	No.	No.
Carryover of unused funds	Unspent funds in an individual's HSA account rollover automatically to the next year and accumulate over time.	Unspent amounts expire at year end ("use it or lose it") unless the employer offers a "grace period" which extends the time during which funds may be used for up to an additional 2-1/2 months. Unspent funds revert to the employer.	Unspent amounts expire at year end ("use it or lose it") unless the employer allows the amounts to be "carried forward" to reimburse expenses in later years.
Portability at termination of employment	Unspent funds in an individual's HSA belong to the individual and are completely portable.	Unspent amounts remaining at termination are forfeited and revert to the employer.	Unspent amounts remaining at termination may be forfeited, or the employer may allow the employee to spend down the remaining amount after termination.

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