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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 plans, which include Health Savings Accounts (HSAs), Health Reimbursement Arrangements (HRAs), Flexible Spending Accounts (FSAs), and defined-contribution plans, give individuals more choices and more control over the money being used to purchase health care, which encourages them to be value-conscious shoppers in the health care marketplace.

Unfortunately, many consumers and employers are confused about the differences between the various consumer-driven plans and which option would be best for them. The Council for Affordable Health Insurance (CAHI) has prepared this analysis in an effort to help people make informed choices.

Health Savings Accounts. According to America's Health Insurance Plans, the HSA program has grown from 438,000 people covered by an HSA in 2004 (the first year of the program's existence) to 3.2 million people in 2005. By 2010, if no changes to the current law are made, the Treasury projects that 14 million policies covering as much as 30 million people could be realized. And, if improvements proposed by President Bush in his health care initiative package are made, the Treasury estimates there could be as many as 21 million HSAs covering as many as 45 million people in the same time frame.

Health Savings Accounts 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. Deposits to HSAs are tax deductible (and in some cases tax free). HSA funds not spent by year's end may be rolled over to the next year and grow with interest tax free. Those who withdraw HSA money for purposes other than health care expenses must pay income taxes plus a 10-percent penalty on the amount withdrawn. The savings account is controlled by the insured and is intended to pay small and routine health care expenses. Specifically, Health Savings Accounts for tax year 2007:

- Must be coupled with a health insurance policy with a minimum deductible of $1,100 for an individual, with total annual out-of-pocket expenses no more than $5,500, or $2,200 for a family deductible, with total annual out-of-pocket expenses no more than $11,000;
- Allowable contributions are now up to $2,850 for an individual or $5,650 for a family regardless of the policy deductible;
- Permit "catch up," or increased, contributions for individuals aged 55 and over — an additional $800 per person; and
- Allow both employers and individuals to contribute to the account.

Flexible Spending Accounts. Congress authorized FSAs under the Revenue Act of 1978. FSAs allow employees to contribute some of their own salary on a pre-tax basis to an account to pay for health care expenses or their share of health insurance premiums. Like HSAs, 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. Although 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 over fund their accounts and by December find themselves spending on unnecessary or frivolous health care so they will not have to forfeit the remaining money.

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 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. With some exceptions, the large majority of employers are not making the funds available.

It's All about Incentives. One of the main differences between the FSA, HRA and now the HSA is the financial incentive to be a value-conscious health care consumer. FSA funds do not accrue to the employee and therefore offer the employee little incentive to control spending — at least at the end of the year. Indeed, the only way to gain value from the money is to spend it. If HRAs are treated like FSAs, they could *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 as well). Congress should 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 table. For a complete analysis of the HSA law, please see CAHI's *Issues and Answers: Answering Your Questions About Health Savings Accounts.*

	HSA	FSA	HRA
Eligibility	Individual must not be enrolled in Medicare and not covered by any other health plan which duplicates any benefits in the qualified high-deductible plan.	Individual must work for an employer who offers one.	Individual must work for an employer who offers one.
Who "owns" it?	Individual/employee.	Individual/employee.	Employer.
Who funds it?	Typically individual and/or employer. Both may make contributions in the same year. Employer allowed to make additional contribution to help lower-paid workers.	Employee only via payroll deduction (self-employed precluded).	Employer only (self-employed precluded).
How is it funded?	For 2007, the maximum allowable contribution to an HSA is $2,850 for individual coverage and $5,650 for family coverage. Taxpayers allowed full-year contributions for part-year coverage. However, they must maintain a qualified HDHP for a full year beginning in the month the HSA begins or pay a tax on the contribution plus 10% penalty. Contributions to the HSA may be made through §125 Cafeteria Plans. An employee is allowed a one-time rollover from an HRA or FSA as long as it is before 01/01/2012. Also allowed is one-time transfer from an IRA to an HSA.	A set amount of pretax wages designated by the employee is deposited directly into an account via payroll deduction.	Employer funding only. Account is "notional" not cash deposits. Employer reimburses employee when presented with a valid receipt.
What type of corresponding health plan is required?	Requires a high deductible health plan with a minimum deductible of $1,100 for individuals and $2,200 for family coverage. Total costs to the insured cannot exceed $5,500 for an individual and $11,000 for a family, including both the deductible and copayments. Since the law does not specifically detail a maximum deductible, the out-of-pocket spending cap in effect becomes the maximum deductible. All amounts are indexed for inflation. HDHP allowed to offer first-dollar coverage for preventive care and still qualify. Penalties for going out of the PPO network do not count toward the total costs to the insured. Employees can have a limited-purpose health FSA or HRA, a suspended HRA, a post-deductible health FSA or HRA, or a retirement HRA (IRS Publication 969).	Any type of health plan arrangement.	Any type of health plan arrangement.
Does interest accrue?	Interest can be accrued tax free in qualified HSAs.	Interest not accrued.	Interest not accrued or addressed in IRS regulations.
Substantiation of expenses	It is self-substantiation of expenses.	The employer must approve expenses and can disallow for reimbursement even though the expense may be a qualified §213(d) expense.	The employer must approve expenses and can disallow for reimbursement even though the expense may be a qualified §213(d) expense.
Is it portable?	Completely portable. The individual owns the HSA and takes it with him or her when leaving employment.	Not portable. Unused funds must be spent by year's end (or by termination of employment before year's end), otherwise individual loses money.	Not portable. 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 10% penalty. After age of Medicare eligibility 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 expenses reimbursed from the HSA are tax-free.	Contributions to the FSA are tax free and so reduce annual taxable income. No limit by law, but the plan sets either a maximum dollar or percentage contribution amount.	Reimbursements to employee are tax free as long as they are used on qualified health care purchases.
Is there a "catch up" contribution provision for older workers?	Individuals age 55 or older may contribute more to the account per year. For tax year 2007, an additional $800 per person is allowed. Married couples may both contribute a catch up contribution to the HSA, if both are eligible.	Not available.	Not available.
How are unused balances treated with other benefit?	Unused funds roll over automatically every year.	Money is forfeited back to employer at year's end if there are any remaining FSA funds. However, in coordination with an HSA, allowed a one-time rollover from FSA as long as it is before 01/01/2012. Rollovers cannot exceed the HSA contribution limit or excess contribution rules (i.e., penalty and tax) apply.	Unused funds may be rolled over to successive years if allowed by the employer. In coordination with an HSA, allowed a one-time rollover from HRA as long as it is before 01/01/2012. Rollovers cannot exceed the HSA contribution limit or excess contribution rules (i.e., penalty and tax) apply.

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