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HSAs, HRAs or FSAs:

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 the newly passed 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. Congress authorized Health Savings Accounts under the Medicare Prescription Drug Improvement and Modernization Act of 2003. HSAs function similar to the older Medical Savings Account (MSA) option that existed between 1996 and 2003, but without many of the restrictions that limited MSAs' availability and desirability.

As with MSAs, 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 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 the taxes they avoided when the money was deposited, plus a 10 percent penalty.

The savings account is controlled by the insured and is intended to pay small and routine health care expenses. Specifically, Health Savings Accounts:

- Must be coupled with a health insurance policy with a minimum deductible of $1,000 for an individual, with total annual out-of-pocket expenses of $5,100, or $2,000 for a family deductible, with total annual out-of-pocket expenses of $10,200;
- Allow annual contributions to the account up to 100 percent of the annual deductible;
- Permit "catch up," or increased, contributions for individuals aged 55 and over—for tax year 2005 an additional $600 per person;
- Allow both employers and individuals to contribute to the account;
- Place no limit on the total number of accounts;
- Are a permanent feature of the tax code, and thus are not time limited as is the Archer MSA demonstration project, which will expire on Dec. 31, 2005; and
- Allow rollovers from MSAs to HSAs.

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 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 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.

Health Reimbursement Arrangements. In June 2002, the IRS authorized HRAs and published guidance regarding their tax treatment. Unlike MSAs at the time, HRAs are largely unrestricted 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 could 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 be below Medicare eligibility age 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.	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?	Minimum $1,000 for individual and $2,000 for family coverage. No maximum deductible. Total costs to the insured cannot exceed $5,100 for an individual and $10,200 for a family, including both the deductible and copays. Thus, a plan that pays 100% of all costs above the deductible could have a deductible as high as $5,100 for an individual or $10,200 for a family.	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.
Is it portable?	Rollover is allowed — individual owns HSA, 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 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 HSAs 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.
Is there a "catch up" contribution provision for older workers?	Individuals age 55 or older may contribute more to the account per year. Starting in 2000, an additional $500 contribution is allowed, increasing $100 per year up to $1,000 per year in 2009 and thereafter. So, for tax year 2005, an additional $600 per person is allowed. Married couples may both contribute a catch up contribution to the HSA.	Not available.	Not available.
Are there other income eligibility requirements?	No.	No.	No.
How are unused FSA balances treated with other benefit?	There is no provision to allow the FSA to roll over into the HSA. However, contributions to the HSA may be made through §125 Cafeteria Plans.	Money is forfeited back to employer at year's end if there are any remaining FSA funds.	N/A

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