



PERSPECTIVES

PROVIDING INSIGHT INTO TODAY'S EMPLOYEE BENEFITS ISSUES

Comparing MSAs, HSAs, HRAs, and FSAs: Which Approach Is Best?

EMPLOYERS are increasingly looking to consumer-driven health plans to help soften the blow of continually rising healthcare costs. Depending on the model, these plans typically include Medical Savings Accounts (MSAs), Health Reimbursement Arrangements (HRAs), Flexible Spending Accounts (FSAs), and most recently, Health Savings Accounts (HSAs). Some plans allow employees to use these accounts to pay for medical expenses that are not covered by insurance, while employers use others to provide employees with a fixed dollar amount with which they can purchase healthcare services or a health insurance policy on the open market.

The explosion of these types of plans — or at least the explosion of *discussion* about these types of plans as a potential cure for rising healthcare costs — has left many consumers and employers confused about the right approach.

This edition of *Perspectives* provides some basic information about the similarities and differences between MSAs, HSAs, HRAs, and FSAs.

Medical Savings Accounts

Perhaps the original consumer-driven health plan, the Archer MSA is an account that allows year-to-year rollovers and is designed to be combined with a high-deductible health insurance policy. The high deductible policy protects the insured from catastrophic loss, such as a prolonged illness or hospitalization, or simply an unexpected period of poor health. The savings account is controlled by the individual, and is intended to pay for routine healthcare services.

MSAs were authorized under the Health Insurance Portability and Accountability Act of 1996 (HIPAA). Congress simultaneously imposed on Archer MSAs several

restrictions that reduce their practicality and appeal to employers and employees. For example, tax-free MSAs are only available to the self-employed and the employees of small businesses (under 50 employees). Larger and medium-sized employers and employees of companies that do not provide health insurance are not eligible for an Archer MSA. These individuals may be eligible for a nonqualified MSA plan, but the nonqualified plans provide no federal tax break.

Another downside to the Archer MSA: the employer and employee may not both contribute to the employee's MSA in the same year.

The MSA pilot program will expire on December 31, 2005. While MSA accounts established prior to this date may continue to be used and receive contributions, no new accounts may be established after December 2005.

Health Savings Accounts

In December 2003, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 established a new type of tax-favored health savings account (HSA). HSAs are much like MSAs, but the rules applicable to HSAs are less restrictive.

An individual that is (a) covered by a high deductible health plan, (b) does not have other health insurance coverage (with some exceptions), and (c) is not claimed as a dependent on another person's tax return may establish an HSA. An HSA may be established by an individual, including the self-employed, or may be employer sponsored. Unlike MSAs, the employer and employee can contribute to the HSA in the same year, subject to annual limits.

Like the MSA, the high deductible health plan is designed to protect the individual against catastrophic loss, but allows the individual to rollover unspent funds in the HSA from year to year. Since the HSA is a tax-exempt trust owned by the individual, the employee takes the account with them upon termination or retirement.

While an HSA could be established as early as January 2004, many insurance carriers are still in the process of creating products that will qualify as a high deductible health plan. IRS guidance has now clarified many of the questions benefit experts were raising related to the use of HSAs.

Flexible Spending Accounts

In 1986, the Internal Revenue Code Section 125 introduced the Flexible Spending Account. FSAs provide a means for employees to considerably reduce their income tax liability through salary reduction. Employees can contribute a portion of their own salary to an account designated to pay for healthcare expenses. These pre-tax contributions are exempt from income and payroll taxes.

Several inherent design flaws have resulted in modest participation in FSAs. Tax code requires that only employers set up these accounts for their employees, leaving self-employed individuals and millions of other employees unable to set up their own accounts. In addition, the use-it-or-lose-it provision within the FSA is its biggest downside. Employees are required to elect a specific amount of salary deduction at the beginning of the year, and then must use every dollar in the account by the end of that year. Because annual medical expenses are hard to predict, employees often overfund the accounts and then spend unnecessarily at the end of the year to avoid forfeiting the money in their accounts.

Legislation that proposed to allow participants to carry over \$500 from the prior year did not pass in 2003 as expected. This change would have built more consumerism into the use of FSAs. However, in 2005, the IRS announced that cafeteria plans could be amended to allow participants to access unused amounts remaining in an FSA at the end of the plan year to pay for expenses incurred during a grace period of up to two and a half months after the end of the plan year. It is important to note that when a plan with a general purpose health FSA provides a grace period, participants will not be eligible to contribute to an HSA until the first day of the first month following the end of the grace period.

Critics of FSAs also note that they are difficult and confusing to set up and administer, causing many small and midsize employers without adequate resources to forego their use. In addition, filing claims for reimbursement can sometimes be difficult and time consuming for the employee.

Health Reimbursement Arrangements

In June 2002, the IRS confirmed that funds within a Health Reimbursement Arrangement (HRA) may be rolled over from year to year. HRAs allow employees to use employer contributions only for medical expenses or to pay health insurance premiums.

Unlike FSAs, unused HRA balances may accumulate from year to year, thus providing a personal stake for the consumer in the financial outcome of his or her healthcare spending decisions.

Because HRAs are group health plans, they are subject to laws such as HIPAA and COBRA. If an employee leaves an employer, he may continue to access unused funds within the

HRA by electing COBRA. Under COBRA, the employer may also be required to continue its contributions during the COBRA coverage period. The requirement to continue contributions and comply with HIPAA is a deterrent for employers to implement an HRA.

Deciding on the Right Approach

Introducing consumerism into your health plan requires an evaluation of the benefits and disadvantages of MSAs, HSAs, FSAs, and HRAs. No one solution is right for every employer. In light of the complexities of choosing the right consumer-driven health plan, many employers continue to take a wait-and-see approach.

If your organization is considering implementing a consumer-driven health plan, your Owen-Dunn Insurance representative can help you decide which plan is best for you.

IRS guidance has now clarified many of the questions benefit experts were raising related to the use of HSAs.

A chart comparing the tax-advantaged accounts discussed in this article follows.

Comparison of Tax-Advantaged Accounts

	HSA	MSA	HRA	FSA
Name of account	Health Savings Account	Medical Savings Account	Health Reimbursement Arrangement	Health Flexible Spending Account
Who owns the account?	Individual/employee	Individual/employee	Employer	Individual/employee
Who may fund the account?	Employer or employee, can be both in the same year Employee can contribute pre-tax dollars through Section 125 plan	Employer or employee, but not both in the same year Must be small employer or self-employed individual	Employer Self-employed individuals, including partners, and more than 2% shareholders in a subchapter S-corporation cannot contribute	Employer/employee Typically the employee contributes pre-tax dollars through a Section 125 plan
What plans may be offered with the tax-advantaged account?	A HDHP as follows*: <u>Min. Deductible</u> \$1,050 I \$2,100 F <u>OPM</u> \$5,250 I \$10,200 F	A HDHP as follows*: <u>Min. Deductible</u> \$1,800 I \$3,650 F <u>Max. Deductible</u> \$2,700 I \$5,450 F <u>OPM</u> \$3,650 I \$6,650 F	Any or no health plan	Any or no health plan
Is there a limit on the amount that can be contributed per year?	Lesser of*: *100% of deductible *\$2,700 I \$5,450 F Catch-up contributions: \$700/year – age 55 by end of tax year Reduced by MSA contributions in same year	*65% of individual deductible *75% of family deductible	No, there is no IRS prescribed limit	No, there is no IRS prescribed limit
Does the uniform coverage rule apply?	No	No	No	Yes

Comparison of Tax-Advantaged Accounts

	HSA	MSA	HRA	FSA
Can unused funds be rolled over from year to year?	Yes	Yes	Yes, subject to COBRA	No, but in some cases employee may elect COBRA through end of plan year
What expenses are eligible for reimbursement?	<p>Section 213(d) medical expenses</p> <p>*COBRA premiums *QLTC premiums *Health premiums while receiving unemployment benefits *If Medicare eligible due to age, health insurance premiums except medical supplement policies</p>	<p>Section 213(d) medical expenses</p> <p>*COBRA premiums *QLTC premiums *Health premiums while receiving unemployment benefits</p>	<p>Section 213(d) medical expenses</p> <p>*Health insurance premiums for current employees, retirees, and qualified beneficiaries, and QLTC premiums</p> <p>Employer can define “eligible medical expenses”</p>	<p>Section 213(d) medical expenses</p> <p>Expenses for insurance premiums are not reimbursable</p> <p>Employer can define “eligible medical expenses”</p>
Must claims submitted for reimbursement be substantiated?	No	Yes	Yes	Yes
May account reimburse non-medical expenses?	Yes, but taxed as income and 10% penalty (no penalty if distributed after death, disability, or eligible for Medicare)	Yes, but taxed as income and 15% penalty; no penalty if after age 65	No	No
Is interest earned on the tax-advantaged account?	Yes, accrues tax-free	Yes, accrues tax-free	Yes, paid to the employer	No

*For calendar year 2006.

Perspectives is provided to Owen-Dunn Insurance clients for informational purposes.
Please seek qualified and appropriate counsel for advice on how to apply the topics discussed herein to your employee benefits plan.
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