BENEFITS INSIGHTS

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Comparing 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 health care costs. Depending on the model, these plans typically include Health Reimbursement Arrangements (HRAs), Flexible Spending Accounts (FSAs) and 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 health care services. This article provides some basic information about the similarities and differences between HRAs, FSAs and HSAs.

Health Savings Account

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 established a tax-favored health savings account (HSA). HSAs are much like the older Medical Savings Accounts, 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 it may be employer-sponsored. Both employer and employee can contribute to the HSA in the same year, subject to annual limits.

The high-deductible health plan is designed to protect the individual against catastrophic loss, but allows the individual to roll over unspent funds in the HSA from year to year. Since the HSA is a tax-exempt trust owned by the individual, the may keep the account upon termination or retirement.

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 health care expenses. These pretax contributions are exempt from income and payroll taxes.

Consumer driven health plans help soften the blow of continually rising health care costs. These plans are Health Reimbursement Arrangements (HRAs), Flexible Spending Accounts (FSAs) and Health Savings Accounts (HSAs).

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Several inherent design flaws have resulted in low participation in FSAs. The tax code requires that only employers may 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 FSA has a use-it-or-lose-it provision. 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.

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, unless the employee has a zero balance in the FSA at the end of the plan year, or if a qualified HSA distribution of the entire remaining balance is made as of the end of the plan year.

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

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 health care 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 HRA.

Deciding on the Right Approach

Introducing consumerism into your health plan requires an evaluation of the benefits and disadvantages of 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, The Wladis Companies, Inc. can help you decide which plan is best for you.

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

Comparison of Tax-Advantaged Accounts

	HSA	HRA	FSA
Name of account	Health Savings Account	Health Reimbursement Arrangement	Health Flexible Spending Account
Who owns the account?	Individual/employee	Employer	Employer
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*	Employer/employee* Typically the employee contributes pre-tax dollars through a Section 125 plan
What plans may be offered with the tax-advantaged account?	An HDHP as follows: <u>Min. Deductible</u> $1,300 Ind. $2,600 Family (2016 and 2017) <u>OPM</u> $6,550 Ind. $13,100 Family (2016 and 2017)	Effective for 2014 plan years, an employer must offer a health plan and the HRA must be considered integrated with group health plan coverage. Stand-alone HRAs are not permitted unless they are limited to excepted benefits or fall under an exemption to the Affordable Care Act (ACA).	Effective for 2014 plan years, health FSAs must qualify as excepted benefits to satisfy ACA reforms. To qualify as an excepted benefit, the FSA must meet a maximum benefit requirement and other group health plan coverage must be offered by the employer.
Is there a limit on the amount that can be contributed per year?	$3,350 Ind. $6,750 Family (2016) $3,400 Ind. $6,750 Family (2017) Catch-up contributions: $1,000/year—age 55 by end of tax year Reduced by MSA contributions in same year	No, there is no IRS prescribed limit	Effective for taxable years beginning after Dec. 31, 2012, employees may not elect to contribute more than $2,500 per year to a health FSA offered through a cafeteria plan. For 2015 and 2016 taxable years, the annual limit is $2,550.
Does the uniform coverage rule apply?	No	No	Yes

Self-employed individuals, including partners, and more than 2% shareholders in a subchapter S-corporation **cannot contribute.*

Comparison of Tax-Advantaged Health Accounts

	HSA	HRA	FSA
Can unused funds be rolled over from year to year?	Yes	Yes	No, with two exceptions. If the FSA allows, unused amounts may be used for expenses incurred during a grace period of 2-1/2 months after end of plan year. Also, if the FSA does not incorporate a grace period, it may allow employees to carry over up to $500 in unused funds into the next plan year.
What expenses are eligible for reimbursement?	Section 213(d) medical expenses Effective 12/31/10, OTC medicine or drug expenses cannot be reimbursed unless they are prescribed or are insulin. -COBRA premiums -QLTC premiums -Health premiums while receiving unemployment benefits -If Medicare eligible due to age, health insurance premiums except medical supplement policies	Section 213(d) medical expenses Effective 12/31/10, OTC medicine or drug expenses cannot be reimbursed unless they are prescribed or are insulin. Health insurance premiums for current employees, retirees, and qualified beneficiaries, and QLTC premiums Employer can define “eligible medical expenses”	Section 213(d) medical expenses Effective 12/31/10, OTC medicine or drug expenses cannot be reimbursed unless they are prescribed or are insulin. Expenses for insurance premiums are not reimbursable Employer can define “eligible medical expenses”
Must claims submitted for reimbursement be substantiated?	No	Yes	Yes
May account reimburse non-medical expenses?	Yes, but taxed as income and 20% penalty (no penalty if distributed after death, disability, or age 65)	No	No
Is interest earned on the tax-advantaged account?	Yes, accrues tax-free	Yes, paid to the employer	No

This Chart is provided to you for informational purposes only. Please seek qualified and appropriate counsel for advice on how to apply the topics discussed herein to your employee benefits plan.