

**Comparison of Health Savings Accounts (HSAs) with  
Health Reimbursement Arrangements (HRAs), Flexible Spending Arrangements (FSAs), and Medical Savings Accounts (MSAs)**

	HSA	HRA	FSA	MSA
<b>I. IN GENERAL</b>				
	<p>Effective January 1, 2004, an HSA is a tax-advantaged trust or custodial account created for the benefit of an individual (<u>not</u> limited to employees) covered under a high deductible health plan. The trustee may be a bank, an insurance company or another person (<i>e.g.</i>, a third party administrator) agreed to by the Secretary of Treasury. Contributions can be made by the employer, the employee, or another (subject to gift tax). Contributions are deductible if made by the employee, and are excludable from income and wages (for employment tax purposes) if made by an employer. Earnings grow tax-free and distributions for qualified medical expenses are tax-free. Nonqualified withdrawals are subject to income and penalty taxes. Amounts not distributed are carried forward. Like an IRA, the HSA is owned by the individual who is the account beneficiary and, therefore, the HSA is portable.</p> <p>Section 1201 of the Medicare Act<sup>1</sup> creates new Code § 223 governing HSAs.</p>	<p>A health reimbursement arrangement (“HRA”) is an arrangement funded solely by the employer. HRAs may be offered to employees or former employees. Amounts must be used for qualified medical expenses and balances may be carried forward. Depending upon the terms of the HRA, coverage may (or may not) continue if the employee terminates service. HRAs are not portable.</p> <p>HRAs are described in administrative guidance. <i>See</i> Notice 2002-45, 2002-2 C.B. 93; Rev. Rul. 2003-43, 2003-21 I.R.B. 935.</p>	<p>A health flexible spending arrangement (“FSA”) is an arrangement that may be funded by the employer and/or the employee via salary reduction. Health FSAs may be offered to employees (self-employed persons are not eligible). Amounts must be used for qualified medical expenses and balances may not be carried forward. FSA coverage may not continue if the employee terminates service, unless continuation coverage is elected under COBRA. FSAs are not portable.</p> <p>FSAs were codified in Code §106(c) under § 301(c)(2) of the Health Insurance Portability and Accountability Act of 1996 (“HIPAA”). However, FSAs previously existed through administrative guidance. In 1989, the IRS issued proposed regulations that apply to health FSAs. <i>See</i> Prop. Reg. § 1.125-2, Q&amp;A-7.</p>	<p>In general, an Archer Medical Savings Account (“MSA”) is a tax-advantaged trust or custodial account created for the benefit of an individual covered under a high deductible health plan who is (1) an employee of a small employer, or (2) self-employed. Contributions are deductible if made by an eligible individual, and are excludable from income and wages (for employment tax purposes) if made by an employer. Contributions may be made either by the employee or the employer, but not both. Earnings grow tax-free and distributions for qualified medical expenses are tax-free. Nonqualified withdrawals are subject to income and penalty taxes. New MSAs may not be established after 12/31/03; legislation is pending that would extend this deadline. Like HSAs, MSAs are portable.</p> <p>MSAs were created under § 301 of HIPAA. In 1996, the IRS issued further guidance on MSAs. <i>See</i> Notice 96-53, 1996-2 C.B. 219.</p>

<sup>1</sup> The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (the “Medicare Act”) was enacted on December 8, 2003.

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<b>II. Contributions</b>				
A. Tax Treatment of Employer Contributions	Excludable for income and employment tax purposes. Medicare Act § 1201(d)(1), 1201(d)(2)(B) & (C) creates new Code §§ 106(d), 3306(b)(18) & 3401(a)(22), respectively.	These arrangements are unfunded. Payments from the employer and coverage under the HRA are excluded from the employee's income under Code §§105, 106.	Same as HRA.	Same as HSA.
B. Tax Treatment of Individual Contributions	Deductible on individual's income tax return. Code § 223(a).	Employee contributions are not permitted, although an HRA can be offered in conjunction with an excludable FSA, subject to ordering rules discussed below.	Same as HSA.	Same as HSA.
C. Restriction for Medicare Eligibles	No contributions can be made once an employee becomes eligible for Medicare. Code § 223(b)(7).	No restriction for Medicare eligibles.	No restriction for Medicare eligibles.	Same as HSA.
D. Maximum Deduction and Exclusion	<p>In 2004, the maximum deduction and exclusion is:  \$2,600 (self-only coverage), or  \$5,150 (family coverage). Code § 223(b).</p> <p>These maximums are indexed for cost of living, beginning in 2005. Code § 223(g).</p> <p>The deduction and exclusion cannot exceed the deductible under the "high deductible health plan" described below.</p> <p>Individuals who are age 55 or older may deduct an additional \$500 in 2004. This catch-up amount will increase in \$100 increments annually, until it reaches the limit of \$1,000 in 2009. Code § 223(b)(3).</p> <p>These maximums are decreased by the aggregate amount paid into an MSA. Code § 223(b)(4).</p>	No statutory limit but benefits for highly-compensated employees may be limited by the application of nondiscrimination rules under Code §105(h).	No statutory limit but benefits and salary reduction for highly-compensated employees may be limited by the application of nondiscrimination rules under Code §105(h).	<p>In 2004,  \$1,690 (self-only coverage), or  \$3,862.50 (family coverage)</p> <p>Indexed in future.</p> <p>The deduction and exclusion cannot exceed 65 percent of the deductible for self only coverage, (or 75 percent for family coverage) or compensation.</p>

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<b>III. TAXATION OF DISTRIBUTIONS</b>				
A. Qualified Medical Expenses	<p>No tax on distributions for qualified medical expenses. Code § 223(f)(1).</p> <p>Qualified medical expenses are expenses for medical care generally defined as under § 213(d) for the employee, spouse, and dependents. Code § 223(d)(2)(A).</p> <p><u>EXCEPTIONS:</u> They do not include expenses for health insurance <i>except</i>:</p> <ul style="list-style-type: none"> <li>(i) for <u>long-term care</u> insurance,</li> <li>(ii) premiums for health coverage during any period of continuation coverage required by federal law,</li> <li>(iii) premiums for health care coverage while an individual is receiving unemployment compensation under federal or state law, and</li> <li>(iv) for Medicare eligibles, premiums for any health insurance other than a Medicare supplemental policy. Code § 223(d)(2)(B).</li> </ul>	<p>No tax.</p> <p>Qualified medical expenses are expenses for medical care as defined under Code § 213(d) for the employee, spouse, and dependents, and depending on the HRA's terms may include premiums for any accident or health coverage, including long-term care, for current employees, retirees, and COBRA qualified beneficiaries.</p>	<p>No tax.</p> <p>Qualified medical expenses are expenses for medical care as defined under Code § 213(d) for the employee, spouse, and dependents. FSAs may <i>not</i> be used to reimburse insurance premiums, including long-term care.</p>	<p>No tax.</p> <p>Same as HSA without exception number (iv).</p>
B. Other Nonqualified Withdrawals	Taxable plus a 10 percent penalty, with exceptions to the penalty for Medicare eligibles, disability, or death. Code § 223(f)(2) & (4).	Amounts cannot be used for any purpose other than to cover qualified medical expenses.	Amounts cannot be used for any purpose other than to cover qualified medical expenses.	Same as HSA (except with a 15 percent penalty tax).
<b>IV. EARNINGS</b>				
Tax Treatment of Earnings	Tax-free growth.	N/A	N/A	Same as HSA.

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<b>V. ELIGIBILITY</b>				
A. Eligible Individual	<p>HSAs are available to any individual covered under a “high deductible health plan,” who is not simultaneously covered under a <i>non</i>-high deductible health plan (<i>i.e.</i>, a health plan which provides coverage for any benefit already covered under the high deductible health plan). Code § 223(c)(1)(A).</p> <p><u>EXCEPTIONS:</u> For purposes of determining eligibility, coverage for long-term care, dental or vision, accident, or disability is disregarded. Similarly, certain “permitted insurance” (<i>e.g.</i>, insurance covering certain types of liabilities, specific illnesses or diseases, or hospitalization) is disregarded. Code § 223(c)(1)(B) and (c)(3).</p> <p>Eligible individuals do not include individuals who may be claimed as dependents on another person’s tax return. Code § 223(b)(6).</p>	<p>HRAs may be offered to current and former employees and individuals electing COBRA.</p>	<p>FSAs may be offered to current employees and individuals electing COBRA.</p>	<p>MSAs are limited to self-employed individuals and employees of small employers (<math>\leq 50</math> employees) who participate in a “high deductible health plan” and who is not simultaneously covered under a <i>non</i>-high deductible health plan.</p> <p><u>EXCEPTIONS:</u> Same as HSA.</p> <p>Eligible individuals do not include individuals who may be claimed as dependents on another person’s tax return.</p>
B. High Deductible Health Plan	<p>For 2004, a health plan is considered to be a high deductible health plan if it has an annual deductible of at least \$1,000 for self-only coverage (or \$2,000 for family coverage) and the total out-of-pocket expenses is not more than \$5,000 for self-only coverage (or \$10,000 for family coverage). The deductible and out-of-pocket limits will be adjusted for cost of living increases in \$50 increments, beginning in 2005. Code § 223(g).</p> <p>For purposes of determining the out-of-pocket limits, expenses of out-of-network services do not apply. Code § 223(c)(2)(D).</p> <p>High-deductible health plans may have a zero deductible for preventive care. Code § 223(c)(2)(C).</p>	N/A	N/A	<p>A health plan is considered to be a high deductible health plan if it has an annual deductible between \$1,700-\$2,600 for self-only coverage (or \$3,450-\$5,150 for family coverage) and the total out-of-pocket expenses is not more than \$3,450 for self-only coverage (or \$6,300 for family coverage). The deductible and out-of-pocket limits will be adjusted for cost of living increases in \$50 increments.</p> <p>High-deductible health plans may have a zero deductible for preventive care.</p>

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C. Combining Arrangements (“FSAs”)	Generally, it would appear that an HRA and an FSA could not be provided with an HSA because the HRA and FSA may be characterized as other insurance under a non-high deductible health plan. However, it may be possible for the HRA to be designed so that it is the high-deductible health plan paired with the HSA. Alternatively, an employer may provide an HSA, HRA, and FSA if the HRA and FSA provide only excepted coverage ( <i>e.g.</i> , dental or vision, accident, or disability) or coverage not available under the high deductible health plan ( <i>e.g.</i> , prescription drugs). Presumably, premium conversion arrangements for high-deductible health plans or other excepted coverage could be offered because the premium conversion arrangement is not “insurance.”	See discussion on HSAs. In addition, if an HRA is provided in addition to an FSA, special rules apply to the ordering of payments. Absent a specific ordering rule in the HRA document, the HRA funds must be used first if the FSA covers a medical expense that also is covered by the HRA.	See discussion for HSAs and HRAs. Note that long-term care coverage, which can be offered in an HSA, cannot be offered in an FSA pursuant to Code §106(c).	Appears to be the same as HSAs.
D. Cafeteria Plans	Can be offered under a cafeteria plan. Medicare Act § 1201(i) creates new Code § 125(d)(2)(D).  [While it is clear that HSAs can be funded via salary reduction as part of a cafeteria plan, there may be some question as to whether other cafeteria plan rules ( <i>e.g.</i> , substantiation of expenses) would be imposed. The better interpretation is that an HSA is analogous to 401(k) plans offered under a cafeteria plan. In that case, the 401(k) rules, not the cafeteria plan rules, govern the account. Similarly, offering an HSA through a cafeteria plan should not trigger application of those rules to payments from the account.]	Presumably, a health option in a cafeteria plan may include coverage in an HRA as long as it does not result in deferred compensation.	Can be offered under a cafeteria plan.	Cannot be offered under a cafeteria plan.
E. Number of Accounts	It appears that an HSA may be established for each family member covered under a high deductible health plan ( <i>e.g.</i> , each individual family member may have his own HSA) but presumably they are subject to the combined deduction limit.	Presumably an employer could design an HRA with subaccounts for particular family members, but there appears to be no tax advantage for doing so.	Same as HRA.	It does not appear that multiple MSAs can be established.

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<b>VI. OTHER</b>				
A. DAC Tax	Excepted from the DAC tax. Medicare Act § 1201(h) creates new Code § 848(e)(1)(b).	N/A	N/A	Same as HSA.
B. Non-Discrimination Rules	An employer who makes contributions into an HSA must make available “comparable contributions” to HSAs of all “comparable participating employees.” In general, “comparable” means the same amount or the same percentage of the deductible under the high deductible health plan. These rules apply to the entire controlled group. Non-compliance triggers a 35 percent excise tax. Medicare Act § 1201(d)(4)(A) creates new Code § 4980G.	HRAs are subject to the nondiscrimination rules under Code § 105(h), which prohibit benefit or coverage discrimination in favor of highly compensated employees.	FSAs are subject to the nondiscrimination rules under Code § 105(h), which prohibit benefit or coverage discrimination in favor of highly compensated employees.	Same as HSA.
C. Rollovers	Rollovers permitted from MSAs and other HSAs. Code § 223(f)(5); Medicare Act § 1201(c) amends Code § 220(f)(5)(A).	Query whether the employer can design an HRA to voluntarily rollover HRA funds into an HSA. Such rollovers, if permitted, would seem to reduce the HSA deduction limits.	Rollovers not permitted.	Rollovers permitted from other MSAs.
D. Transfers Incident to Divorce	Transfers of an individual interest to a spouse or former spouse under a divorce or separation agreement is not subject to tax. Upon such transfer the spouse is considered the new account beneficiary. Code § 223(f)(7).	Subject to COBRA rules. See discussion below.	Same as HRA.	Same as HSA.
E. Surviving Spouse	Surviving spouse who is the beneficiary of the HSA becomes the new account beneficiary, and the decedent’s estate receives a deduction. Code § 223(f)(8)(A).	May depend upon the terms of the particular HRA and application of COBRA.	FSA coverage may not continue upon the death of the employee, unless continuation coverage is elected under COBRA.	Same as HSA.
F. Estate or Other Beneficiary	On the date of death, the HSA loses its status as an HSA; in general, the estate or other non-spouse beneficiary will be subject to income tax in an amount equal to the fair market value of the assets, subject to special rules. Code § 223(f)(8)(B).	May depend upon the terms of the particular HRA and application of COBRA.	FSA coverage may not continue upon the death of the employee, unless continuation coverage is elected under COBRA.	Same as HSA.

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G. COBRA	COBRA is inapplicable to HSAs, but it would apply to a high deductible health plan. [Query whether other court orders could be obtained by a former spouse or children to access the HSA.]	COBRA is applicable, but it is unclear how the account dollars are shared among all potential beneficiaries. Treasury/IRS have promised guidance on this issue.	COBRA is applicable.	COBRA is inapplicable.
H. Investment and Taxation of Assets	Presumably, the same rules apply as for IRAs (including rules for UBTI). ERISA fiduciary rules on investment of assets could apply to the extent the HSA is part of an employer arrangement in which the employer selects the investment custodian and investment medium. Code § 223(e)(1).	N/A	N/A	Same as HSA.
I. Deduction Limits for Employer Welfare Funds	Since HSAs are owned by the individual and funds are not legally restricted to the payment of qualified medical expenses, the Code § 419 deduction limits should not apply to employer contributions.	N/A	N/A	N/A
J. Other Laws	Depending on their design, HSAs may raise ERISA and HIPAA compliance questions. State law tax conformity will need to be reviewed.			