

This article reflects the state of health spending accounts as of 2003; it has not been updated to reflect any subsequent changes in laws or regulations pertaining to such accounts. You may want to visit the [Internal Revenue Service website](#) to find more recent information.

Health Spending Accounts

by [Haneefa T. Saleem](#)

Originally Posted: October 29, 2003

Revision Posted: [December 19, 2003](#)

Several options exist for employers to provide accounts that employees can use to pay for health care expenses not otherwise covered by a health plan; the options vary as to tax treatment, who can contribute, and what expenses can be covered.

There are three types of accounts that can be used to help fund employee health care expenses: flexible spending accounts, medical savings accounts, and health reimbursement arrangements. A description of each type of account follows, as well as some information on how the Bureau of Labor Statistics (BLS) handles these accounts in its collection of data on employer-provided benefits. (See the [appendix](#) for a summary of key features of each type of account.)

Flexible Spending Accounts

Health care flexible spending accounts are employer-established benefit plans that reimburse employees for specified medical expenses as they are incurred. These accounts are allowed under section 125 of the Internal Revenue Code and are also referred to as "cafeteria plans" or "125 plans." The employee contributes funds to the account through a salary reduction agreement and is able to withdraw the funds set aside to pay for medical bills. The salary reduction agreement means that any funds set aside in a flexible spending account escape both income tax and Social Security tax. Employers may contribute to these accounts as well.

There is no statutory limit on the amount of money that can be contributed to health care flexible spending accounts. However, some companies place a limit of \$2,000 to \$3,000 on flexible spending accounts. Once the amount of contribution has been designated during the open enrollment period that occurs once each year, the employee is not allowed to change the amount or drop out of the plan during the year unless he or she experiences a change of family status. By law, the employee forfeits any unspent funds in the account at the end of the year. There have been proposals introduced in Congress to ease this "use it or lose it" rule by allowing up to \$500 to be carried over to the next year; such proposals have not been enacted.

Medical Savings Accounts

Medical savings accounts are savings accounts used to pay for unreimbursed health care expenses. These accounts can accumulate tax-deferred interest similar to individual retirement accounts (IRAs). Authorized by Title III of the Health Insurance Portability and Accountability Act of 1996, medical savings accounts became available starting on January 1, 1997.

Funds are controlled and owned by the account holder. The employee or the employer--never both--makes contributions. In order to qualify, the employee must be covered by a high-deductible health insurance plan and must be self-employed or employed by a firm with 50 or fewer employees. For 2001, the annual deductible for qualifying high-deductible insurance was between \$1,600 and \$2,400 for self-only coverage; the ceiling on annual out-of-pocket expenses for covered benefits could not exceed \$3,200. For family coverage, the deductible could not be less than \$3,200 or more than \$4,800, and the ceiling on out-of-pocket expenses could not exceed \$5,850.

Savings are rolled over every year and are portable, regardless of employment status. Funds can be used on a pretax basis to pay for long-term care insurance premiums, health insurance premiums paid while unemployed, and COBRA premiums

(for continuation of health insurance coverage available to formerly covered individuals under provisions of the Consolidated Omnibus Budget Reconciliation Act).

Funds can accumulate earnings, which are not taxed unless funds are withdrawn for nonmedical expenses. If withdrawn for nonmedical purposes, savings are considered taxable income and are subject to income taxes in addition to a 15-percent penalty tax. If the employee becomes disabled or reaches Medicare eligibility age, however, distributions for nonmedical expenses from the account are subject only to ordinary income tax, not the penalty tax.

The maximum contribution to a medical savings account for single coverage is 65 percent of the deductible on the employee's health plan and 75 percent of the deductible for family coverage. For example, if an employee has a health plan with a deductible of \$2,225, then he is allowed to contribute a maximum of \$1,446.25 to a medical savings account for single coverage. With a family plan deductible of \$4,500, a maximum contribution of \$3,375 is allowed.

Health Reimbursement Arrangements

Health reimbursement arrangements, also known as "health reimbursement accounts" or "personal care accounts," are a type of health insurance plan that reimburses employees for qualified medical expenses. The U.S. Department of the Treasury issued guidance on health reimbursement accounts in a revenue ruling in June 2002. Because these plans are just emerging, their designs are still evolving.

Health reimbursement accounts consist of funds set aside by employers to reimburse employees for qualified medical expenses, just as an insurance plan will reimburse covered individuals for the cost of services incurred. The guidance provided by the Department of the Treasury makes it clear that health reimbursement accounts are not a new type of account designated within the Internal Revenue Code. Rather, employers qualify for preferential tax treatment of funds placed in a health reimbursement account in the same way that they qualify for tax advantages by funding an insurance plan. (Employers can deduct the cost of an insurance plan -- and now a health reimbursement account -- as a business expense under Internal Revenue Code section 162.)

Health reimbursement arrangements are open to employees of companies of all sizes, unlike medical savings accounts that are only available for small business employees. A health reimbursement account provides "first-dollar" medical coverage until funds are exhausted. For example, if an employee has a \$500 qualifying medical expense, then the full amount will be covered by the health reimbursement arrangement if the funds are available in the account. Under a health reimbursement account, the employer provides funds, not the employee. All unused funds are rolled over at the end of the year. Former employees, including retirees, can have continued access to unused reimbursement amounts. Health reimbursement accounts remain with the originating employer and do not follow an employee to new employment.

BLS Data On Health Spending Accounts

The [National Compensation Survey \(NCS\)](#) provides comprehensive information on employer-provided health care benefits, including employer and employee costs, the extent of worker participation, and detailed provisions of benefit plans.¹ To the extent that employers contribute to any of these accounts, that cost is included in estimates of employer health insurance costs, including estimates of the quarterly change in those costs that is part of the BLS Employment Cost Index (ECI). Data on the availability of flexible spending accounts are included in the NCS. Because medical savings accounts and health reimbursement accounts are quite new, participation is not currently captured in the NCS. BLS will continue to track these accounts as they evolve, and may expand its data collection in the future to provide more details on these benefits.

Appendix. Comparison Of Key Features Of Health Spending Accounts

	Flexible Spending Account	Medical Savings Account	Health Reimbursement Arrangement
--	----------------------------------	--------------------------------	---

Initial legislation or regulation	Revenue Act of 1978	Health Insurance Portability and Accountability Act of 1996	U.S. Department of the Treasury Revenue Ruling 2002-41
Date effective	January 1, 1979	January 1, 1997	June 26, 2002
Internal Revenue Code reference	Internal Revenue Code section 125	Internal Revenue Code section 106(b)	Internal Revenue Code section 105-106
Eligibility	All employees except self-employed	Self-employed or an employee of a small business (50 or fewer employees) Must be covered by high-deductible health plan	All employees
Qualified medical expenses	Unreimbursed medical care expenses as defined by Internal Revenue Code section 213, excluding premiums for health insurance coverage and long-term care expenses	Unreimbursed medical care expenses as defined by Internal Revenue Code section 213 Health insurance premiums under a continuation of coverage arrangement (such as COBRA) Health insurance premiums when receiving unemployment compensation Qualified long-term care insurance premiums	Unreimbursed medical care expenses as defined by Internal Revenue Code section 213
Nonqualified medical expenses	Expenses not under Internal Revenue Code section 213 Health insurance premiums under a continuation of coverage arrangement (such as COBRA) Health insurance premiums when receiving unemployment compensation Qualified long-term care insurance premiums	Expenses not under Internal Revenue Code section 213 Employer may set additional restrictions	Expenses not under Internal Revenue Code section 213
Must be covered by a health insurance plan	No	Yes	No
Contributor	Employee, employer, or both	Employee or employer, but not both	Employer
Contribution limits	No statutory limit; limits may be set by employer	Single coverage--65 percent of deductible	No statutory limit; limits may be set by employer

		Family coverage--75 percent of deductible	
Funds carried over to next year	No	Yes	Yes
Portability	Account cannot be maintained if the employee is no longer working for the employer	Continued access to unused account balance if the employee is no longer working for the employer Withdrawals for non-medical purposes are subject to income tax and a 15 percent penalty tax Once the account holder reaches age 65 (the Medicare eligibility age), becomes disabled, or dies, withdrawals for non-medical purposes are subject to income tax only, with no penalty	At employer discretion

Haneefa T. Saleem

is a senior Public Health student at Johns Hopkins University. She was an intern in the Division of Compensation Data Analysis and Planning, Bureau of Labor Statistics, in summer 2002 and summer 2003.

NOTE: The revised version of this article, posted on the BLS Internet on December 19, 2003, includes changes from the original that correct errors and clarify language. In two cases, references to Internal Revenue Code sections were incorrect and have been revised. In addition, descriptions of qualified expenses that may be paid from various health accounts were not clear in the original and have been revised.

Notes

¹ Data from the National Compensation Survey may be obtained on the BLS website at <http://www.bls.gov/ncs/home.htm>