Flexible Spending Accounts and Medical Savings Accounts:  
A Comparison

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Flexible Spending Accounts and Medical Savings Accounts: A Comparison

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Bob Lyke and Chris L. Peterson
Domestic Social Policy Division
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Summary

Flexible spending accounts (FSAs) are employer-established benefit plans that reimburse employees for specified expenses; they first began in the 1970s. Medical savings accounts (MSAs) are tax-advantaged individual savings accounts that can also be used for unreimbursed expenses; they became available under a demonstration that began in 1997. President Bush’s FY2004 budget proposed changes to FSAs and a permanent extension and substantial expansion of MSAs that are identical to President Bush’s FY2003 budget proposal.

FSAs and MSAs are similar in some respects but dissimilar in others. Both can be used for unreimbursed medical expenses, and contributions to both have tax advantages. However, FSA contributions are forfeited if not used by the end of the year, while MSA contributions may be carried over. More important, MSA contributions can be made only when account owners have high deductible health insurance, while contributions to FSAs can occur with any type of insurance. FSAs can also be used for child and dependent care expenses, provided a separate account is established for this purpose. Both FSAs and MSAs should be distinguished from health reimbursement accounts (HRAs), for which the Internal Revenue Service (IRS) issued guidance in June, 2002.

In 1999, more than one in five private-sector employees could establish an FSA. FSAs were more common for state and local government employees but less so for workers in small businesses. In establishments with fewer than 50 employees, 8% of workers had access, compared to 57% of workers in establishments with at least 2,500 employees. In July 2003, FSAs will be available to federal employees for the first time. Although there is little information on participation in FSAs, such information exists on MSAs: fewer than 100,000 MSAs were established through June 2002, far lower than the number authorized by statute. Low participation rates are one reason new legislation is being considered. These other points might be noted about health care FSAs and MSAs:

- FSAs are limited to employees and former employees, while MSAs are limited to the self-employed and employees covered by a high deductible insurance plan established by their small employer.
- IRS imposes no dollar limit on health care FSA contributions, but employers generally do. MSA contributions, which can be made when the account owner has qualifying high deductible insurance, are limited to a percentage of the deductible.
- Contributions to FSAs and MSAs are exempt from taxes, as are withdrawals used for deductible medical expenses.
- FSAs can be used only for unreimbursed medical expenses that would be deductible under the Internal Revenue Code, with some exceptions. MSAs may also be used for such expenses (also with some exceptions), though nonqualified withdrawals are also permitted. The latter withdrawals are taxable and generally subject to an additional penalty.
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Flexible Spending Accounts and Medical Savings Accounts: A Comparison

Introduction

Flexible spending accounts (FSAs) are employer-established benefit plans that reimburse employees for specified expenses as they are incurred. They arose in the 1970s as a way to provide employees with a flexible benefit at a time when the costs of health care were of growing concern. In contrast to traditional insurance plans, FSAs generally allow employees to vary benefit amounts in accordance with their anticipated health care needs.

Medical savings accounts (MSAs) are tax-advantaged individual savings accounts that can also be used for unreimbursed expenses. They too were proposed as a flexible arrangement for dealing with rising health care costs. A limited number of MSAs became available under a demonstration that began in 1997 and originally was to be closed to new accounts at the end of 2000. However, authority to establish new MSAs was extended through December 31, 2002, by legislation at the end of the 106th Congress (the Community Renewal Tax Relief Act of 2000, P.L. 106-554 (H.R. 5662, incorporated into H.R. 4577)). This legislation also formally renamed MSAs as Archer MSAs. Authority to establish new MSAs was extended once more, through December 31, 2003, by legislation signed into law in March 2002 (the Job Creation and Worker Assistance Act of 2002, P.L. 107-147 (H.R. 3090)).

FSAs and MSAs are similar in some respects but dissimilar in others. Both can be used for unreimbursed medical expenses, and contributions to both have tax advantages. However, FSA contributions are forfeited if not used by the end of the year, while MSA contributions may be carried over. More important, MSA contributions can be made only when account owners have high deductible insurance, while contributions to FSAs can occur with any type of insurance. High deductible insurance may be most attractive to people who are young and healthy, resulting in risk pooling imbalances.

This report compares FSAs and MSAs. It begins by describing FSAs, the basis for their tax treatment, and data on their use. It then describes the MSA demonstration authorized by the Health Insurance Portability and Accountability Act of 1996 (HIPAA), the basis for their tax treatment, and data on their use. The report continues by making comparisons of FSAs and MSAs with respect to these points:

- eligibility,
- contributions,
- qualified withdrawals,
- nonqualified withdrawals, and
- carryover of unused funds.
Both FSAs and MSAs should be distinguished from health reimbursement accounts (HRAs) for which the IRS issued guidance in June, 2002.¹ HRAs are established by employers for employee unreimbursed medical expenses. They must be funded solely by employers (and not through salary reduction agreements); while unused balances can be carried forward to following years, they cannot be given to employees when they terminate employment. HRA disbursements are not taxable.

The report concludes with a brief discussion of President Bush’s FY2004 budget proposal and the health savings accounts (HSAs) and health savings security accounts (HSSAs) that were included in H.R. 1, the House-passed Medicare prescription drug bill.

### Flexible Spending Accounts

FSAs are employer-established benefit plans that reimburse employees for specified expenses as they are incurred. They usually are funded through salary reduction arrangements under which employees receive less take-home pay in exchange for contributions to their accounts. Employees each year choose how much to put in their accounts, which they may use for dependent care or for medical and dental expenses other than insurance. However, there must be separate accounts for these two purposes, and amounts unused at the end of the year must be forfeited to the employer. If FSAs meet these and other rules, contributions are not subject to either income or employment taxes.

To illustrate the tax savings, consider a health care FSA funded for an employee through a salary reduction arrangement. Before the start of the year, the employee elects to reduce his salary by $75 a month in exchange for contributions of that amount to the FSA. Other employees might choose to contribute more or less than $75. Throughout the year, as the employee incurs medical and dental expenses not covered by insurance or other payments, he may use funds in the account to pay them. His total draw, which must be available at the start of the year, is limited to $900 (the sum of his monthly contributions for the year); if all $900 is used the first 9 months, he generally cannot replenish the account until the next year; while if $100 or so remains unspent after 12 months, it is forfeited to the employer. If the FSA were funded by the employer, as sometimes is the case, the employee’s draw must similarly be available at the start of the year. It is possible for FSAs to be funded both by salary reductions and employer contributions.

If the employee were in the 30% tax bracket, the federal income tax savings from the $900 salary reduction used to fund the account would be $270 (i.e., $900 \times .30); in addition, the employee could save $69 in social security and Medicare taxes (i.e., $900 \times .0765).² There could be state income tax savings as well. If the employee were in the 15% tax bracket, the federal income tax savings would be...

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¹ Revenue Ruling 2002-41 and Notice 2002-45.
² If the employee’s earnings exceeded the social security wage base ($87,000 in 2003), the only savings would be $13 from Medicare taxes (i.e., $900 \times .0145). Reductions in social security taxes due to FSA salary reductions could affect the social security benefits that the worker later receives.
The breakeven point for an employee in the 30% bracket who contributes $900 would generally be $561 (i.e., $900 minus income tax savings of $270 and employment tax savings of $69). The employer would also save $69 in employment taxes from the $900 salary reduction. Employers often use these savings to help pay the expenses of administering an FSA.

Tax savings can exceed losses due to forfeiture of a remaining balance at the end of the year; thus, not all of an account must be used for employees to come out ahead financially. Since tax savings are greater in the higher tax brackets, higher income employees may be less concerned about forfeitures (assuming they recognize they could still be better off) than lower income employees.\(^3\)

The tax savings associated with a health care FSA are not unlike those for traditional comprehensive health insurance, which also allows employer payments to be excluded from the income and employment taxes of the employees as well as from the employment taxes of the employer.

In September 2002, the Office of Personnel Management (OPM) announced that federal employees will be able to enroll in health care and child-care FSAs beginning in mid-2003.

**Basis for Tax Treatment**

FSAs are one way that employment benefits can be varied to meet the needs of individual employees without loss of favorable tax treatment. Flexible benefit arrangements generally qualify for tax advantages as "cafeteria plans," under which employees choose between cash (typically take-home pay) and certain nontaxable benefits (typically reimbursements for health care or dependent care expenses) without paying taxes if they select the benefits. The general rule is that when taxpayers have an option of receiving cash or nontaxable benefits they are taxed even if they select the benefits; they are deemed to be in constructive receipt of the cash since it is made available to them. Section 125 of the Internal Revenue Code provides an express exception to this rule when certain nontaxable benefits are chosen under a cafeteria plan.\(^4\)

FSAs and cafeteria plans are closely related, but not all cafeteria plans have FSAs and not all FSAs are part of cafeteria plans. FSAs are considered part of a cafeteria plan when they are funded through voluntary salary reductions; this exempts the employee’s choice between cash (the salary subject to reduction) and

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3 The breakeven point for an employee in the 30% bracket who contributes $900 would generally be $561 (i.e., $900 minus income tax savings of $270 and employment tax savings of $69). The employee comes out ahead if unreimbursed expenses exceed that amount, assuming they would have been incurred in the absence of the FSA. If expenses would not have been incurred except for the FSA, then the breakeven point generally would be higher since the employee presumably values the obtained services at less than the market price.

4 In addition, cafeteria plans may include some taxable benefits; like cash, these are taxable if the employee selects them.
normally nontaxable benefits (such as health care) from the constructive receipt rule and permits the latter to be received free of tax. Thus, instead of receiving a full salary (for example, $30,000), the employee can receive a reduced salary of $29,100 with a $900 FSA contribution and will need to treat only $29,100 as taxable income.

However, if FSAs are funded by nonelective employer contributions then their tax treatment is not governed by the cafeteria plan provisions in Section 125; in this situation, the employee does not have a choice between receiving cash and a normally nontaxable benefit. Instead, the benefits are nontaxable since they are directly excludable under some other provision of the Code. For example, nonelective employer-funded FSAs for dependent care are tax-exempt under Section 129, while nonelective employer-funded FSAs for health care are tax-exempt under Sections 105 and 106.

Particular rules governing the tax treatment of FSAs are not spelled out in the Internal Revenue Code; rather, they were included in proposed regulations that the Internal Revenue Service (IRS) issued for cafeteria plans in 1984 and 1989. Final rules regarding circumstances in which employers may allow employees to change elections during a plan year were issued in March 2000 and January 2001. To be exempt from the constructive receipt rule, participants must not have cash or taxable benefits become “currently available”; they must elect specific benefits before the start of the plan year and be unable to change these elections except under specified circumstances. With respect to health care FSAs:

- the maximum amount of reimbursement (reduced by any benefits paid for covered expenses) must be available throughout the coverage period;

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5 For a critical discussion of the Internal Revenue Service’s interpretation of constructive receipt with respect to employee benefit plans and Section 125, see Irish, Leon E. Cafeteria Plans in Transition. Tax Notes, Dec. 17, 1984. p. 1135-1136.

6 For many years, the Code had no explicit reference to FSAs. The Health Insurance Portability and Accountability Act of 1996 (P.L. 104-191) added a definition in subsection 106(c)(2) when it disallowed coverage of long-term care services through such accounts.

7 49 Federal Register (FR) 19321 (May 7, 1984), 49 FR 50733 (Dec. 31, 1984), and 54 FR 9460 (Mar. 7, 1989). The proposed regulations have not been finalized, but they remain the position of the IRS. The rules cover both FSAs funded by salary reductions and FSAs funded by nonelective employer contributions. One general requirement for FSAs is that the maximum annual reimbursement must be limited to less than 500% of any premium for the participant’s coverage (including both employer-paid and employee-paid portions of the premium); this would distinguish FSAs from health insurance generally.

8 65 Federal Register 15548 (March 23, 2000) and 66 Federal Register 1837 (January 10, 2001). The rules apply to cafeteria plans generally, not just FSAs. The rules allow mid-year election changes for changes in status (marital status, number of dependents, employment status, place of residence) and significant changes in cost or coverage; however, mid-year election changes for health care FSAs are not allowed for cost or coverage changes since the plans must exhibit the risk-shifting and risk-distributions characteristics of insurance. These rules only permit employers to allow mid-year changes, they do not require them.
Thus an employer might refund the same dollar amount to every participant, even though some used all their benefits while others forfeited unused amounts.

54 FR 9460, Q and A 7. Some of the seven requirements listed in the text had been issued in 1984.

A $5,000 limit applies to dependent care FSAs. The latter are governed by section 129, which includes that limit.

The IRS rules lay out what is permissible with respect to FSA plans, but employers may add their own requirements. For example, the IRS does not limit the amount that an employee can be reimbursed through a health care FSA, but employers may establish their own ceiling. Similarly, employers may exclude certain elective expenses from their plans, or they might require employees who terminate employment to continue to participate until the end of the plan year.

One justification for the tax advantages of FSAs is that they might be equivalent to the tax savings associated with comprehensive insurance plans having negligible deductibles and copayments; from this perspective, they seem equitable. On the other hand, similar tax savings are not available to individuals who can only claim an itemized deduction for unreimbursed expenses that exceed 7½% of their adjusted gross income.

9 Thus an employer might refund the same dollar amount to every participant, even though some used all their benefits while others forfeited unused amounts.

10 A $5,000 limit applies to dependent care FSAs. The latter are governed by section 129, which includes that limit.