

Dollar for Dollar

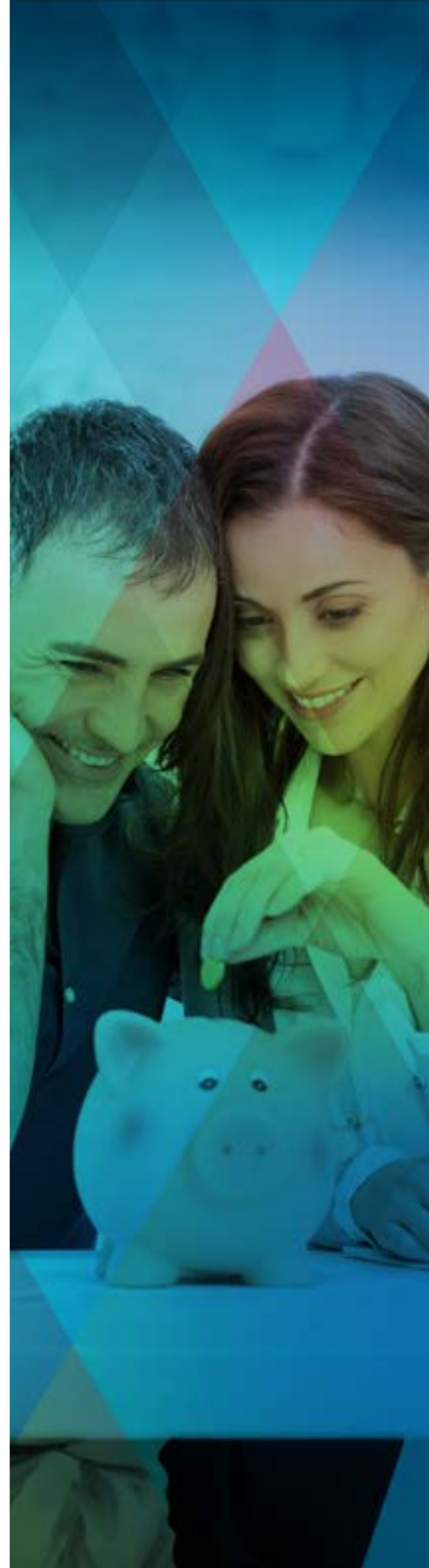
Eligible Expenses for FSAs, HSAs and HRAs

Fall 2023

Many individuals have access to one or more tax-favored “account-based plans” for purposes of paying for certain medical-related expenses on a pretax basis. The most common are health Flexible Spending Arrangements (FSAs), Health Savings Accounts (HSAs) and Health Reimbursement Arrangements (HRAs). Questions often arise regarding what items can be paid for with these plans.

Under section 213(d) of the U.S. Internal Revenue Code, the term “medical care” means amounts paid for —

- a. The diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body;
- b. Transportation primarily for and essential to medical care referred to in subparagraph (a);
- c. Qualified long-term care services (as defined in section 7702B(c));
- d. “Insurance (including amounts paid as premiums under Part B of Title XVIII of the Social Security Act, relating to supplementary medical insurance for the aged) covering medical care referred to in subparagraphs (A) and (B) or for any qualified Long-Term Care Insurance contract (as defined in section 7702B(b)).”



The regulations define when amounts paid for lodging away from home when undergoing treatment are a medical expense, and they define “prescribed drugs.” The regulations also specifically exclude cosmetic surgery as “medical care.”

When determining if an item is medical care, the first question is whether the item was for the diagnosis, cure, mitigation, treatment or prevention of disease. From there, significant special rules might apply. The IRS has provided the following specific expenses that satisfy this question.

- Hospital services
- Nursing services
- Medical, laboratory, surgical, dental and other diagnostic and healing services
- X-rays
- Medicine and drugs
- Artificial teeth and limbs
- Ambulance services
- Personal protective equipment (PPE) to prevent the spread of COVID-19
- Home kits to test for COVID-19
- Menstrual care products

Expenses that are for an overall benefit of health or are preventive in nature — such as vacation and gym memberships — are not medical care under 213(d). Popular exercise equipment such as treadmills, exercise bikes and free weights are very rarely classified as a 213(d) medical expense. Expenses that are generally understood to be for personal, living or family expenses are not a 213(d) expense if they would not have been incurred “but for” medical conditions.

Over-the-Counter Drugs

Medicine and drugs are a 213(d) medical expense regardless of whether they are obtainable only with a prescription through a pharmacy or over the counter (OTC). On October 17, 2022, the FDA’s OTC hearing aids ruling went into effect, allowing you to buy a hearing aid without a medical exam, prescription or professional fitting.



Special Considerations for Each Plan Type

Health FSAs have annual limitations on how much can be deposited into the account and are subject to either grace period or rollover limitations at the end of the year.

FSA Reimbursements

An FSA is a self-insured medical reimbursement plan that is a tax-favored account and is set up through an employer to help employees pay for certain qualified expenses under §213(d) of the Internal Revenue Code. It may be funded with employee or employer dollars, or a combination of both. Health FSAs have annual limitations on how much can be deposited into the account and are subject to either grace period or rollover limitations at the end of the year. Employers may design FSAs to reimburse only a limited amount of expenses from the eligible expenses defined by regulators. For example, an employer could design a health FSA benefit to be used only for prescription drug expenses. FSAs are subject to strict substantiation rules that employers should follow.

FSAs may never be used to pay health insurance premiums.

To use an FSA to pay for a medical expense, the expense must be incurred by the employee, the employee's spouse, an employee's child who has not attained age 27 as of the end of the employee's taxable year, or the employee's tax dependent for health coverage purposes. Funds may not be used for a domestic partner who fails to satisfy the conditions for being a Code §105(b) tax dependent.

HSAs have annual limitations on how much may be deposited into the account, but unused funds remain in the participant's account at the end of the year and are never lost or expired.

HSA Reimbursements

An HSA is a tax-favored, IRA-type trust or custodial account that is set up with a qualified trustee (a bank, credit union or insurance company) and is used to pay for qualified medical expenses. First available in 2004, HSAs have become an exceedingly popular choice as employers design their benefit programs. HSAs are coupled with High-Deductible Health Plans (HDHPs) and are the cornerstone of consumer-driven healthcare. They are a personal bank account owned by the employee and may be funded with employee or employer dollars. HSAs have annual limitations on how much may be deposited into the account, but unused funds remain in the participant's account at the end of the year and are never lost or expired. HSAs also have different eligibility requirements, and to be eligible, a participant cannot be enrolled in a different non-HSA medical plan. This excludes HSA members from contributing to an FSA while they are enrolled in an HSA plan. However, HSA participants may participate in a Limited-Purpose FSA (LPFSA) as long as the LPFSA is properly limited to nonmedical eligible expenses, such as dental and vision expenses.

HSA distributions may be used to pay for essentially anything (medical or nonmedical) but are only tax-free if they are timed properly and used to pay for unreimbursed medical expenses as defined by Code §213(d). Employers may not design HSAs to reimburse only certain types of medical expenses, as the money sits in an account that is owned and managed by the employee. Employers, as a general rule, cannot recoup money once it is deposited into an HSA account.

Individuals enrolled in COBRA or collecting unemployment benefits may use their HSA to pay for their health insurance premiums.

Only the medical expenses of the employee, spouse or Code §105(b) tax dependents may be reimbursed under an employee's HSA. An employee's domestic partner, or an adult child who is not the employee's tax dependent, may have their own HSA but a domestic partner's or adult child's medical expenses cannot be paid under the employee's HSA.

Individuals 65 and older may use money in their HSA for expenses not related to medical care and only pay income tax on the reimbursement, rather than income tax plus excise taxes. Similarly, HSA funds may be withdrawn without excise taxes due to death or disability.

Traditional HRAs may not be used to pay for medical insurance premiums, although certain specialty HRAs (such as ICHRAs) may be used for premium reimbursement.

HRA Reimbursements

Health Reimbursement Arrangements (HRAs), which can include a type of account known as a medical expense reimbursement program (MERP), are tax-favored, self-funded reimbursement programs funded entirely by employer dollars. Unused HRA dollars may either roll over or expire at the end of the year, based on how an employer designs its plan.

Employers may also design HRAs to only reimburse a limited amount of expenses from the eligible expenses defined by regulators. Employers may never use an employee's money to fund an HRA or build additional premiums into the health plan to fund an HRA benefit.

HRAs may only reimburse medical expenses as defined by IRS Code §213(d), with some limitations. Those are:

- HRAs may not be used to pay for qualified long-term care expenses if the HRA falls under the definition of a Flexible Spending Arrangement.

HRAs may be used to reimburse an employee's copays and deductibles. Traditional HRAs may not be used to pay for medical insurance premiums, although certain specialty HRAs (such as ICHRAs) may be used for premium reimbursement. Some employers use Limited-Purpose HRAs to reimburse employees for very specific medical expenses, including those related to a certain condition, such as infertility or cancer.

HRAs may provide tax-free benefits to participants enrolled in the employer plan, including the employee, the employee's spouse, an employee's child who has not attained the age of 27 by the end of the tax year or the employee's tax dependent for health coverage purposes. A domestic partner who fails to satisfy the conditions for being a Code §105(b) tax dependent may not have their expenses reimbursed tax-free from the employee's HRA. Employers may also offer Qualified Small-Employer Health Reimbursement Arrangements (QSEHRAs) and Individual Coverage Health Reimbursement Arrangements (ICHRAs), which, while related to traditional HRAs, are very different and should not be confused with "plain HRAs."

Publication 502: Proceed with Caution

The IRS issues an annual Publication 502 (Medical and Dental Expenses), which provides guidance on what expenses are for medical care. However, the purpose of this guide is to inform individual taxpayers about which expenses may be deducted from their Form 1040. It is not a perfect match for which expenses can be paid with an FSA, HSA or HRA, although it can provide helpful context or considerations. Employers should be cautious in reviewing Publication 502 to determine if an expense may be paid with an FSA, HSA or HRA.