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Flexible spending account

From Wikipedia, the free encyclopedia

A **flexible spending arrangement** (FSA), or Flexible Spending Account, as they are commonly called, is one of a number of tax-advantaged financial accounts that can be set up through a cafeteria plan of an employer in the United States. An FSA allows an employee to set aside a portion of his or her earnings to pay for qualified expenses as established in the cafeteria plan, most commonly for medical expenses but often for dependent care or other expenses. Money deducted from an employee's pay into an FSA is not subject to payroll taxes, resulting in a substantial payroll tax savings.

The most common FSA, the **medical expense FSA** (also **medical FSA** or **health FSA**), is similar to a health savings account (HSA) or a health reimbursement account (HRA). However, while HSAs and HRAs are almost exclusively used as components of a consumer driven health care plan, medical FSAs are commonly offered with more traditional health plans as well. An FSA may be utilized by paper claims or an FSA debit card also known as a Flexcard.

Types of FSAs

Most cafeteria plans offer two different flexible spending accounts; one is for qualified medical expenses and the other is for dependent care expenses. A few cafeteria plans offer other types of FSAs, especially if the employer also offers an HSA. Participation in one type of FSA does not affect participation in another type of FSA, but funds cannot be transferred from one FSA to another.

Medical expense FSA

The most common type of FSA is used to pay for medical expenses not paid for by insurance; this usually means deductibles, copayments, and coinsurance for the employee's health plan, but may also include expenses not covered by the health plan, such as dental and vision expenses and over-the-counter drugs including a first aid kit. A medical FSA cannot pay for health insurance premiums, cosmetic items, cosmetic surgery, controlled substances (in violation of federal law), or items that improve "general health". All items must be intended to treat or prevent a specific medical condition; this can be as significant as diabetes or pregnancy, or as trivial as skin cuts. Generally, allowable items are the same as those allowable for the medical tax deduction, as outlined in IRS publication 502.

The annual caps for a medical FSA varies by employer. Unlike dependent care FSAs, there is no IRS cap on medical FSAs, but employers generally limit the annual amount each employee may contribute, in order to reduce the risk of pre-funding. Should the employee leave or be terminated and thus no longer pay in to the plan, the employer does not recapture their pre-funding from the employee's payroll deduction.

Flexible Spending Accounts debit card allows for the automatic electronic transfer of pre-tax dollars from an employee account when paying for qualified expenses. Employees are able to receive immediate reimbursement of their medical, dependent care, and commuter expenses simply by using their card at the point of service. The normal paper claims process is eliminated, as are worries of forgotten purchases or lost receipts.

Dependent care FSA

FSAs can also be established to pay for certain expenses to care for dependents that live with you while you are at work. While this most commonly means child care, it can also be used for adult day care for senior citizen dependents that live with you, such as parents. It cannot be used for summer camps (other than "day camps") or for long term care for parents that live elsewhere (such as in a nursing home).

The dependent care FSA is federally capped at $5,000 per year. While married spouses can each elect to have this amount deducted from their paycheck and applied to expenses, at tax time all withdrawals in excess of $5,000 are taxed. Unmarried couples can each deduct and use $5,000.

Unlike medical FSAs, dependent care FSAs cannot be "pre-funded"; employees can only receive reimbursement as funds are deposited into the FSA. Also, although FSA debit cards can be used with dependent care FSAs, they are subject to restrictive IRS requirements that generally require employees to pay the first child-care bill of each year by other means, among other things.

While medical FSAs almost always favor the taxpayer, dependent care FSAs are a more complicated matter because they are a tradeoff between pre-tax deductions and tax credits, not itemized deductions. Enhancements to child tax credits in recent years have made them more attractive than dependent care FSAs for many taxpayers.

If married, BOTH spouses must earn income in order for the Dependent Care FSA to work. The only exception is if the non-earning spouse is disabled or a student. If one spouse earns less than $5,000 then the benefit is limited to whatever that spouse earned. Many plan coordinators do not warn of this limit. This limitation can create a situation where the earning spouse sets up a Dependent Care FSA and dutifully sends in receipts to withdraw funds and then at tax time the FSA is effectively eliminated and all the work wasted. See IRS Form 2441 Part III for details.

Other FSAs

Though not as common as the FSAs listed above, some employers have offered adoption assistance through an FSA. Also, though medical FSAs cannot reimburse for health premiums, some small employers without a health plan have established FSAs to reimburse their employees for individual health premiums.

FSA's coverage period

An FSA's coverage period ends either at the time the "plan year" ends for your plan or at the time when your coverage under that plan ends. Example: Loss of coverage due to a separation from the employer.

This means that if, for example, you are employed by a company from January through June and covered on their cafeteria benefits plan (including FSA) during that time, but do not elect and pay for continued coverage under that plan (i.e., COBRA). Your coverage period is defined only as January through June, not January through December as one might think. [1] In this example, all covered expenses must be incurred between January and June of that year.

Methods of withdrawal from FSAs

In recent years, the FSA debit card was developed to eliminate "double-dipping" by allowing employees to access the FSA directly, as well as to simplify the substantiation requirement which required labor-intensive claims processing; the debit card also enhances the effect of "pre-funding" medical FSAs. However, the substantiation requirement itself did not go away, and has even been expanded on by the IRS for the debit-card environment; therefore, withdrawal issues still remain for FSAs.

According to Celent, as of May 2006, there were approximately 6 million debit cards in the market tied to an FSA account, representing 25% of the FSA participating community. Celent projects that FSA cards will increase FSA adoption rates. The average card participation rate was around 20% as of May 2006. By 2010, it is projected this rate will increase to 85%.

Plan year grace period

In 2005, the Internal Revenue Service authorized an optional 2½ month grace period that employers can use in their plans, allowing use of the funds for 2½ months after the end of the plan year.

Advantages and disadvantages of all FSAs

An FSA allows money to be deducted from an employee's paycheck pre-tax and then spent on qualified expenses.

For an example of potential tax savings associated with a flexible spending account, a person in the 28% Federal marginal tax bracket and an example 4% state tax (along with FICA taxes of typically 7.65%, for a total tax of almost 40%), could deduct $2,000 and put that money into an FSA for health care. This would result in almost $800 in tax savings.

Example 1: No FSA Account with Fixed Medical Expenses

```
$NET_INCOME = $INCOME * (1 - $TAX_RATE) - $MEDICAL_EXPENSES
```

- Income = $50,000
- Tax Rate = 40%
- Medical Expenses = $2,000
- **Net Income = $28,000**

Example 2: Fixed Medical Expenses Reserved in an FSA Account

```
$NET_INCOME = ($INCOME - $MEDICAL_EXPENSES)(1 - $TAX_RATE)
```

- Income = $50,000
- Tax Rate = 40%
- Medical Expenses = $2,000
- **Net Income = $28,800**

There is a straight-line savings of $800, **IF** you spend everything in the FSA account **AND** you need everything you purchase.

Example 3: Minimum FSA Account Spending Threshold to Realize Savings

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$MEDICAL_EXPENSES * (1 - $TAX_RATE)
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- Tax Rate = 40%
- Medical Expenses = $2,000
- **Threshold = $1,200**

As long as you spend at least this amount from an FSA account, every additional dollar spent improves your Net Income.

If this example person had not utilized the FSA and instead itemized their deductions, they likely would not have been able to deduct this $2,000 expense because it would not have met the 7.5% of Adjusted Gross Income threshold needed to be able to deduct it on their federal tax return. Even if the expenses had met the 7.5% threshold, only the part in excess of 7.5% would count as an itemized deduction; and itemized deductions are only beneficial if they exceed the standard deduction, which is hard to meet unless you have home mortgage interest or large charitable contributions. Finally, expenses for over-the-counter drugs cannot be deducted or counted towards the 7.5% threshold, but they can be paid for by the FSA.

Pre-funding

One consideration regarding medical FSAs is that they are in a sense "pre-funded" by the employer: If an employee sets aside an amount per year in a medical FSA (as in the earlier example), the entire amount is available immediately--either at the start of the plan year (commonly January 1) or after the first contribution to the FSA is received by the FSA vendor, depending on the plan--even though the employee only contributes to the FSA in small increments throughout the year (for example, 1/26 of the annual amount if you are paid biweekly).

An employee does not continue to contribute to the plan upon termination of employment. Thus, one could use the entire amount on day one of the plan year, terminate employment on day two of the plan year, and contributions would have been none or negligible (e.g., perhaps 1/26 in the case of biweekly contributions). The "free" money is not taxable. The reason for this is that the IRS views these plans as health insurance plans for tax purposes. [2] According to IRS section 125, benefits received from a health insurance plan are not considered taxable income.

The same reasons that make pre-funding a possible benefit to a an employee participating in a plan make them a potential risk to employers setting up a plan. The employer has to make up the difference that the employee has spent from the flexible spending account but not yet contributed. The amount the employer loses due to pre-funding may eventually be partially or more than made up by employees that do not spend all of the money in their FSA account by the end of the plan year and grace period.

Over-the-counter drugs and medical items

Another very powerful medical FSA feature that has been introduced in recent years is the ability to pay for over-the-counter (OTC) drugs and medical items. In addition to substantially expanding the range of "FSA-eligible" purchases, adding OTC items made it easier to "spend down" medical FSAs at year-end to avoid the dreaded "use it or lose it" rule.

However, substantiation has again become an issue; generally, OTC purchases require either manual claims or, for FSA debit cards, submission of receipts after the fact. Most FSA providers require that receipts show the complete name of the item; the abbreviations on many store receipts are incomprehensible to many claims offices. Also, some of the IRS rules on what is and isn't eligible have proven rather arcane in practice. The recently-developed inventory information approval system (IIAS), which separates eligible and ineligible items at point-of-sale and provides for automatic debit-card substantiation, should eliminate these issues and make medical FSAs very attractive for OTC purchases.

Use it or lose it

One major drawback is that the money must be spent **within the coverage period** as defined by the benefits cafeteria plan coverage definition. This coverage period is usually defined as the **period that you are covered** under the cafeteria plan during the "plan year". The "plan year" is commonly defined as the calendar year.

Any money that is left unspent at the end of the coverage period is forfeited back to the company; this is commonly known as the **"use it or lose it" rule**.

A second requirement is that all applications for refunds must be made by a date defined by the plan. If funds are forfeited, this does not eliminate the requirement to pay taxes on these funds if such taxes are required. For example, if a single person elects to withhold $5000 for child care expenses and gets married to a non-working spouse, the $5000 would become taxable. If this person did not submit claims by the required date, the $5000 would be forfeited but taxes would still be owed on the amount.

Also, the annual contribution amount must remain the same throughout the year unless certain qualifying events occur, such as the birth of a child or death of a spouse.

See also

- Cafeteria plan
- Consumer driven health care
- Consumer driven health plan
- FSA debit card
- Health insurance
- Health Reimbursement Account
- Medical savings account

Footnotes

1. ^ **Internal Revenue Service Regulation 1.125-2**: Miscellaneous cafeteria plan questions and answers [1].
2. ^ **IRS Publication 969**: Flexible Spending Arrangements (FSAs) - Distributions From an FSA [2]

References

- IRS Publication 969 (PDF)
- IRS Publication 969 (HTML)
- IRS Publication 502, Medical and Dental Expenses (PDF)
- IRS Revenue Ruling 2003-102 (OTC items)
- Internal Revenue Bulletin: 2007-2 (Flex Debit cards)
- Internal Revenue Service Regulation 1.125-2 (Miscellaneous cafeteria plan questions and answers)

External links

- Official IRS site on Medical Expenses as a tax deduction - Explains which medical expenses are covered and which are not. (While this publication will generally also apply to the Medical Flex Spending benefit, some expenses listed in the publication are not eligible in the Medical Flex, including Long-Term care insurance, insurance premiums and expenses paid in the current year for services in prior years).

- Health Savings Accounts vs. Health Reimbursement Accounts vs. Medical Savings Accounts vs. Flexible Spending Accounts - very helpful PDF chart comparing these, but has not been updated since 2005.
- A Fact Sheet on FSAs from the Employee Benefit Research Institute (EBRI), May 2007