Flexible Spending Accounts

- Internal Revenue Code (IRC) Sec. 125, created by the Revenue Act of 1978, formally introduced tax-qualified flexible benefit plans. These plans include all those that offer employees a choice between at least one qualified nontaxable benefit and one taxable benefit (including cash). Sec. 125 allows employers to provide employees with a choice among benefits without requiring them to include the value of the benefits in their adjusted gross income unless they choose taxable options.

- There are three types of qualified plans under Sec. 125: flexible spending accounts (FSAs), premium conversion plans (which allow employees to make their contribution to the premium of the health plans with pretax dollars), and cafeteria plans. This fact sheet describes flexible spending accounts.

- Flexible spending accounts (FSAs) may exist as stand-alone plans or within a cafeteria plan. Employees choose how much money they want to contribute to an FSA at the beginning of the plan year. To the extent that these funds are not used during the plan year, they are forfeited. There are two types of FSAs: a health care spending account and a dependent care spending account. Employers may offer employees one or both types, but the money contributed to each must be treated separately.

Health Care Spending Account

- There are no legal limits on contributions to a health care FSA, but a plan sponsor may set a limit. An employee determines before the beginning of a calendar year how much money he or she wishes to contribute in the calendar year ahead. The employer deducts equal installments from each paycheck consistent with the designated yearly amount. Under the uniform reimbursement requirement, the amount for eligible medical expenses under a health care FSA must be available at all times during the year.

- Allocation of unused portions of an FSA is at the plan sponsor’s discretion. By law, the only action a plan sponsor may not take is returning the unused portion to the employee. The employee forfeits any claim to the unused portion. However, because of the uniform reimbursement requirement, if an employee uses the entire amount in the FSA before the end of the calendar year and leaves employment with that employer, he or she does not have to reimburse the employer the difference between what was contributed, up to that point, and the amount used.

- According to a study by Mercer Human Resource Consulting, in 2002, 21 percent of employers with 10 or more employees offered a health care FSA, and 34 percent of eligible employees were participating.

- In 2002, the average contribution to a health care FSA was $1,292.

- An employer that offered a health care FSA in 2002 could have had a net tax saving of $2,076. This figure is based on an employer of 100 employees, with an average salary of $30,000, in which 21 percent of employees participate in the health care FSA, with each contributing $1,292.

- An employee making $35,000 a year, who contributed to a health care FSA (the average amount of $1,292), would see a net tax savings of $284. (Standard deduction and federal income tax are based on an individual claiming single status under age 65.)

- Medical expenses that qualify under IRC Sec. 213 may be reimbursed through a health care FSA. Sec. 213 defines medical expenses to include amounts paid for the diagnosis, treatment, or prevention...
of disease, and for treatments affecting any part or function of the body. The expenses must be for
the alleviation or prevention a physical defect or illness.

- In September 2003, the IRS issued a revenue ruling stating that over-the-counter medications may be
reimbursable through a health care FSA. Since some medications that can be bought over the counter
today were recently available only through a doctor’s prescription (such as Claritin), the IRS reasoned
that including over-the-counter medications as a reimbursable expense is consistent with the
definitions of medical expenses in Sec. 213. However, items such as vitamins and dietary
supplements are not reimbursable.

**Dependent Care Spending Account**
- Contributions to a dependent care FSA are limited by law to no more than $5,000 a year. Allocation
of the unused assets in a dependent care FSA are treated in the same manner as the allocation for the
health care FSA (meaning that they are forfeited). One notable exception is that the uniform
reimbursement requirement does not apply to dependent care FSAs.

- An eligible dependent is defined as an individual who can be claimed by an employee as a dependent
for federal tax purposes under IRC Sec. 151(c) and meets the following requirements:
  - Child under age 13.
  - An individual, such as a disabled parent, who requires full-time care because of a physical or
    mental incapacity.
  - An employee’s spouse who is physically or mentally incapable of caring for himself or
    herself.

- Expenses for care outside of the taxpayer’s home may be claimed only for dependents who are under
age 13 or who regularly spend eight hours per day in the taxpayer’s home.

- According to a study by Mercer Human Resource Consulting, in 2002, 22 percent of employers with
10 or more employees offered a dependent care FSA and 14 percent of eligible employees were
participating.

- In 2002, the average contribution to a dependent care FSA was $3,024.

- An employer that offered a dependent care FSA in 2002 could have had a net tax saving of $4,858 per
year. This figure is based on an employer of 100 employees, with an average salary of $30,000, in
which 21 percent of employees participated in the dependent care FSA, each contributing $3,024. This
is an example for illustrative purposes. It matches the example used in the Dependent Care FSA.

- An employee making $35,000 a year, who contributed to a dependent care FSA (the average amount
of $3,024), would see a net tax savings of $690.\(^a\) (Standard deduction and federal income tax are
based on an individual claiming head of household status plus one dependent under age 65.)

For more information, contact Ken McDonnell, (202) 775-6342, or see EBRI’s Web site at www.ebri.org.

\(^a\) Calculations are based on an individual in the 15 percent federal tax bracket plus 7.65 percent FICA tax
contributions. State income taxes are left out of this calculation due to the high variance in state income tax
rates.