Flexible Spending Accounts

What is a Flexible Spending Account?
A flexible spending account (FSA) is an account in an employee's name that reimburses the employee for qualified health care or dependent care expenses. It allows an employee to fund qualified expenses with pre-tax dollars deducted from the employee's paychecks. The employee can receive cash reimbursement up to the total value of the account for covered expenses incurred during the benefit plan year and any applicable grace period.

"Use-it-or-lose-it" Rule
As required by the Internal Revenue Service (IRS), an FSA has a "use-it-or-lose-it" provision stating that any unused funds at the end of the plan year (plus any applicable grace period) will be forfeited. When electing an FSA during open enrollment, the employee must specify how much he or she would like to contribute to the FSA for the year. The goal is to choose an amount that will cover medical or dependent care expenses, but that is not so high that the money will be forfeited at the end of the year.

The IRS allows employers to offer an extended deadline, or grace period, of two and a half months after the end of a plan year to use FSA funds. Thus, for a plan year ending Dec. 31, employees would have until March 15 to spend the funds in their FSAs. This provision is strictly optional; the employer must choose to implement it.

In addition, employers may allow participants to carry over up to $500 in unused funds into the next year. Similar to the grace period rule, this carry-over rule is strictly optional, and employers must choose to implement it. The carry-over provision is only available if the plan does not also incorporate the grace period rule.

Types of FSAs
There are two different types of FSAs: health care accounts and dependent care accounts. An employee can elect to have both types of accounts and contribute separate pre-tax dollars to each. These accounts are kept separate; for instance, an employee could not be reimbursed for dependent care expenses from his or her health care account.

Health Care Accounts
A health care FSA reimburses employees for eligible medical expenses, up to the amount contributed for the plan year. A health care FSA offered through a cafeteria plan must limit the amount of salary

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reduction contributions that employees can make.

The Affordable Care Act (ACA) revised the definition of "qualified medical expenses" for purposes of reimbursement from health care FSAs. Under the revised definition, qualified medical expenses include amounts paid for medicines or drugs only if the medicines or drugs are prescribed (determined without regard to whether the drugs are available without a prescription) or if they are insulin. This means that health care FSAs may not reimburse the cost of over-the-counter medications that do not have a prescription.

A health care FSA only reimburses employees for money spent on medical care, as defined under Section 213(d) of the Tax Code. Section 213(d) of the Tax Code defines "medical care" to include amounts paid "for the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body."

Examples of qualified medical expenses include deductibles and copayments for an individual's health plan. Eye exams, eyeglasses, contact lenses, hearing exams, hearing aids, physical exams and smoking cessation programs are also covered. For a complete list of qualified medical expenses, visit the IRS website.

Dependent Care Accounts

The second type of FSA is a dependent care account. This account can be used to pay for care of dependent children under the age of 13 by a babysitter, day care center, or before- or after-school program. Care for a disabled spouse, parent or child over the age of 12 is also eligible for reimbursement.

Many of the same general rules that apply to health care FSAs also apply to dependent care accounts, such as the "use it or lose it" rule. However, there are some other important differences between the two types of accounts. For dependent care accounts:

- There is an annual limit as to how much an employee can contribute. This amount is $5,000, or, if lower, the maximum amount that can be excluded from the employee's income under Section 129 of the Tax Code when the employee's election is made;
- The money in a dependent care account is not available until it has been deposited by the employee; and
- Dependent care expenses cannot be reimbursed until they are actually incurred. This can be an issue when child care centers "pre-bill" for services, and employees are required to pay in advance.

For more information on FSA plan design and compliance, contact Tilson HR today.