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Flexible Spending Account: Employer Perspective

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What is a flexible spending account (FSA)?

A flexible spending account (FSA) allows employees to pay for certain qualifying expenses with pretax dollars. With an FSA, your employees contribute pretax earnings to the plan, usually through salary reduction, and submit qualifying expenses to the plan for reimbursement. Qualifying expenses can include either medical expenses or dependent care expenses.

In addition to providing your employees with tax savings, an FSA is also a cost-efficient way of providing employee benefits. Because your employees fund the FSA, associated costs are minimal. In addition, employee contributions reduce your taxable payroll, thereby decreasing your payment of Social Security, Medicare, and federal unemployment taxes.

Tip: *An FSA can be offered as a stand-alone plan, or as part of a more comprehensive cafeteria plan.*

How does an FSA work?

Employees make an FSA election

Employees elect to contribute a specified amount to the FSA plan each plan year. This election generally must be made before the start of each plan year, and is irrevocable. Employees must, therefore, estimate qualifying expenses for the coming plan year. Participation in an FSA is voluntary — an employee does not have to contribute to the FSA.

Tip: *While employee contribution elections are irrevocable, a plan may allow participants to change contribution amounts in specific situations. For example, a plan may allow a participant to change a contribution election during the plan year if the participant gets married or divorced, or has a child.*

Employees submit qualifying expenses for reimbursement

The FSA reimburses employees for qualifying expenses that are properly submitted. Only expenses that are incurred during the plan's period of coverage will be reimbursed. The period of coverage generally means the plan year (while this is often a calendar year, it does not have to be). However, the terms of a plan may allow the period of coverage to provide a "grace period" of up to 2½ months after the end of the plan year.

Tip: *FSA plans that allow an extra 2½ months effectively have a 14-month and 15-day coverage period.*

Tip: *Plans may also allow an additional period of time to submit expenses for reimbursement after the close of the coverage period. So an FSA that operates on a calendar year might provide for reimbursement of expenses incurred through March 15 (2½ months after the end of the plan year), but might allow employees to submit those expenses through April 15.*

Health-care flexible spending accounts

A health-care flexible spending account reimburses employees for qualifying medical and dental expenses. Expenses that can be reimbursed by a health-care FSA include the annual deductibles for a health-care plan, as well as any qualified medical and dental expenses that your health plan does not cover. As of 2011, a health-care FSA cannot reimburse employees for over-the-counter (OTC) medications, except in the case of insulin and OTC medicines prescribed by a physician (a similar restriction applies to health reimbursement arrangements [HRAs], Health Savings Accounts [HSAs] and Archer Medical Savings Accounts [MSAs]).

With a health-care FSA, an employee can receive reimbursement for expenses before sufficient funds are withheld from the employee's pay, as long as total expenses submitted don't exceed the contribution amount elected by the employee. As a result, the employer runs the risk of having an employee terminate his or her employment at a time when expenses reimbursed exceed contributions to his or her flexible spending account.

Example(s): *John, an employee at Company X, elects to contribute $1,200 to the Company X health-care FSA. As a result, $100 is deducted from John's pay each month and contributed to the FSA plan. One month into the plan year, John pays $1,200 in qualifying medical expenses, and submits the expenses for reimbursement. Even though John has paid only $100 to the FSA at* *the time he submits the expenses for reimbursement, the FSA will reimburse John for the full $1,200 in qualifying expenses. If John leaves employment before the end of the plan year, Company X will not receive the full $1,200 in compensation from John.*

Tip: *For 2019, the FSA annual contribution limit is $2,700. Note that employers may impose their own lower limits.*

Dependent-care flexible spending accounts

A dependent-care FSA reimburses employees for qualifying expenses relating to the care of eligible individuals. Qualifying expenses are non-medical expenses that allow the employee, or the employee's spouse, to work or attend school full time. These expenses include day care, nursery school, day camp, babysitters, before/after school programs, and caregiver expenses for disabled individuals who live with the employee.

Tip: *Eligible individuals include qualifying dependents who are children under the age of 13, a spouse who is physically or mentally incapable of caring for him or herself, or a disabled individual who requires full-time care because of a physical or mental incapacity.*

Tip: *An employee can contribute up to $5,000 each year to a dependent-care FSA (individuals who file their federal income tax returns as married filing separately can contribute up to $2,500 each year).*

Unused funds are forfeited ("use it or lose it")

Employee funds remaining in an FSA after all qualifying expenses for the coverage period have been paid are generally forfeited. This is commonly known as the "use it or lose it" rule. However, in late 2013, the IRS issued Notice 2013-71, which modified the Section 125 "use it or lose it" rule for health-care FSAs to allow these plans to permit up to $500 of unused amounts to be carried over to the following plan year. Plan participants can then use these funds to reimburse qualified expenses incurred during that following year. Note that any plans adopting the carryover provision cannot also permit a grace period. Plans must be amended to both add the carryover provision and omit the grace period, if one applies.

The $500 carryover is in addition to the maximum $2,700 (2019 limit) employees can set aside for qualified medical expenses. Note that employers can choose to impose lower limits.

Employers are generally able to use forfeited funds to pay administrative costs of the plan.

Tip: *Why are employees required to forfeit unused funds? Internal Revenue Code (IRC) Section 125, which governs flexible spending accounts, prohibits the deferral of compensation. Were an FSA to allow an employee's unused funds to "roll over" to the next period of coverage, the employee would effectively be deferring compensation.*

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