Flexible Spending Accounts

POLICY GUIDE

Flexible spending accounts are arrangements that allow employees to pay for qualified health care or dependent care expenses on a pre-tax basis. Employers may offer a flexible spending account as an option within a comprehensive flexible benefit program or as a stand-alone plan.

The maximum amount of expenses an employee may be reimbursed for under a dependent care flexible spending account is $5,000 annually ($2,500 for a married taxpayer filing separately). In contrast, employees may receive an unlimited amount of reimbursement under a medical expense flexible spending account. However, employers usually set a maximum limit for medical expense reimbursements to protect themselves against major losses under the 'risk-of-loss' rule. The risk of loss rule requires employers to make the full amount of coverage elected under the plan available to employees from the first day of the plan year, regardless of how much salary they have contributed to the account.

Flexible spending accounts provide a number of advantages. For example, employees generally do not pay taxes on the amounts they contribute to a qualified plan, and employers, in turn, pay less FICA and FUTA taxes because employees' gross incomes are marginally reduced. In addition, flexible spending accounts provide employers an opportunity to offer a relatively low-cost benefit that is targeted to meet employee needs in two critical areas - medical care and child care. Moreover, spending accounts can help control benefits costs, since employees generally fund their accounts with their own pre-tax salary, leaving the employer to cover only administrative expenses.

Flexible spending accounts must meet the requirements of Internal Revenue Code section 125 to maintain their tax qualified status. Flexible spending accounts are also subject to those portions of the Code that apply to the type of benefit offered - section 129 for dependent care accounts and section 213 for medical expense accounts. In addition, medical flexible spending accounts are subject to certain health care continuation requirements under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) and the Employee Retirement Income Security Act (ERISA) (see the chapters COBRA Health Care Continuation Coverage and Employee Retirement Income Security Act in section 339).

APPLICATION OF POLICY

Operation of FSAs

Flexible spending accounts - also referred to as reimbursement accounts - reimburse employees for qualified expenses that are incurred during the plan year. The accounts are usually funded through voluntary pre-tax salary reduction agreements with employees, although they may be funded with employer-provided amounts, as long as the amounts provided to employees are spelled out in the written plan document. The amounts employees may elect to contribute on a salary reduction basis should also be specified in the plan document.
Employees elect to participate in the flexible spending account at the beginning of each plan year. They also specify the amount of pre-tax salary to contribute. Once made, benefit elections may not be changed during the plan year, unless there is a change in family status, such as marriage, divorce, or birth of a child. Since amounts that remain in employees' accounts at the end of the plan year are forfeited, employees should take care not to over-fund their accounts.

Employees receive reimbursements from account funds by providing their employer with written proof that they have incurred an expense that is qualified for reimbursement under the plan.

**Nondiscrimination Rules**

As with other qualified plans, the federal tax advantages of medical flexible spending accounts are tied to the requirement that they not favor highly compensated employees in plan availability or benefits offered.

Self-insured medical expense reimbursement plans, which are offered as benefits in cafeteria plans, are subject to the nondiscrimination requirements described in Internal Revenue Code Section 105(h). Generally, a self-insured medical expense reimbursement plan is any separate written plan for the benefit of employees that provides for reimbursement of employee medical expenses listed as deductible medical expenses under Code Section 213. Such a plan does not include fully insured plans or prepaid health care plans where the risk is shifted to an unrelated third party.

Under Section 105(h), a plan is discriminatory for eligibility unless it benefits:

- 70 percent or more of all employees;
- 80 percent of those employees eligible to benefit, as long as 70 percent or more employees are eligible to benefit under the plan; or
- A nondiscriminatory classification of employees.

A self-insured medical expense reimbursement plan is discriminatory for benefits if the type and amount of benefits available to highly compensated participants are not also available on the same basis to other participants. The comparison is based on benefits subject to reimbursement, rather than actual benefit payments or reimbursements under the plan, and on dollar amounts, rather than percentages of pay.

For purposes of the Section 105(h) tests, highly compensated employees are those who are:

- Among the five highest-paid officers of the employer;
- Shareholders who own more than 10 percent in value of the employer's stock; or
- The highest paid 25 percent of all employees.

**Ed. Note:** This definition of highly compensated employee differs from the definition found in Code Section 414(q), which applies to qualified pension, profit-sharing, and stock
bonus plans.

Excess reimbursements by highly compensated individuals in discriminatory plans are treated as taxable benefits under the cafeteria plan.

**Code Section 125**

To maintain tax-qualified status and offer tax advantages to both employees and employers, flexible spending accounts must comply with regulations under Internal Revenue Code section 125. Section 125 contains regulations that apply to both dependent care and medical expense flexible spending accounts, such as the 'use-it-or-lose-it' rule and other provisions concerning periods of coverage, incurred expenses, and benefit elections.

**Benefit Election Rules** - Code section 125 requires employees to make irrevocable benefit elections prior to the beginning of each plan year, before benefits become available. When making an election to participate in a flexible spending account, employees should specify the amount of pre-tax salary they wish to contribute to the plan. Employers should include in the plan document both the amounts that employees are allowed to contribute to a flexible spending account and any employer-provided amounts.

Employees may change their benefit elections during the plan year only under the following circumstances:

- A third-party health care provider significantly changes an employee's coverage (The participants affected by such a change may be allowed to revoke their coverage elections, or the plan may adjust their elections automatically);
- The plan participant separates from the employer's service; and
- The plan participant has a change in family status. A change in family status includes marriage or divorce, death of a spouse or dependent, birth or adoption of a child, termination of a spouse's employment, a switch in employment status, an unpaid leave of absence, or any significant change in health coverage attributable to a spouse's employment.

Employers generally may treat any events that are similar in nature to the above examples as changes in family status. However, employers that allow changes in elections as a result of similar circumstances should either include these events in the plan document or include objective criteria for determining what other types of events will permit changes in elections.

**Expense Reimbursement** - Flexible spending accounts may reimburse employees only for qualified expenses that are "incurred" during the plan's "period of coverage."

- *Period of coverage.* The period of coverage for a medical or a dependent care flexible spending account is 12 months - or in practical terms, the plan year. A flexible spending account plan may not allow employees to participate only for periods during which they expect to incur qualified expenses, such as on a month-by-month or an expense-by-expense basis,
• **Incurred**, Expenses are incurred after the service or item has been provided, not when the employee is formally billed or pays for the service, according to IRS. Thus, employees may not be reimbursed in advance for services not yet rendered. However, employers may choose not to reimburse expenses until after the period of coverage has ended. In general, employers should specify in the written plan document the date by which employees must submit claims for each plan year.

**EXAMPLE:** Jane has a medical emergency on December 30, 1991, and is taken by ambulance to a local hospital. Ambulance costs are not covered by her employer-provided health care plan. However, she has enough funds left in her 1991 flexible spending account to cover the ambulance cost when the plan year closes on December 31. Although Jane does not file a reimbursement claim until she returns to work on January 15, 1992, she may receive reimbursement funds out of her 1991 FSA, since the cost was incurred during that plan year and the plan permits employees to submit claims until January 31 for the previous year.

**Forfeitures** - Any unused amounts remaining in an employee's flexible spending account after the plan year ends may not be refunded to the employee, under the 'use-it-or-lose-it' rule. This rule, which applies to both medical and dependent care accounts, may be the most significant restriction on the use of a flexible spending account from an employee's perspective.

To reduce the chance of significant losses occurring under the use-it-or-lose-it rule, many employers caution employees not to elect a contribution level greater than the amount of reimbursable expenses they expect to incur. Although employees terminating from service are prohibited from receiving any unused flexible spending account funds as cash, some employers permit such employees to continue to submit claims for covered expenses incurred during the remainder of the plan year. Such a policy should be specified in the written plan document. Otherwise, terminating employees must forfeit any unused amounts.

Employers may utilize forfeitures by applying them (and any other income the flexible spending account plan produces) toward reasonable administrative costs incurred during the plan year. Employers also may credit experience gains to employees' accounts in the following plan year, as long as the funds are allocated on a reasonable and uniform basis to all plan participants. The funds may be allocated on a per capita basis or according to the level of coverage selected under the plan, but may not be allocated to employees in a way that is directly or indirectly based on their claims experience.

**Payment Cessation** - If an employee fails to make scheduled contributions to a flexible spending account, the employer may consider that the period of coverage under the plan has ended, according to IRS. This provision affords employers some protection against loss in such cases as employees who terminate employment and elect participation in a medical spending account as continuation coverage under COBRA. Employers that have such a policy, however, should include it in their plan document.

**EXAMPLE:** An employee elects to contribute $300 to a medical FSA for the plan year. The plan requires the employee to make a contribution of $25 per month for the 12-month period of coverage. The employee decides to leave the company at the end of June and refuses to make
additional payments to the plan. Because the plan provides that the FSA's period of coverage does not extend beyond June if the employee does not continue to make the required premium payments, participation in the plan is terminated. If the employee had made the entire $300 contribution to the plan, however, the employer could not have terminated participation in the FSA simply because the employee had separated from service before the end of the coverage period.

**Terminating Employees** - Employees who terminate their employment before the end of the plan year have several options:

- They may forfeit their account balances, if they fail to continue scheduled contributions and revoke their benefit elections;
- They may continue to pay their premiums until year's end, thereby continuing to be covered by the plan until the end of the plan year; or
- They may elect COBRA benefit continuation coverage, paying 102 percent of the premium and extending the coverage period until COBRA eligibility expires (see the chapter *COBRA Health Care Continuation Coverage* in section 339).

**Medical Spending Accounts**

In general, medical expenses that may be reimbursed through a medical flexible spending account - under Code section 213 - include the following:

- Deductible payments;
- Co-insurance payments;
- Dental care not provided through another health insurance plan;
- Prescriptions drugs;
- Emergency ambulance service;
- Chiropractic services;
- Eyeglasses;
- Hearing devices;
- Psychiatric care; and
- Psychologists' fees.

Medical flexible spending accounts may not reimburse employees for expenses that are covered under another health plan. Also excluded from reimbursement are health insurance premiums, whether for the employee, the employee's spouse, or the employee's dependents. *(Note: Premium payments may be paid on a salary reduction basis as part of a normal cafeteria plan arrangement or through a premium-only-plan.)* *(IRC §213)*

**Claims Submission** - Employers may reimburse an employee's medical flexible spending account claim only if the employee provides: (1) a written statement from an independent third party stating that the expense has been incurred and the amount of the expense; and (2) a statement that the medical expense has not been reimbursed and is not reimbursable under any other health plan coverage.
This information could be obtained through items such as a physician's bill or sales receipt to prove employees have incurred an expense covered under the medical spending account. In addition, employers can require employees to sign a statement on their claims submission form that the expense is not reimbursable under any other health care plan coverage.

Payment of Claims - Employers must reimburse employees' medical spending account claims on at least a monthly basis, or when the total amount of the claims reaches a specified, reasonable, minimum amount.

Uniform Coverage - The uniform coverage requirement, sometimes called the risk-of-loss rule, requires health care expense flexible spending accounts to operate like insurance plans rather than reimbursement accounts. Specifically, employers must make the full amount of coverage elected by a plan participant available to the employee from the start of the plan year, regardless of how much has been paid into the account up to that point.

EXAMPLE: An employee elects to establish a $1,200 medical expense FSA by agreeing to have $100 deducted from pay every month. Under the uniform coverage requirements, if the employee incurs a $1,200 medical care expense in the first month of the plan year, pays the bill, and submits the claim to the employer for reimbursement, the employer would have to reimburse the employee for $1,200, even though only $100 had accumulated in the FSA. (Note: This requirement would subject the employer to a loss of $1,100 if the employee, after receiving the $1,200, either quits or has a change in family status and then changes the FSA election to zero.)

Minimizing Risk of Loss - Given average rates of employee turnover, most employers are not likely to be exposed to significant risk under the uniform coverage rule. However, employers can help protect themselves against losses by taking some of the following steps:

- Set or lower caps on medical expense flexible spending accounts to $300, $500, or $1,000 per plan year rather than maintain high limits;
- Adopt plan provisions that restrict both employees and former employees from reducing their health FSA elections during the plan year;
- Assess employees a small surcharge to offset possible losses, such as requiring employees to pay an additional $50 for coverage;
- Put funds contributed to FSAs in an interest bearing account to generate earnings to offset losses; and
- Use amounts forfeited under the use-it-or-lose-it rule to offset losses, and reserve this right in the plan document.

Employers may not deduct from employees' final paychecks premium payments that are due for the rest of the year as a method of minimizing their loss. Such a policy would tend to eliminate any risk of loss to the employer and thus violate the requirement that flexible spending accounts exhibit risk-shifting characteristics. Also, employers are not allowed to base employees' contribution schedules on the rate or amount of claims they submit under the plan.

Financial Audits and ERISA - Employers sponsoring medical expense flexible spending accounts are required to file an annual Form 5500 with the Department of Labor, under the
Employee Retirement Income Security Act. (ERISA). The filing must include a financial audit of the accounts, since employee contributions qualify as plan assets. (Participant contributions applied to pay benefits are considered plan assets because they can be segregated from an employer's general assets.)

However, there are certain exemptions to the medical spending account reporting requirements under ERISA. For example, plans with fewer than 100 participants are exempt from filing an annual report if benefits are:

- Paid solely from the general assets of the employer (or employee organization);
- Provided exclusively through insurance contracts, the premiums for which are paid directly by the employer (or employee organization) from its general assets or partly from general assets and partly from contributions from its employee, provided participant contributions are forwarded to insurance carriers within three months of receipt; or
- Provided partly from the general assets of the employer and partly through insurance contracts. (29 CFR §§2510.3-102, 2520.104-20, 2520.104-44)

**Ed. Note:** There has been some confusion over whether or not participant contributions to flexible spending accounts - which can by definition be segregated from an employer's general assets - preclude exemptive relief from the reporting requirements. The general argument was that FSAs are not eligible for exemptive relief since benefits under the account could not be considered paid 'solely from the general assets of the employer.'

To resolve this issue, DOL announced in 1992 that - until it provides further guidance - no violations will be asserted against an FSA that does not meet all the reporting exemption requirements solely as a result of using participant contributions to pay plan benefits or expenses in connection with the provision of benefits. DOL also reaffirmed its position that it will not assert a violation in any enforcement proceeding solely because of a failure to hold participant contributions in trust. Thus, exemptive relief from the reporting requirement is available for flexible spending accounts if the requirements described above are met. (DOL Technical Release 92-01)

**Obligations Under COBRA** - Employees have a right to elect continued participation in a medical expense flexible spending account as their continuation health coverage under COBRA. However, employees covered under COBRA may find little incentive to continue their participation in an FSA, since they will be charged 102 percent of the cost of health care (see the chapter *COBRA Health Care Continuation Coverage* in section 339).

Since employees generally fund FSAs through their elective salary deferrals, an employee choosing continuation coverage under such an account essentially could be required to pay $1.02 for every $1.00 worth of coverage under the plan. Except for this additional premium charge (which is meant to cover the employer's administrative costs), employers generally must provide the continuation coverage on the same terms that it is provided to current employees.
Dependent Care Accounts

A dependent care flexible spending account may reimburse an employee for up to $5,000 ($2,500 for a married employee filing separately) of dependent care expenses each plan year. Reimbursable expenses include any non-medical expenses that:

- Enable the employee or the employee's spouse to be gainfully employed or to attend school full-time; and
- Ensure a qualified dependent's well-being and protection. (For more information, see the chapter Dependent Care Benefits in this section.)

Dependent care flexible spending accounts may not reimburse employees for amounts paid to persons whom they claim as their own dependents for income tax purposes, or for amounts paid to a child of their own who is under age 19 at the close of the tax year. Additionally, employees may not be reimbursed for amounts paid to camps where their dependents stay overnight. (IRC §§129, 21(b)(2))

**Dependent Care Tax Credit** - Certain employees may be eligible to receive the dependent care tax credit, which is equal to 20 percent to 30 percent - depending on adjusted gross income - of eligible expenses for dependent care services that are necessary for an individual's gainful employment. Eligible expenses may not exceed $2,400 for one dependent or $4,800 for two or more dependents.

The maximum expenses for the tax-credit calculation must be reduced, dollar for dollar, by the amount of expenses excluded from income under a dependent care FSA. Because of this provision, employees will need to evaluate the most favorable tax position before deciding whether to use the tax credit or the maximum $5,000 tax exclusion available under a dependent care FSA. In general, employees with one child and household income of under $25,000 will do better using the tax credit, while higher-paid employees with more than one child will do better using the full tax exclusion and losing the tax credit. (IRC §21)

**Claims Submission** - To receive reimbursement for qualified expenses through a dependent care flexible spending account, employees must submit the following information to their employer:

- A written statement from an independent third party stating that the expense has been incurred and the amount of the expense; and
- A statement that the expense has not been reimbursed and is not reimbursable under any other dependent care plan.

Employers generally require employees to submit a bill or receipt from their day care provider. The bill should indicate the amount charged for the service and the dates of service covered. Employers also may require employees to sign a statement on their claims submission form stating that the claim is not payable under any other dependent care plan.

**No Advance Payment** - Dependent care expenses may not be reimbursed until they are
actually incurred. Thus, even though some day care centers require advance payment for services, employers may not reimburse employees for the expense until after the care has been pro- vided. Whether an employee may make a daily, weekly, or monthly claim for expenses that have been incurred is up to the employer, which should specify its policy in the written plan document.

**Identifying Care Providers** - Employees who participate in dependent care flexible spending accounts are required to include the name, address, and taxpayer identification number (Social Security or employee number) of their day care provider on their personal income tax return.

Although employers are not responsible for enforcing this requirement, it is advisable to alert employees of the rule before they make their spending account elections. The notification could help employees avoid using the services of a day care provider who is unable or unwilling to provide the necessary information. (IRC §129(e)(9)

**Survey Data**

- *Flexible spending accounts* were the most prevalent option offered in 1994 by employers looking to provide greater choice and flexibility in their benefit programs, reveals a survey of 489 employers conducted by Hewitt Associates.

According to the survey, 87 percent of respondents offered pre-tax premiums and salary conversions, 72 percent provided dependent care spending accounts, and 69 percent offered health care spending accounts. While just 3 percent of respondents said they plan to add pre-tax premium or salary conversion benefits to their plans by 1997, 12 percent said they will include dependent care spending accounts and the same number said they will add health care spending accounts to their benefit packages, the survey notes.

The majority (75 percent) of benefit programs offered by survey respondents include one or more flexible spending account options, with 66 percent of respondents offering both health and dependent care flexible spending accounts, 6 percent providing dependent care accounts only, and 3 percent providing health care accounts only. Despite the number of flexible spending account programs available, however, employee participation rates remain low, the survey points out. Specifically, only 16 percent of eligible employees participated in health care spending accounts in 1994, and just 3 percent participated in dependent care accounts.

Regarding employee contributions to their flexible spending accounts, meanwhile, the survey finds that the median participant contribution is $650 for health care spending accounts and $3,028 for dependent care spending accounts. A small number (6 percent) of employers with spending accounts subsidize them by either making direct contributions or by matching some portion of the employee's contribution, the survey adds.

**Account forfeitures** - the amounts remaining in participant accounts once the year-end grace period has lapsed - occurred in 93 percent of health care accounts and 71 percent of dependent care accounts, the survey finds. The median amount forfeited from 1993 accounts was
Flexible spending accounts have become a standard part of most employers' benefits programs, suggests a survey of 1,008 employers conducted by consulting firm Hay/Huggins.

According to the survey, the number of employers that provide flexible spending accounts has increased steadily. Specifically, just over three-quarters of respondents (76 percent) offered one or more flexible spending accounts in 1995, compared with 73 percent in 1993, and 68 percent in 1991. Of these respondents, 88 percent provide accounts for dependent care expenses, 82 percent provide health care premium accounts, and 79 percent provide accounts for unreimbursed medical expenses, the survey finds.

A majority of the flexible spending accounts offered are funded entirely by employees, the survey says, with 92 percent of respondents providing no employer contributions. The few respondents that do provide employer contributions, the survey notes, provide a flat dollar amount - typically $500 or less.

Despite the increase in the number of employers offering flexible spending accounts, employee participation remains relatively low. For example, 73 percent of respondents with dependent care spending accounts report employee participation levels of 5 percent or less, and just 1 percent report employee participation above 40 percent, the survey says. Among respondents that offer medical spending accounts, meanwhile, the most common participation rate is between 11 percent and 20 percent of employees (cited by 29 percent of respondents).

The maximum contribution employees may make to a flexible spending account differs based on the type of account. Nearly all of the respondents that offer dependent care spending accounts cap employee contributions somewhere between $4,000 and $5,000, the survey finds. In contrast, medical spending account limits vary widely. Thirty-six percent of respondents with medical spending accounts cap employee contributions between $2,000 and $3,000, while 32 percent cap them between $1,000 and $2,000, and 16 percent cap contributions between $4,000 and $5,000, the survey notes. ("1995 Hay/Huggins Benefits Report," Hay/Huggins Company, Inc., 229 S. 18th St., Philadelphia, Pa. 19103; (215) 875-2833)