BUILDING & GROWING WEALTH

RIVERVIEW CAPITAL ADVISERS

RIVERVIEW INSIGHTS

September 2014 | *Flexible Spending Accounts*

Introduction

Flexible Spending Accounts (FSA)s were introduced in the late 1970s as a response to the growing concern of rising cost of health care. *FSAs offer employees a tax-favored program to help pay for unreimbursed qualified medical expenses (*Healthcare FSA*) and dependent care costs (*Dependent Care FSA*) for qualifying persons.

FSA is an employer established plan where both an employee and employer are eligible to contribute. Typically, the FSA is employee-funded through salary deferral and all contributions into the plan are made on a pre-tax basis. This ability to effectively reduce taxable income can result in meaningful increases to an employee's take home pay.[1]

Tax Advantages

	With FSA	Without FSA	FSA Savings
Annual Income	$300,000	$300,000	
FSA Pretax Contribution	$5,000	$0	
Taxable Income	$295,000	$300,000	
Estimated Federal Withholding	$66,960	$68,656	
Dependent Care Expenses	$5,000*	$5,000	
After-Tax Income	$228,040	$226,344	$1,696

**Cost of Dependent Care expense is paid from FSA contribution.*

Disclaimer: The example does not account for the Dependent Care Expense Credit.

While Dependent Care FSAs are most often utilized with children under the age of 13 years old, it can also be used for children of any age who are physically or mentally incapable of self-care, as well as adult day care for senior citizens who live with the employee. The person(s) on whom the funds are used must be filed as dependent(s) on the employee's tax return. The funds cannot be used for long-term care for parents who live far away (i.e. nursing homes).

*Health plans must be FSA approved. Depending on the size of the company, setup, admin and annual costs apply.

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Key Points

- Healthcare FSA vs. Dependent Care FSA
- When to enroll in FSA
- Contributions and Withdrawals
- Annual FSA options

Did You Know?

A qualifying person is:

1. You and your spouse.
2. All dependents you claim on your tax return.
3. Any person you could have claimed as a dependent on your return except that:
   a. The person filed a joint return, or
   b. Had gross income of $3,900 or more.
4. Your child under age 27 at the end of your tax year.

More information, see *Publication 503*.

What can FSAs pay for?

As previously mentioned, you can utilize different types of FSAs to pay for qualified medical expenses that your insurance doesn't cover, or day-to-day expenses of caring for a dependent. See the chart to the right for a breakdown of qualified expenses for each account.

Many employers require a written statement from your health care provider to guarantee compliance.

Healthcare FSA

- Co-payments, office visits, vision, dental, chiropractic care, lab, hospital fees, medications, immunizations

Dependent Care FSA

- Before and after school care, child care, nanny, nursery school, preschool, summer day camp

When can I enroll?

The enrollment period is established by your employer; however it is typically towards the end of the calendar year before the current plan period ends.

How much can I contribute?

The Healthcare FSA and Dependent Care FSA are independent of each other.

The amount contributed is a commitment between you and your employer and cannot be changed once established during the enrollment period. Healthcare FSA limits are per employee and make no consideration for other family members. Dependent Care FSA limits do allow for a family limit. See the chart to the right for 2014 contribution limits to each plan.

	Maximum Annual Contributions	
	Single	Married
Healthcare FSA	$2,500	$2,500
Dependent Care FSA	$5,000	$5,000

How can I withdraw?

Healthcare FSAs are pre-funded, meaning you can use your committed balance from day one.

For example: A client establishes a **Healthcare FSA** on January 1st with a committed balance of $2,500. The balance in the plan on January 15th is $250. Suddenly, on February 1st the client incurs a large qualified medical expense of $2,000. With a Healthcare FSA, the client is able to withdraw $2,000 immediately.

On the contrary, **Dependent Care FSAs** are <u>not</u> pre-funded: the amount of withdrawals must be within the account balance.

For example: A client establishes a Dependent Care FSA on January 1st, the balance in the plan on March 15th is $1,000. On April 1st, the employee would like to use the funds to pay for his son's preschool. The employee is only allowed to withdraw the accumulated balance of $1,000.

What happens to the balance at yearend?

Employers typically provide two options to their employees on their annual **Healthcare FSA** contribution. One option is a grace period, in which an employer typically allows up to 2 ½ months following the year-end to use up their balance. The second option is a carryover of the funds to the following year. However, only $500 of the unused balance can be carried over into the employee's Healthcare FSA for the next calendar year.[2] **Healthcare FSA** cannot have both a carryover and a grace period; it can have one or the other or neither. See example below for a better understanding.

Healthcare FSA Example

A client is an employee of Company X that offers a Healthcare FSA. The client contributed monthly up to his $2,500 limit and at year-end uses only $1,700 of his balance. If Company X offers a **grace period**, the client would have from January 1st until March 15th to use up the remaining $800. If Company X offers a **carryover**, the client would only be allowed to carryover a maximum of $500 into his next period, losing the remaining $300. If the company does not allow either option, the balance is forfeited.

Dependent Care FSA allows only a grace period; the carryover rule does not apply. See example below.

Dependent Care FSA Example

A married client is an employee of Company Y that offers a Dependent Care FSA. The client contributed monthly up to his $5,000 limit and at year-end uses only $4,000 of his balance to pay for his son's preschool. If Company Y offers a **grace period**, the client will have from January 1st until March 15th to use up the remaining $1,000 balance. If the balance is not used by March 15th, the remaining balance is forfeited.

Is it possible to have both an HSA and FSA simultaneously?

Many employees are unsure if they can utilize HSAs and FSAs at the same time. You are able to have both accounts, but only under special circumstances. If your employer offers a Limited Expense FSA (limited to dental, preventative care and vision expenses) or Post-Deductible Care FSA (use funds *after* the plan deductible is met), then you may still be eligible to have an HSA.[1] To learn more about HSAs, read the full article **here**.

Summary

A plainspoken understanding and a little planning can go a long way in helping FSAs stretch one's hard earned dollar. Flexible Spending Accounts, both Healthcare and Dependent Care, offer an array of benefits. Clients with high medical expenses or dependents can benefit tremendously from FSA's due to their flexibility of coverage and pre-funding. Keep in mind, FSAs are financial tools and may not be appropriate for everyone. If you'd like to learn more and discuss options on an individual level, please contact us.

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Sources:

1. http://fas.org/sgp/crs/misc/RL32656.pdf
2. https://www.healthcare.gov/can-i-use-a-flexible-spending-account-fsa/