



**Flexible Spending Accounts (FSAs)** are also called **Section 125 plans** after the section of tax code that governs their use. FSAs earn their nickname from the flexibility they give you in choosing from a menu of benefits. With an FSA, the employee authorizes the employer to deduct a fixed amount from their before-tax income. FSA contributions are made to a reimbursement account that is used to pay for qualified expenses that are incurred during the year. Qualified expenses include health care, dependent care and group insurance premiums that the employer does not reimburse. Contributions to an FSA are

exempt from FICA, Medicare, federal and state income taxes. Also, employers do not have to pay their half of FICA and Medicare taxes or federal and state unemployment insurance on contributions to an FSA plan. Therefore, employers also benefit from the use of a FSA plan.

### *Advantages to Employees*

- Insurance premiums are paid with pre-tax dollars saving FICA, Medicare, federal and state tax on the cost of the premiums.
- Although many people cannot deduct their medical expenses on their tax return due to income limitations, out of pocket medical expenses can be paid with pre-tax dollars through an FSA.
- If participating in a medical reimbursement plan, the entire election amount must be made available on the first day of the plan year. Therefore, employees are able to pay high out of pocket costs over time, without incurring finance charges.
- Able to claim up to \$5,000 in dependent care expenses, compared to a possible lesser deduction if you completed IRS Form 2441.

### *Disadvantages to Employees*

- “Use it or lose it” rule – if employee doesn’t use the amounts they elected, they lose the balance in the reimbursement account.
- Other than during the open enrollment period, elections can only be changed for specific changes in family status. These changes include birth or adoption of a child, marriage, divorce, death of a spouse of child, or change in job status.

### *Advantages to Employers*

- By implementing an FSA at the same time as health insurance costs are increasing, employers can pass the increase along to the employees and lessen the impact on the employees’ take home pay.
- Saves FICA, Medicare, FUTA and SUI taxes on amounts elected by employees.

### *Disadvantages to Employers*

- The entire medical expense election must be made available to the participant on the first day of the plan year. Therefore, the employer runs the risk that the employee would incur a large expense early in the plan year and then terminate employment before having deductions to cover the expense.
- Employee education may be required so employees understand the real value of an FSA.

## Savings at the Employee Level

**EXAMPLE:** A married couple with two children earns combined gross income of \$80,000. They anticipate total unreimbursed health and dependent care expenses for 2009 to be \$10,000. Therefore, each spouse enrolls in their employer's dependent and health care reimbursement plan by making a \$2,500 election to each plan, for a combined total of \$10,000.

|   | Participating in an FSA Plan | Not Participating in an FSA Plan |
|---|------------------------------|----------------------------------|
| Gross income                                | \$80,000                     | \$80,000                         |
| Less contributions to an FSA plan           | 10,000                       | 0                                |
| = Taxable income                            | \$70,000                     | \$80,000                         |
| Less FICA/Medicare taxes (7.65%)            | 5,355                        | 6,120                            |
| Less federal income tax (estimated at 27%)  | 18,900                       | 21,600                           |
| Less state income tax (estimated at 6%)     | 4,200                        | 4,800                            |
| = Net Pay                                   | \$41,545                     | \$47,480                         |
| Less qualified expenses                     | N/A                          | 10,000                           |
| = Take home pay after expenses              | \$41,545                     | \$37,480                         |
| <b>Savings from participating in an FSA</b> | <b>\$4,065</b>               | <b>\$0</b>                       |

## Savings at the Employer Level

**EXAMPLE:** The employer receives significant tax savings through an FSA plan. The example below assumes 200 participants with varied levels of participation in the FSA plan.

**ASSUMPTIONS:** Employee Premiums: based on insurance premiums averaging \$200 per month per employee for 200 employees (200 employees x \$200 per month = \$480,000 annually). Medical Reimbursement: based on 125 employees who contribute an average of \$75 per month (125 employees x \$75 per month = \$112,500 annually). Dependent Care Reimbursement: based on 75 employees who contribute an average of \$400 per month (75 employees x \$400 per month = \$360,000 annually).

|  | Without an FSA Plan | With an FSA Plan |
|--|---------------------|------------------|
| Annual Payroll   | \$16,500,000        | \$16,500,000     |
| Employee Premiums  | \$0                 | \$480,000        |
| Medical Reimbursement                                    | \$0                 | \$112,500        |
| Dependent Care Reimbursement                             | \$0                 | \$360,000        |
| Taxable Payroll  | \$16,500,000        | \$15,547,500     |
| Estimated FICA & Medicare*                               | \$1,231,250         | \$1,158,384      |
| <b>Total FICA &amp; Medicare tax Savings to Employer</b> | <b>\$0</b>          | <b>\$72,866</b>  |

\*Represents estimated FICA and Medicare taxes on the taxable payroll (after FSA elections), assuming the compensation of approximately 20 employees is approximately \$25,000 in excess of the FICA taxable wage base. Actual savings will vary depending upon specific tax situation. There will also be a savings of unemployment taxes, but those savings have not been factored into this example.