ALERTS AND UPDATES

A "Less" Flexible Savings Account, Starting in 2011

November 24, 2010

Flexible spending accounts, or FSAs, are an excellent way to pay for healthcare expenses using pre-tax money. These voluntary, employer-sponsored programs, allow employees to save a portion of their income on qualified medical expenses incurred during their benefit plan year for themselves and covered dependents. The contributions, maxed at $5,000 for 2010, are deducted from an employee's pay into an FSA and are tax-free, resulting in a substantial payroll tax savings. One key drawback to the FSAs is the "use it or lose it" rule. Any funds remaining at the end of the benefit year, including the two-and-a-half-month allowable extension, are forfeited. They may be applied to future plan administrative costs or can be equally allocated as taxable income among all plan participants.

Currently, the IRS allows a healthcare FSA (HFSA) to reimburse eligible medical expenses—including certain over-the-counter (OTC) items—for employees and covered dependents. Generally, qualifying reimbursable medical expenses are those that result from the diagnosis, cure, mitigation, treatment or prevention of a disease or illness affecting any part or function of the body.[1] Medical expenses recommended for the bettering of an individual's general health or well-being (*e.g.*, vitamins or gym memberships) are generally not eligible for reimbursement. Furthermore, some expenses require additional documentation, such as a required Letter of Medical Necessity, or LMN. An LMN is a doctor's statement that indicates a specific medical disorder, the specific treatment needed and how the treatment will alleviate the medical condition.

However, in the near future, FSAs and HFSAs will be more regulated than ever before. Healthcare reform legislation signed into law in March 2010 changed the definition of a "qualified medical expense" and included a provision that will cap the amount that can be put into FSAs, per employee. Beginning in 2011, expenses incurred for OTC medications will no longer be eligible for payment or reimbursement, unless specifically prescribed for by a doctor. The new law also imposes, effective in 2013, a new limit on contributions made by employees to FSAs. The legislation limits contributions to no more than $2,500 annually, a reduction from the current $5,000 annual limitation. The new limit is indexed for inflation for future years.

Since the law will not be fully phased in until 2013, and the earliest change will not occur until January 1, 2011, a planning opportunity exists. Employees may want to consider accelerating expensive medical procedures (*e.g.*, orthodontics) into 2011 or 2012 in order to take advantage of the current $5,000 pre-tax limit. They may also wish to consider stocking up on OTC medications this year to take advantage of expiring allowance of pre-tax reimbursements for OTC medications.

For Further Information

If you would like more information about this topic or your own unique situation, please contact Michael A. Gillen, director of the Tax Accounting Group, or the practitioner with whom you are regularly in contact.

Note

1. Remember, each employer plan is different. For specific information relating to your plan, employees should check their employer's plan documents.