

The Essential Guide to FSAs

By David Hakala

An FSA (Flexible Spending Account) is one of several options that an employer can set up under a [cafeteria benefits plan](#). An FSA allows an employee to direct a portion of his or her pretax pay to a special account from which withdrawals can be made to pay for qualified expenses established by the cafeteria plans. Employees benefit by paying for necessary expenses with pretax dollars, while employers benefit by avoiding [payroll taxes](#) on the pay contributed to FSAs.

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When an FSA is created, an employee commits to a fixed contribution amount to be taken from his or her paycheck over the course of a plan year. An annual maximum contribution is set by law for some FSAs, while others are capped by employers. If the employee does not use all of the money contributed to his or her FSA by the end of the plan year, the remaining amount is forfeited to the employer. FSAs, unlike [HSAs](#) (Health Savings Accounts) are a "use it or lose it" proposition, much like regular health insurance premiums.

Two common types of FSA can be set up. (Some less common types are set up by employers who offer HSAs.) Employees can contribute the maximum allowed to each FSA. However, funds cannot be transferred from one FSA to another.

Medical FSAs

The most common FSA is a medical FSA, which can be used for medical expenses that are deductible under [IRS](#) (Internal Revenue Service) rules. A medical FSA can be used for co-payments for office visits or drugs, vision and dental care, deductibles and some over-the-counter health care items. A medical FSA cannot pay for health insurance premiums, cosmetic items, cosmetic surgery, controlled substances or items that improve general health. All items must be intended to treat or prevent a specific medical condition; this can be as significant as diabetes or pregnancy or as trivial as superficial skin cuts.

One powerful benefit of medical FSAs is their coverage of many over-the-counter drugs and other medical products. These items can help employees use up their FSA benefits rather than lose them at the end of a plan year. A number of employers opt to give employees FSA debit cards, which can be used like regular debit cards at many retailers.

When a basketful of goods is scanned, the employee pays for part of the bill with the FSA debit card and the rest by other means.

Medical FSAs are like insurance in that they are prefunded by employers. In other words, an employee can spend the entire FSA annual allowance early in the plan year, before the FSA is fully funded by payroll contributions. If an employee leaves the company before paying the amount of FSA funds used, the employer is stuck with the remaining expense. For this reason, employers typically cap medical FSAs at \$5,000 or less.

Dependent Care FSAs

Dependent care FSAs can be used to pay for expenses for care of dependents while an employee is at work. Dependents can include not only young children but also parents or other senior relatives who live with you. Dependent care cannot include summer camps where children stay away from home, but can include day camps during your working hours. On the other hand, senior dependent care can include care in a residential facility away from your home.

Unlike medical FSAs, dependent care FSA contributions are capped by federal law at \$5,000 per individual; in other words, a married couple can each contribute \$5,000 to a dependent care FSA for a total of \$10,000. Also, dependent care FSAs are not prefunded. Reimbursements from the FSA account are limited to the contributions that an employee has already made. Debit cards can be used for dependent care FSA payments, but they are subject to numerous restrictions.

Dependent care FSAs are less often favorable to taxpayers than medical care FSAs. In particular, recent changes to child care tax credits may make them more advantageous to taxpayers and dependent care FSAs. Also, dependent care FSAs must be funded from income. If one spouse earns less than \$5,000 per year, then his or her contribution to a dependent care FSA is limited to total income.

Other FSAs

Some employers have set up FSAs to help with adoption expenses. However, much more common are FSAs created by employers without health plans to help employees pay health insurance premiums. Note that HSAs cannot be used to pay insurance premiums.

The Role of FSAs

FSAs are part of an overall trend toward consumer-driven benefits packages, which give consumers more choices in the benefits they can select from an employer's cafeteria plan. The theory of consumer-driven benefits is that every employee's situation is unique, and each employee is best served by a customized mixture of FSAs, HSAs, traditional insurance, high-deductible insurance and other plans such as dental and vision coverage.

Unfortunately, choice is complicated by all the decisions that must be made. Inconsistent tax treatment of medical and dependent care FSAs is another complication. The administrative costs to employers can eat up some of the payroll tax savings. The bottom line is that FSAs require careful planning and painstaking record keeping to be successful for both employers and employees.