

TIME TO GET FLEXIBLE WITH FLEXIBLE SPENDING ACCOUNTS

Flexible spending accounts are becoming more attractive for workers to offset rising healthcare and childcare costs – if only more eligible workers would take advantage of the accounts.

A flexible spending account, or reimbursement account, is an account offered through your employer that allows you to set aside wages tax-free to pay for such out-of-pocket expenses as medical or dependent care of a child or adult. At the start of the enrollment period, you declare how much you want to set aside for the next 12 months to pay for anticipated expenses. Say it's \$1,200 for medical care (there are separate accounts for medical and dependent care). The employer takes out a portion of that amount each paycheck, such as \$100 a month (some employers might require a larger initial payment). As you incur qualified out-of-pocket expenses, you turn in the receipts to your employer, who reimburses you up to the \$1,200 – even if the expenses total \$1,200 in the first month.

Unlike tax-deferred money eventually withdrawn from an employer's retirement plan, FSA reimbursements are never taxed as long as they are used for qualified expenses. This means the government (federal and most states with income taxes) effectively underwrites a portion of the expenses. If you're in a combined federal/state income-tax bracket of 30 percent, then you'll save about \$400 in taxes on the \$1,200 you set aside.

Federal law doesn't limit how much you can set aside in a healthcare FSA as long as it doesn't exceed your income. But most employers cap healthcare FSAs at \$2,500 to \$5,000. Federal law limits dependent care FSAs to \$5,000.

Despite these clear tax benefits, only 18 percent of eligible workers signed up for healthcare FSAs and just 7 percent for dependent care accounts, according to 2002 statistics from Mercer Human Resources Consulting. Why such a low participation rate?

First, many workers don't realize the tax advantages. But the bigger barrier to FSAs has been worker fears that they'll set aside too much. Under FSA rules, you forfeit to the employer any money set aside that you don't spend by the end of the 12-month period. For example, if you set aside \$1,200 but incur only \$1,100 in qualified expenses, you forfeit \$100. You can't roll it into the following year or take back the leftover money.

Careful projection of upcoming expenses can alleviate much of this risk. Also, a recent IRS ruling has broadened what's covered under a healthcare FSA, making it easier to avoid the "use it or lose it" problem. Under the old rules, out-of-pocket qualified medical expenses included deductibles and co-pays, prescription drugs, eyeglasses, orthodontia and birth control pills. The new rules allow over-the-counter medications such as pain relievers and cold medication, as well as antacids, pregnancy test kits, band-aids, nicotine patches and even cotton balls (some plans may not allow some or any of these items). Beyond the fact that these nonprescription medications are covered, their inclusion reduces the risk of forfeiting FSA funds. One could always load up on nonprescription drugs toward the end of the year in order to use up leftover FSA funds.

Employers also are making FSAs more valuable, though in a more perverse way. As employers shift more of the cost of healthcare co-pays and deductibles to their employees (you can't pay for premiums through an FSA), flexible spending accounts can help offset some of the increase.

Unfortunately for many workers, FSAs are offered mainly through larger employers. And not all workers should take advantage of available FSAs. Financial planners note that low-income families may come out ahead financially claiming the childcare tax credit instead of using a dependent care FSA (you can't claim both), though the healthcare FSA remains a good deal regardless of income.

Workers nearing retirement for an employer providing a traditional defined benefit plan also need to keep in mind that their retirement payouts are usually based on their average salary for the last three to four years of work. Pre-tax money set aside for FSA accounts reduces that base salary, and thus will reduce retirement benefits. You also don't pay Social Security and Medicare taxes on the set-aside amount, potentially reducing your eventual Social Security benefits.

But for most workers eligible for such plans, FSAs are a real deal.