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CURBING FLEXIBLE SPENDING ACCOUNTS COULD HELP PAY FOR HEALTH CARE REFORM

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Congress should consider scaling back or eliminating health care flexible spending accounts (FSAs)¹ as part of its effort to pay for health care reform. This paper, which is part of a series of papers on proposals to help pay for health reform, outlines several ways in which Congress could curtail FSAs.

FSAs are designed to allow employees to pay out-of-pocket health care costs with pre-tax dollars. Employees have a set amount deducted from each paycheck to be deposited in their FSA — free of any income or payroll tax — from which they are reimbursed for out-of-pocket health care costs they incur during the year. FSAs, however, suffer from significant flaws.

FSAs encourage the overconsumption of health care, which runs directly counter to a critical goal of health care reform. They also provide only modest tax savings to many workers while imposing onerous recordkeeping costs on accountholders. In addition, health care reform is likely to require health policies to limit beneficiaries' out-of-pocket costs, which would weaken the rationale for FSAs.

If Congress chooses not to eliminate FSAs, it should scale them back by limiting annual contributions, placing reasonable limits on the kinds of expenses FSAs can cover, and possibly placing an income cap on FSA participation. (We do not yet have reliable estimates of the amount of revenue that such proposals could generate.) In addition, if Congress caps the tax exclusion for employer-sponsored insurance (as we and many other analysts have recommended), the cap should cover the total amount of health care benefits an employee may accrue as tax-exempt compensation, including FSAs. Otherwise, employers may respond to the cap by shifting more health care costs to employees (with a corresponding adjustment in their wages and salaries) and have employees pay the shifted health care costs through tax-exempt FSAs — with the result that the amount of tax-exempt compensation used to subsidize health care spending would not change.

¹ A separate kind of FSA enables employees to pay *child care* costs with pre-tax dollars. This paper focuses solely on FSAs that are used to pay out-of-pocket health care costs.

Reasons to Eliminate or Limit FSAs as Part of Health Reform

- **FSAs encourage excess utilization of health care.** Funds in an FSA can be used to purchase nearly any health care service or item, regardless of whether it is medically necessary, cost effective, or of meaningful health value. FSA funds can also be used for a wide array of expenses commonly regarded as standard household purchases, including bandages, sunscreen, antacids, pain relievers, and humidifiers. In effect, FSAs encourage non-essential health care spending and subsidize purchases of questionable priority.
- **FSAs' "use or lose it" requirement promotes wasteful spending.** Employees must spend all of their annual FSA contributions by March 15 of the following year or forfeit any remaining balance. For many FSA participants, therefore, the approach of March 15 sets off a scramble to use up any funds in their accounts. As one consumer education website proclaims, "If you have an FSA, spend that money!"² Another advises, "if you have FSA money to burn, humidifiers generally count as an FSA purchase."³

Many people end up buying things they don't need. Others fail to spend their balances: Aetna reported that 14 percent of its accountholders — one of every seven — failed to spend all of their balances in 2007 and lost an average of \$723, while Mercer Human Resources Consulting estimates that 4 percent of total FSA contributions were forfeited in 2006.

- **FSAs complicate peoples' lives while providing only modest benefits for non-wealthy accountholders.** People with high incomes benefit disproportionately from FSAs because they are in higher tax brackets, tend to consume more health care, and can afford to deposit larger amounts in their accounts.

Middle- and lower-income people benefit much less, if at all. For example, someone in the 15 percent income tax bracket who contributes \$1,208 a year to an FSA (the average contribution for all accountholders) would save approximately \$274 in federal income and payroll taxes. Moreover, that \$1,208 figure is pushed up by the large contributions from upper-income individuals; the typical middle-income individual likely contributes much less than that — and thus receives even smaller tax savings.

Low- and moderate- income households are unlikely to reap *any* income-tax savings from FSAs because they pay little or no income tax. They do receive payroll tax savings, but the Social Security portion of those savings comes at a price. Since the amount of a worker's Social Security's retirement benefits reflects his or her payroll tax contributions, workers who pay less in payroll taxes because of their FSA will qualify for lower Social Security benefits when they retire. In fact, the Urban Institute reports that low-income workers will lose more in future Social Security benefits as a result of tax-exempt health benefits than they gain in lower payroll taxes. Few lower-income employees who sign up for an FSA are likely aware of this.

² "FSA, HSA, HRA, RRA...What's It All Mean?" <http://www.planforyourhealth.com/family/allmean/>.

³ "Do you need to spend FSA money?" November 2008, <http://frugaldrmom.blogspot.com/2008/11/do-you-need-to-spend-fsa-money.html>.

In addition, because employees forfeit any FSA balances remaining if they are laid off — and because lower-income workers are more susceptible to unexpected job loss — lower-income workers who participate in an FSA face a greater risk of losing the funds in their FSAs due to job turnover.

While FSAs provide only modest benefits for most workers, the accounts can impose considerable record-keeping costs. Human resource staff encourage employees to keep all receipts and documentation for every FSA-related purchase — for example, a receipt for the purchase of a box of anti-allergy medication — should they later need to justify the purchase. Accountholders must also track their FSA balances and complete the paperwork needed to obtain reimbursement. It is questionable whether most accountholders gain enough from their FSAs to justify this effort.

- **Health care reform's changes to the treatment of out-of-pocket costs are likely to weaken the rationale for FSAs.** Health care reform is likely to include subsidies for the purchase of health insurance and minimum coverage standards for health insurance policies, and may include a requirement for policies to include a limit on out-of-pocket costs. These aspects of health care reform further diminish the already weak policy rationale for FSAs.

Policy Options for Limiting FSAs

- **Eliminate health care FSAs.** There are several strong reasons to take this step. FSAs, which roughly 30 percent of employers with ten or more employees offer, distort consumption choices: they can be used for virtually any health care service, irrespective of cost-effectiveness or clinical effectiveness, and their “use or lose it” requirement pushes people to make unnecessary purchases at the end of the plan year. They are labor-intensive for taxpayers but yield only modest tax savings for most people and do so in a regressive manner. Finally, if Congress enacts health care reform that assures that coverage is affordable for people of moderate means and limits households' out-of-pocket costs, the rationale for FSAs would largely disappear.
- **If Congress retains FSAs, count them toward any limit it imposes on tax-exempt health care benefits.** If Congress caps the total amount of compensation paid for an employee's health care costs that is exempt from taxation, FSAs should count toward the cap. Not only are FSAs part of the system of tax subsidies related to employer-based coverage, but they foster overconsumption of health care, and one of the prime goals of the cap would be to restrain such overconsumption. Therefore, a comprehensive cap should include FSAs as part of total compensation.

If Congress does not count FSAs toward the cap, employers would be able to circumvent the cap by shifting more of the cost for a health insurance policy to employees and then having the employees pay those costs through tax-exempt FSAs. Where this occurred, the amount of compensation that is sheltered from taxation would not change, and the savings from the cap would be diluted.

- **Limit annual FSA contributions.** Many similar tax provisions (e.g., FSAs for child care, IRAs, and education tax benefits) have contribution limits established by law. FSAs are an exception. Imposing such a limit would make FSAs' treatment more consistent with the rest of the tax code.

As noted, the average FSA contribution was \$1,208 in 2006, and because the large contributions made by upper-income individuals boost the average, the median contribution was likely much lower. An annual contribution limit of \$1,000 would be reasonable. Other possibilities include \$1,500 or \$2,500, though a higher limit would generate less revenue.⁴

A \$1,000 limit would not likely restrict FSA savings available to most low- and middle-income individuals. For example, a single, 40-year-old male, with health insurance and earnings of \$40,000, could maximize his tax savings on medical, dental, vision, and prescription- and non-prescription drug costs by contributing just \$594 per year, according to an FSA calculator based on average claims and utilization data. Similarly, the calculator recommended that a single, 40-year-old female with the same income set aside just \$337 annually in her FSA.

- **Limit the expenses allowable under FSAs to those deductible under the rules for itemized medical expenses.**⁵ While FSA funds can be used for a wide variety of products and services of varying worth, the IRS's list of medical expenses that filers can deduct is more restrictive. Conforming the list of allowable FSA expenses with the list of deductible medical expenses would help align the treatment of individual health expenses in the tax code, reducing taxpayer confusion about what medical expenses are exempt from taxation. It also could reduce the wasteful and excessive consumption of health care products and services with FSA funds.
- **Impose an income cap on FSA participation, possibly in conjunction with a contribution limit.** Similar tax provisions — tax-favored IRAs and some education tax benefits, among others — have income limits that are set by law. FSAs are an exception. Imposing such a limit would make their treatment more consistent with other parts of the tax code.

There are two basic ways to structure an income cap. One would be to have FSA eligibility end abruptly for individuals above the cap. Alternatively, to avoid this "cliff effect," Congress could phase out FSA eligibility for people above the cap by phasing down the contribution limit above that income threshold until it reaches \$0.

For example, Congress could place an income cap on FSAs that starts phasing out at the same level that tax-deductible IRAs start phasing out. (In 2009 this level was \$89,000 for married couples filing jointly and \$55,000 for singles and heads of households.) The Roth IRA income limits (\$166,000 and \$105,000, respectively) provide another option.

⁴ Most employers place a limit on annual FSA contributions, but the limits often are high. For example, many employers allow contributions up to \$2,000 or \$5,000.

⁵ Filers can deduct allowable medical expenses that exceed 7.5 percent of their adjusted gross income.