RESEARCH

Big Benefits could come from Small Changes to Flexible Spending Accounts

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Executive Summary

One little-known provision of the Affordable Care Act (ACA) surreptitiously penalizes a select group of people – employees who, or whose dependents, require significant levels of health care of types not covered by insurance. This group includes families with children who have certain types of special needs, people with Type I ("juvenile") diabetes, people with disabilities, and even families with children requiring orthodontic treatment. Also affected are employees facing higher deductibles and co-payments – both of which are encouraged by other provisions of the ACA.

The common characteristic is that these families face significant health care costs not covered by insurance, but costs that can be paid for through a Health Care Flexible Spending Account (FSA). A Health FSA allows employees to set aside pre-tax dollars to pay for health care services not covered by insurance, as well as deductibles and copayments (but not premiums). The Internal Revenue Service (IRS) estimates that about 14 million American families use Health FSAs.[1] The ACA imposed a maximum amount employees may set aside of $2,500 per year, starting in 2013. Previously, there was no limit set by law, but employers typically set a limit, most commonly $5,000.[2] The ACA also limited the ability of patients to use Health Savings Account (HSA) funds for nonprescription drugs and medical supplies. The Joint Committee on Taxation (JCT) estimated that the imposition of a $2,500 limit on FSAs would increase tax revenue by $13 billion over 10 years, and the restriction on nonprescription items would increase revenue by another $5 billion.[3] A previously existing IRS regulation imposes a "use it or lose it" rule that requires employees to forfeit unused funds each year (and under certain circumstances when they change employers); this was unchanged by the ACA.

The reduced limit amounts to a heavy tax on employees with substantial health care needs of a type not covered by insurance. Because the impact affects the payroll tax as well as the income tax, the tax increase applies to employees with any level of income. The impact is greatest for employees with incomes below the Social Security tax limit ($118,500 in 2016), above the threshold for the 25 percent tax bracket ($37,650 for single filers in 2016), and who live in states with high income taxes.

In addition, the "use it or lose it" creates substantial inefficiencies, encouraging wasteful spending at the end of the year by those who incurred lower-than-expected health care costs, and implicitly imposing a tax increase on those who needed more

health care than expected during a given year.

Background

In 1978, Congress amended the Internal Revenue Code to allow employers to set up FSAs for their employees.[4] Employees may use funds in these accounts to pay for deductibles, and copayments, but not insurance premiums. Employees may also use these funds to pay for health-related expenses not covered by insurance at all, such as; wheelchairs and prosthetics, medical accommodations for special-needs education students, diabetic supplies, hearing aids, eyeglasses, orthodontic services, or non-prescription drugs and medical supplies.

At the beginning of the year, the employee must choose an amount to set aside, and a proportional amount is deducted from the employee's gross pay during each pay period. By law, the employer is not permitted to return unused funds at the end of the calendar year to the employee; in effect the employee forfeits the funds and they revert back to the employer. On the other hand, the employer is required to make the entire annual amount available starting at the beginning of the calendar year (or the employee's hire date); if the employee uses all the funds and then leaves the job before the end of the year, the employer effectively forfeits to the employee the amounts that would have been deducted from subsequent paychecks that were not earned.[5]

These “calendar-year” provisions were imposed not by Congress, but by IRS regulations which change from time to time. For example, in 2005, the IRS modified the rule, allowing employers to add a “grace period” permitting employees to use funds set aside in one year to pay for expenses incurred up to two months and fifteen days after the end of the tax year. In 2013, the IRS further modified the rule, permitting employers to allow employees to carry over a maximum of $500 from one year to pay for expenses any time in the following year. However, employers who chose to allow the $500 carry-over must eliminate the grace period entirely. In other words, employers may allow either a limited carry-over, or a limited grace period, but not both.[6] If the employer chooses a carry-over, any amounts in excess of $500 for a given year are forfeited on January 1 of the next year, but the first $500 remaining unspent would be available for the entire following year. This choice must be made by each employer for all of its employees.

Using an FSA can provide substantial benefits for employees. Since funds are taken on a pre-tax basis, they are effectively exempt from both standard income taxes and payroll (Social Security and Medicare) taxes, as well as state income taxes. This benefit is greatest for employees who have incomes below the Social Security tax limit ($118,500 in 2016), above the threshold for the 25 percent tax bracket ($37,650 for

single filers in 2016), and who live in states with high income taxes. Since payroll taxes apply even to the first dollar of income, every employee at every income level benefits by at least 15.3 percent of the amount placed into an FSA and used for qualifying expenses.

The "use it or lose it" provisions have a number of undesirable effects. Because most employees cannot perfectly forecast all their health care expenses in advance, many set aside less than they would like, to avoid losing the money entirely. Those who end up with excess funds at the end of the year (or the March 15 end of the grace period) often rush to spend the money on "something," even if that something would not have been worth buying otherwise. (Seasonal advertisements for spare eyeglass and cosmetic dental services are obvious evidence of this effect.)

In addition, because employers are required to make the entire annual amount available at the beginning of the year, employees who expect to leave their jobs mid-year can intentionally spend down their FSA balances before quitting, leaving employers in effect paying compensation that was not actually earned.

Initially, Congress did not set any limit on the amount that employees could put into an FSA each year, but structured the law in such a way that each employer offering an FSA program set limits for their own employees. The most common limit was $5,000, although some employers set higher or lower limits, sometimes up to $20,000 per year.

The ACA Restricts FSA Use

The ACA made two critical changes to the FSA provisions. Section 9003 restricted the medications that could be purchased with FSA funds to prescription drugs and insulin. Drugs that are available without a prescription may still be purchased with FSA funds if a physician or other authorized provider writes a prescription anyway, but this may involve additional office visits, along with attendant costs to patients and insurers that might far exceed the cost of the drugs or supplies to be obtained. Some of these visits would serve no other purpose, and would thus be completely wasteful for all concerned. Section 9003 applies the same restrictions to HSAs and Archer Medical Savings Accounts (MSAs) as well, with the restriction beginning in 2011. The JCT projected that these restrictions would increase tax revenue by $5 billion over the 10 years from 2010 to 2019 (combined for FSAs, HSAs, and MSAs).[7]

Additionally, Section 9005 limited the amount placed in an FSA to $2,500 per taxable year starting in 2013, with that amount adjusted for inflation thereafter in $50 increments. The limit was increased to $2,550 in 2015, and remains the same for 2016. The JCT projected that this limitation would increase tax revenue by $13 billion from

the 2013 effective date to 2019.[8]

The "use it or lose it" rules are not directly affected by the ACA.

Budgetary Effects of The ACA's FSA Restrictions

In March 2010, the JCT scored the revenue effect of the $2,500 (plus inflation) limit in the original ACA as an increase of $13 billion between 2010 and 2019. This included only seven years of the effects, however, because the new limit did not go into effect until 2013.[9] Just over two years later, in July 2012, the Congressional Budget Office (CBO) scored the effect of repealing the limit (as part of an ACA repeal) at $24 billion between 2013 and 2022.[10]

Approximately half of the discrepancy between the two projections results from the fact that the second projection includes three more years of revenue. Assuming the same average annual revenue during the additional three years (which show no particular time trend), the original projection is equivalent to $18.6 billion over 10 years of actual revenue effects. The remainder of the discrepancy, approximately $5.4 billion, is presumably due to changes in the baseline forecast of FSA balances, perhaps taking into
account previously unexpected effects of the ACA that became apparent in the interim.

Adverse Economic Effects of Current FSA Restrictions

The IRS estimates that 14 million American families use FSAs. The average employee contribution in 2012 was $1,484, and the average amount forfeited due to the "use it or lose it" rule was 4 percent, or about $60.[11]

Since the average contribution is well below the current limit of $2,500, one might assume that raising the limit would not affect many people, and the economic benefit would be low. However, this fails to take into account the fact that employees are careful to avoid putting "too much" into their FSAs, to avoid forfeiting funds under the "use it or lose it" rule – even though this would result in higher after-tax costs for employees in the event of greater-than-expected health needs. Likewise, one could assume that the elimination of the "use it or lose it" rule would save only about 4 percent of the balances. However, in the absence of that rule, employees could keep more funds in their accounts to prepare for unexpected health care expenditures, such as copayments for a surgery, or save up to prepare for expected future expenditures, such as orthodontics, or special-needs schooling for a child not yet of school age.

The combination of the higher limit and the reduced risk of forfeiting funds would combine to generate increased FSA balances in the years soon after the changes are adopted, but as employees build up balances in their accounts, they might set aside fewer dollars in future years.

Most importantly, the "use it or lose it" rules encourage employees to spend excess FSA funds on health care items of relatively low value, in order to avoid losing funds at the end of the year or above the $500 carry-over limit (depending on each employer's policy), or when they expect to leave an employer. In addition, some of the wasteful spending consists of copayments for services that are not urgent (or perhaps not even necessary) and have relatively low value, but are covered by insurance. To that extent, the "use it or lose it" rule results in higher health plan claim payments, which in turn increases premiums for employer-sponsored health plans. The result is higher premiums for everyone in those insurance plans, even those who do not have FSAs.

Elimination of such waste – which is caused entirely by the FSA "use it or lose it" rule, would be an unmitigated economic benefit.

Additionally, one of the primary effects of the ACA has been the increase in deductibles, copayments, and coinsurance, as regulators put pressure on premiums at the expense of cost-sharing. At the same time, the ACA also set a low FSA limit, making it more difficult for employees to mitigate the adverse effects of the other parts of the ACA by setting aside a higher percentage of expected cost-sharing from pre-tax dollars.

Potential Improvements in FSA Policy

In order to eliminate the inefficiencies induced by the FSA rules, and improve the ability of the FSA program to help families meet medical expenses, two steps are necessary.

First, the "use it or lose it" rules should be eliminated, allowing employees to save unspent FSA funds to use for future medical expenses. This should apply to both the "use it or lose it" rule that occurs on an annual basis, and the "use it or lose it" that occurs when an employee leaves an employer. This could be accomplished by having FSA funds held by a financial institution rather than the account-holder's employer, similar to the way HSAs have been handled for many years. Alternatively, employees leaving a job could be allowed to transfer their FSA balances into an HSA upon leaving an employer.

In addition, it would be reasonable at the same time to relax the rule requiring unearned compensation to be made available at the beginning of each year – a change

that would not impose such a hardship, because employees would not be starting each year with a zero balance (or one limited to $500).

This change would eliminate wasteful spending to avoid forfeiture of funds, allow employees more flexibility in health care spending from year to year, and allow employees to save up for expected future health expenses. It would also eliminate the twin inequities of requiring employees to forfeit some of their compensation to employers in certain circumstances, and requiring employers to pay unearned compensation in other circumstances.

Second, the arbitrarily low limit on annual FSA contributions should be raised or eliminated. This would allow employees with routinely high non-covered health expenses, such as those for chronic disease or special-needs children, to use FSA funds to meet those needs. It would also allow all employees to partially offset the increases in deductibles and out-of-pocket spending attributable to the ACA.

Pending Legislation

Introduced in 2015, the Responsible Additions and Increases to Sustain Employee Health Benefits Act (H.R. 1185)[12] makes changes to existing FSA rules. The bill raises the annual FSA limit to $5,000 per year, plus an additional $500 per year for each dependent after the first two. Additionally, it would eliminate the annual "use it or lose it" provision by allowing employers to permit employees to carry over their entire FSA balance to the following year, without reducing their ability to set aside the full amount in the following year as well. In both cases, employers would be permitted, but not required, to allow these changes. Employers could still set limits below $5,000 per year, and would not be required to allow carry-over balances. However, it is likely the vast majority of employers would allow the maximum limit and the full carry-over, as it allows them to provide benefits to employees at little cost to themselves.

The changes in the bill would provide a valuable buffer for those facing higher deductibles and co-payments due to the ACA. The benefit would be concentrated among middle-class families in which each worker earns between $50,000 and $121,000 per year.[13] The bill would also reduce much of the wasteful spending generated by the "use it or lose it" provision, when people find that they have unused balances at the end of the year. The reduction in tax revenue will be very modest, and may be mitigated somewhat if the reduction in wasteful spending on covered health care with co-payments results in lower premium subsidies paid by the federal government.

If the only provision of H.R. 1185 were the increase in the FSA limit with no additional

effects, a reasonable forecast of the 10-year budget impact would be in the range of those two estimates; i.e., between $18.6 billion and $24 billion. However, the elimination of the "use it or lose it" rules introduces additional effects. In the initial years after H.R. 1185 came into effect, many employees would set aside larger amounts, since they no longer fear forfeiting unused funds if they turn out to have a "healthier" year than expected. As balances increase due to the carrying over of unused funds, employees would see less of a need to set aside more funds each year that could be used only for health care; as a result, annual FSA contributions would decrease.

The increased limits in H.R. 1185 would allow employees to accept higher deductibles and other forms of insurance cost-sharing. Doing so would allow patients to have more control over their own health care spending, a factor which has been shown to improve health outcomes and reduce overall health expenditures.[14] Reducing overall expenditures reduces health insurance premiums. To the extent that employees are in the same risk pools as health insurance exchange enrollees (for example, small-business employees), allowing higher FSA limits could reduce exchange premiums as well, compared to what they would be otherwise. This would flow through to produce a positive budget effect, by reducing exchange premium subsidies paid by the federal government.

As currently written, H.R. 1185 eliminates the "use it or lose it" rule that occurs on an annual basis, but does not affect the "use it or lose it" that occurs when an employee leaves an employer. Indeed, by allowing employees to build up balances in FSA accounts held by their employers, it could even make the "leaving" situation worse. Having a large balance would impose a substantial burden on a job change that might result in "job lock" for affected employees; it would also make layoffs even more devastating to those employees. Even more serious, the prospect of holding forfeited funds could make it inefficiently attractive to lay off employees with high FSA balances.

All of these problems could be averted by changing H.R. 1185 to allow employees leaving a job to transfer their FSA balances into a HSA, which is held by a financial institution rather than by the account-holder's employer. This change to H.R. 1185 would benefit both employers and employees with essentially no effect on tax revenues.

Conclusion

Eliminating the artificially low limits on FSA accounts would provide significant benefits to families with special-needs children, diabetics, and employees who – or

whose families – need vision, hearing, dental or orthodontic care, or any other health care not normally covered by health insurance. It would also lessen the pain of higher health insurance deductibles and other patient cost-sharing, which could even reduce insurance premiums, and therefore federal premium subsidies. The result would be substantial help with health care expenses to families who need it most, with a minimal impact to the federal budget.

In addition, eliminating the FSA "use it or lose it" rules would provide benefits to those same families and many more, while at the same time eliminating wasteful health care spending and possibly reducing health insurance premiums, with almost no additional impact to the federal budget.

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1 "Treaury Modifies 'Use-or-Lose' Rule for Health Flexible Spending Arrangements," 2013, at http://www.treasury.gov/press-center/press-releases/Documents/103113FSA%20Fact%20Sheet.pdf

2 Neil W. McCabe, "Obamacare strikes again: New limits on spending accounts," *Human Events*, October 15, 2012, at http://humanevents.com/2012/10/15/obamacare-strikes-gain-new-limits-on-flexible-spending-accounts-coming-jan-1/

3 Joint Committee on Taxation, "Estimated revenue effects of the amendment in the nature of a substitute to H.R. 4872, the 'Reconciliation Act of 2010,' as amended, in combination with the revenue effects of H.R. 3590, the 'Patient Protection and Affordable Care Act (PPACA),' as passed by the Senate, and scheduled for consideration by the House Committee on Rules on March 20, 2010," Report JCX-17-10, March 20, 2010, at https://www.jct.gov/publications.html?func=download&id=3672&chk=3672&no_html=1

4 Revenue Act of 1978, P.L. 95-600, 92 Stat. 2763, November 6, 1978, Section 132, amending 26. USC 125. at http://www.legisworks.org/GPO/STATUTE-92-Pg2763.pdf

5 Employee Benefit Research Institute, "Flexible Spending Accounts," May 2007, at http://www.ebri.org/pdf/publications/facts/0507fact-flexspend.pdf. However, employees who leave (voluntarily or not) with money remaining in their FSA accounts can access those funds under COBRA if they continue to make payments in lieu of the amounts that would have been deducted from their paychecks (see 26 CFR Part 54, at https://www.irs.gov/pub/irs-regs/121865.pdf).

6 Internal Revenue Service, "Modification of 'Use-or-Lose' Rule For Health Flexible Spending Arrangements (FSAs) and Clarification Regarding 2013-2014 Non-Calendar Year Salary Reduction Elections Under § 125 Cafeteria Plans," Notice 2013-71, at https://www.irs.gov/pub/irs-drop/n-13-71.pdf

7 Joint Committee on Taxation, op. cit., line I(4).

8 *Ibid.*, line I(5).

9 Joint Committee on Taxation, op. cit., line I(5).

10 Congressional Budget Office, Letter to John Boehner, July 24, 2012, Report #43471, at https://www.cbo.gov/sites/default/files/112th-congress-2011-2012/costestimate/43471-hr6079_0.pdf

11 Christina Merhar, "Flexible Spending Accounts (FSAa) – New 'Use It or Lose It' Rules," *Small Business Employee Benefits and HR Blog*, November 1, 2013, at http://www.zanebenefits.com/blog/bid/323382/Flexible-Spending-Accounts-FSAs-New-Use-It-Or-Lose-It-Rules

12 H.R. 1185, the "Responsible Additions and Increases to Sustain Employee [RAISE] Health Benefits Act of 2015."

13 The maximum marginal tax benefit, as a percentage of the amount set aside in an HSA, occurs when the taxpayer is above the threshold for the 25 percent tax bracket, and below the threshold at which Social Security tax is no longer assessed. For single taxpayers, the 25 percent tax bracket begins at an income of $50,000. For each employee, regardless of filing status, Social Security tax is a flat 12.4 percent (putatively shared between the employer and the employee) for all wage income, up to $118,500. Because an employee can currently set aside $2,500 in an FSA, the highest-earning employee to whom the maximum marginal benefit would apply would be employee who currently sets aside the maximum amount out of a pre-FSA salary of $118,500 plus the $2,500 set aside, ot $121,000. For employees earning in that range, the maximum tax benefit would be Employees earning above that level would be 40.3 percent plus their state income tax rate, if any. Employees earning just above that threshold would benefit by 27.9 percent plus their state income tax rate.

14 See, for example, Gail R. Wilensky, "Consumer-Driven Health Plans: Early Evidence And Potential Impact On Hospitals," *Health Affairs*, **25**:174-185 (January 2006), at http://content.healthaffairs.org/content/25/1/174.full.