

BRIEF ANALYSIS

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Flexible Spending Accounts: Making a Good Deal Better

by **Devon M. Herrick**

As the year ends, hundreds of thousands of American workers are scrambling to spend down their flexible spending accounts (FSAs). Some buy designer eyeglasses. Others schedule a last minute appointment for teeth cleaning. Some plan a doctor visit or diagnostic test of questionable value. In almost all cases, this year-end spending goes for items and services that are probably worth less than their cost.

Why do so many people going on medical shopping sprees? Because current federal regulations governing FSAs force them into a “use it or lose it” position. Both employers and their workers would be better off if these regulations were changed.

How FSAs Work. Throughout the year, an estimated 18 million American workers have pretax dollars deducted from their wages and deposited into their FSAs, which they can use to pay for a variety of health-related expenses. FSAs allow workers to manage a portion of their own health care. For instance, they can choose their own doctors and are not subject to managed care controls. However, at year’s end, any unused dollars are forfeited to the employer sponsoring the plan. This “use it or lose it” provision is such a disincentive that less than a fifth of the employees eligible to set up FSAs actually participate [see the figure]. It also contributes to wasteful health care spending.

Recent Treasury Department rulings have improved these accounts. FSAs were once reserved only for prescription medications and doctor visits (all items contained in section 213d of the Internal Revenue Service code). In 2003, however, the list of qualifying

expenses was expanded to include over-the-counter drugs such as cough medicine, aspirin and decongestants.

The Treasury Department has also given the go-ahead to use debit cards for FSA expenditures. This is significant because many FSA administrators were afraid to allow direct access to funds for purchases that had not been scrutinized by plan administrators. If workers are relieved of the lengthy, inconvenient claim submission and reimbursement process, they are more likely to participate.

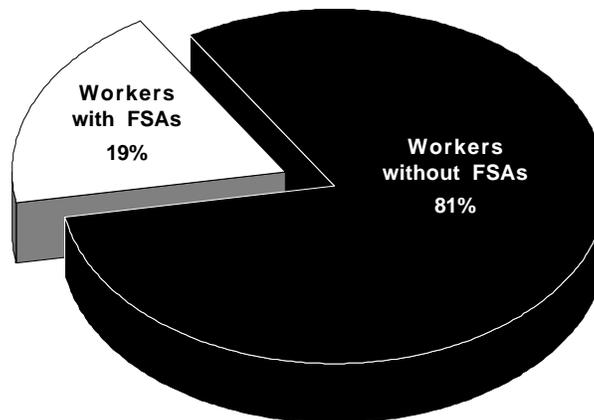
However, despite these improvements, the popularity of FSAs is still limited by restrictions on their funding and use. More flexible FSAs would encourage employees to become better health care consumers.

Needed Reform: Allow Variable Contributions. Once a year, employees choose how many pretax dollars will be deducted each month from their paychecks and deposited into their FSAs. The amount cannot be adjusted during the year as health needs change. In other words, workers can deposit funds into an FSA to pay for dental insurance premiums and routine teeth cleaning, but cannot deposit additional funds to cover their portion of the cost of an unexpected root canal.

Because it is difficult to accurately predict health care expenses in advance, most workers use their FSA accounts only to pay insurance premiums, rather than to pay more out-of-pocket health expenses directly. Allowing workers to contribute to the accounts as needed would make them more attractive.

Needed Reform: Limit Employer Exposure. Employees choose a monthly deduction amount at the beginning of their enrollment period, but an IRS ruling requires employers to give workers immediate access to the total amount of their annual payroll deduction. That means employers essentially make a no-interest

Percentage of Eligible Workers with Flexible Spending Accounts



Source: Mercer Human Resources Consulting, 2004.

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loan to employees who use the funds early in the year. It also means that if an employee leaves during the year, the employer may have difficulty recovering the funds. In order to limit their exposure, employers generally cap the amount employees can contribute to their own FSA at no more than \$2,000 to \$3,000 annually. But workers with chronic conditions might find this too low to cover their annual medical needs. A better solution would allow employees to contribute more, and employers to limit the availability of funds until actual contributions have been made. More employers would offer FSAs if they were not exposed to the risk of workers consuming thousands in medical costs and leaving prior to making contributions.

Needed Reform: Allow Balances to Roll Over.

Employees with FSA accounts deposit an average of more than \$1,100 annually, according to the Employee Benefits Research Institute. However, failure to predict health care spending accurately means sacrificing the end-of-year balance or engaging in last-minute spending on items of marginal value. Furthermore, if an account holder leaves an employer during the year, he or she loses any unspent FSA funds. Human resource consultants Hewitt Associates estimates that there are forfeitures in 91 percent of FSA plans, and the median amount employees lose is about \$100.

President Bush has proposed allowing up to \$500 in unused FSA funds to roll over each year. This would allow workers more leeway when selecting annual contributions and lessen the time pressure to expend the money. Perhaps more importantly, it would eliminate the incentive to engage in year-end spending sprees.

Even bolder reform would allow workers to carry forward unspent FSA balances until retirement. Workers should also be able to roll over accumulated balances into other tax-deferred accounts, including Health Savings Accounts, Individual Retirement Accounts, 401(k)s and 403(b)s.

Needed Reform: Clear Guidelines on Qualifying Expenses. Another problem with FSAs is uncertainty about which medical expenses qualify. The

Treasury Department has issued broad guidelines for FSAs, but third-party plan administrators make the specific decisions on which expenses qualify. A recent *Wall Street Journal* article highlighted examples of over-the-counter medications that might qualify, depending upon the circumstances. For instance,

- Diapers meet FSA guidelines when treating adult incontinence, but not when worn by a baby.
- The herbal remedy St. John's Wort qualifies when doctor recommended, but not merely because it makes you feel better.
- Sunscreen lotion to prevent a reoccurrence of skin cancer qualifies, but not when purchased as a preventative to avoid a vacation sunburn.

Questions regarding qualifying expenses extend to prescription medications as well. While some plan administrators allow reimbursement from a worker's FSA for any treatments prescribed by a doctor, others may arbitrarily require patients to provide additional documentation. Of course, investigating and documenting these nuanced cases raises administrative costs.

Since FSAs are usually funded by employees themselves, they should be allowed access to their own money for any medical treatment that would be deductible on itemized income tax returns.

Needed Reform: Allow Non-Employer Accounts. Federal law allows employers to create FSAs for their employees. However, workers whose employers do not provide these plans cannot purchase one through a third party administrator. Workers in firms that do not have FSAs, and the unemployed, should be allowed to obtain them from third parties such as banks.

The Conclusion. FSAs are a great way to save for medical needs. Unfortunately, restrictions on their use and funding make them less popular than they could be. With fewer restrictions, they could become a powerful force for improving our health care system.

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