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IRS Gives Double Tax Benefits of Health FSAs a Boost

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Life Health Pro

As we inch closer to 2014, many clients are gearing up for a potential reduction in covered health benefits as employer-sponsored health plans are modified and insurers have begun cancelling coverage in anticipation of the **Patient Protection and Affordable Care Act (PPACA)** effective date. Planning for these costs is heating up, and the IRS has placed the significance of the health flexible spending account (FSA) as a tax-free funding tool in the spotlight. While reducing taxable income in light of higher tax rates is a priority for many clients, the potential for increased out-of-pocket medical expenses under PPACA may provide an even stronger motivation in 2014. As a result, the double tax benefits offered by FSAs have become more valuable than ever, and the IRS has recently taken steps to ease the restrictions that may have previously dissuaded clients from taking advantage of these vehicles.

Flexible Spending Accounts: The basics

A client whose employer offers the health FSA option is permitted to contribute up to $2,500 annually in pre-tax dollars to these accounts which, in turn, are used to pay for qualified medical expenses that are not covered under the client's health insurance plan. Because many clients are anticipating higher out-of-pocket health expenses in 2014, FSAs are likely to become more popular than ever because they provide a tax-preferred method of paying for higher co-pays and other health expenses that may be considered "non-essential" under the new law.

Despite this, many clients — especially younger and healthier clients — may have been wary of committing funds to a health FSA in the past because of the so-called "use-it-or-lose-it" rule that required clients to exhaust FSA balances each year to avoid forfeiting those funds. While employers are permitted to include a two and a half month grace period if a client fails to incur enough medical expenses to drain his FSA account during the year, all remaining funds are still forfeited at the end of that period.

In order to encourage their use, the IRS has issued rules designed to make FSAs more flexible by allowing employers to provide that up to $500 of a remaining FSA balance may be carried over into the next tax year. However, it should be noted that employers are not *required* to offer the $500 rollover option, and they are prohibited from offering both the two and a half month grace period and the rollover option in the same year.

Further, the $500 rollover option is not available for dependent care FSAs, which are similar to health FSAs but instead offer a tax-preferred method to reimburse clients for qualified dependent care expenses.

Tax implications for 2014

While contributing to an FSA reduces the client's taxable income, it is important to note that, unlike 401(k) or IRA contributions, funds contributed to the FSA are *never* taxed if they are used to pay for qualified medical expenses (a term that is broad enough to include items such as eyeglasses, hearing aids, and dental expenses).

Because tax rates on income, along with those applicable to capital gains and other investment-type income, have been increased for the foreseeable future, permanently removing funds from a client's taxable income has become a priority for many clients.

As a refresher, clients whose income exceeds $406,750 in 2014 ($457,600 for joint returns) are subject to the new top tax rate of 39.6 percent, as well as the new 20 percent tax on capital gains. The value of itemized deductions and the personal exemption begins to phase out for single taxpayers with income in excess of $254,200 ($305,050 for joint returns). Also, the additional 3.8 percent tax on investment income applies once a client's income reaches a certain threshold level.

Conclusion

Reducing taxable income may always be a priority for clients, but forces have combined in 2014 to make planning for increased health-related costs equally important for many. Therefore, employer-sponsored accounts such as health FSAs are likely to attract more attention this year, as clients seek to permanently reduce taxable income while simultaneously paying for health care costs on a tax-free basis.