

## Key Elements of the U.S. Tax System

How do flexible spending accounts for health care expenses work?

TAXES AND HEALTH CARE

**Q. How do flexible spending accounts for health care expenses work?**

**A. A health care FSA is a tax-advantaged employer-sponsored account used to reimburse employees for qualifying health care expenses.**

Health care FSAs are tax-advantaged benefit plans established by an employer to reimburse employees for qualified medical and dental expenses, such as copayments, deductibles, and prescription drug costs. FSAs are usually funded through salary-reduction agreements in which the employee agrees to receive lower monetary compensation in exchange for equivalent contributions to an FSA. For example, an employee who elects to reduce his or her monthly paycheck by \$200 would receive, in return, a \$2,400 annual contribution to his or her FSA.

The key benefit of FSAs is that these contributions are not subject to income or payroll taxes, which could mean significant tax savings for the account holder. An employee contributing \$200 a month to an FSA would save \$288 in federal income taxes if he or she were in the 12 percent tax bracket ( $\$2,400 \times 0.12 = \$288$ ) and an additional \$184 dollars from reduced Social Security and Medicare payroll taxes ( $\$2,400 \times 0.0765 = \$183.60$ ). Because the federal income tax savings depend upon the employee's income tax rate (which rises with income), the benefit of using an FSA is greater for higher-income workers. For example, the income tax savings for an employee in the 35 percent tax bracket with the same \$2,400 annual contribution would be \$840 ( $\$2,400 \times 0.35 = \$840$ ).

An important attribute of health FSAs is that employers must make the entire value of an employee's FSA account available at the beginning of the year. For example, if either employee discussed above incurred a \$3,000 medical expense in March, he or she could use the full \$2,400 annual FSA contribution to help pay that cost, even though he or she would only have contributed \$600 into the account.

In 2013, the Internal Revenue Service (IRS) instituted a contribution limit for health care FSAs. The limit is adjusted yearly for inflation; in 2020, it is \$2,750 per year per employee. Generally, employees forfeit unused FSA funds at the end of the plan year, although employers may also offer one of two options:

- Provide a grace period of up to 2.5 months into a new plan year to use FSA money from the preceding plan year.
- Allow the employee to carry over up to \$500 per plan year to use in the new plan year.

The Bureau of Labor Statistics in 2019 estimated that about 45 percent of all civilian workers had access to an FSA that year. As a whole, high-income employees and employees in larger firms are more likely to have access. Only 1 in 5 low-income workers had access to an FSA in 2019 compared with around 2 in 3 workers at the top of the earning scale (figure 1).

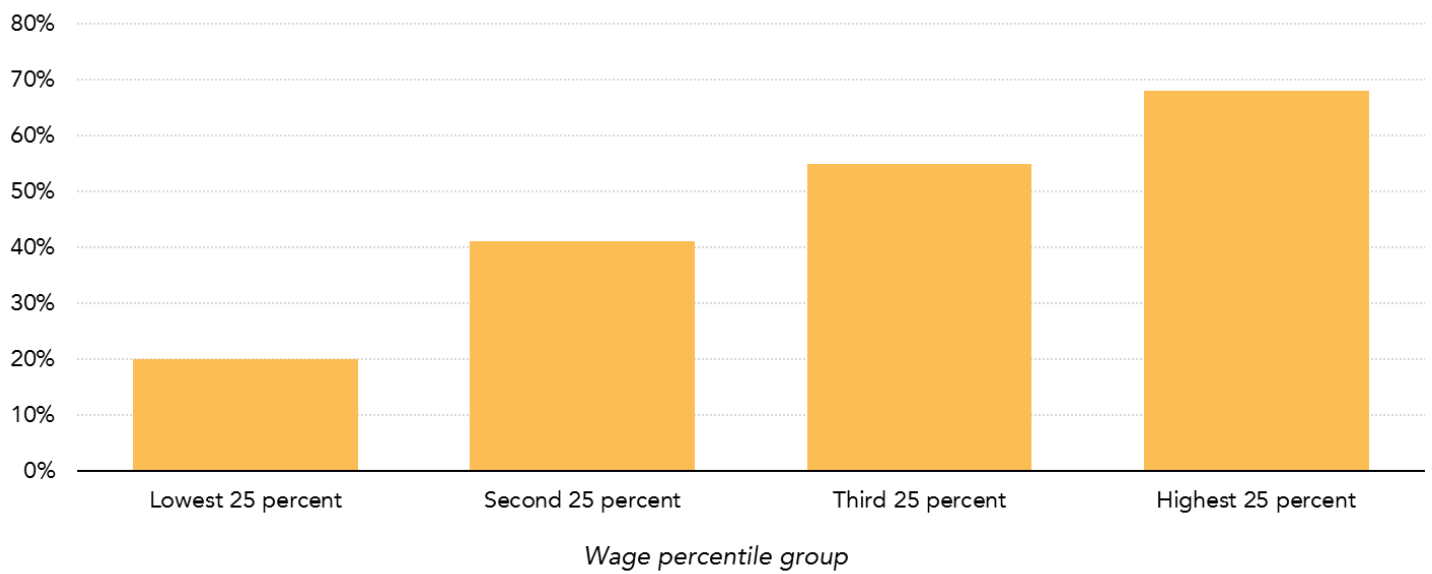
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FIGURE 1

## Share of Workers with Access to Health Care Flexible Spending Accounts by wage percentile, 2019



Source: Bureau of Labor Statistics. National Compensation Survey: Employee Benefits in the United States, March 2019—Civilian Tables. Table 41. "Financial Benefits: Access, Civilian Workers, March 2019."

Employees in larger firms (500 or more workers) are nearly three times as likely to have access than employees in smaller firms (99 or fewer workers), with 76 percent of the former reporting access versus 27 percent of the latter in 2019 (figure 2). Larger firms are typically better able to handle the complexity and administrative costs of offering FSAs.

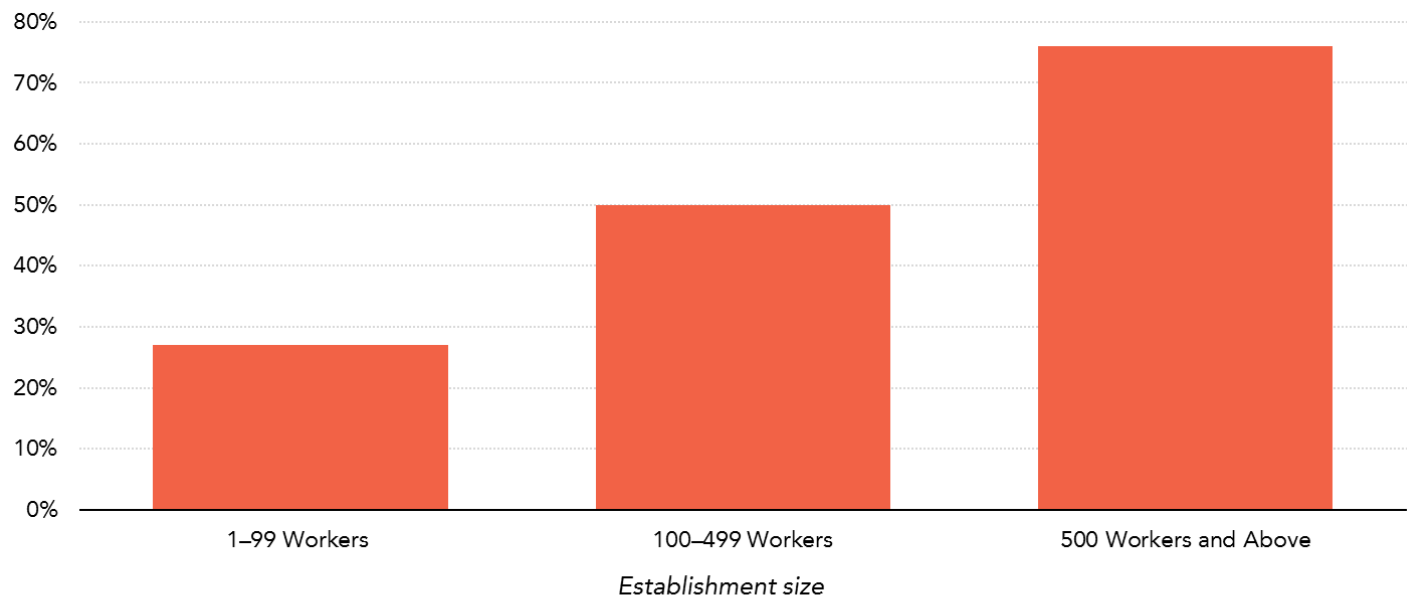
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FIGURE 2

### Share of Workers with Access to Health Care Flexible Spending Accounts by establishment size, 2019



Source: Bureau of Labor Statistics. National Compensation Survey: Employee Benefits in the United States, March 2017—Civilian Tables. Table 41. "Financial Benefits: Access, Civilian Workers, March 2017."

More specific data on exactly who uses FSAs and how much federal tax revenue they cost are difficult to obtain because employees are not required to report FSA elections on federal income tax returns, and few surveys ask specifically about FSA participation.

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### Data Sources

Bureau of Labor Statistics. *National Compensation Survey: Employee Benefits in the United States, March 2019*—Civilian Tables. Table 41. "[Financial Benefits: Access, Civilian Workers, March 2019.](#)"

### Further Reading

IRS (Internal Revenue Service). 2013. "[Application of Market Reform and Other Provisions of the Affordable Care Act to HRAs, Health FSAs, and Certain Other Employer Healthcare Arrangements.](#)" Notice 2013-54. Washington, DC: Internal Revenue Service.

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Rapaport, Carol. 2013. ["Tax-Advantaged Accounts for Health Care Expenses: Side-by-Side Comparison, 2013."](#) CRS Report RS21573. Washington, DC: Congressional Research Service.