



The World of Flexible Benefits

It looks like Flexible Spending Accounts (FSAs) are about to become front-page news once again. Besides Health Savings Accounts (HSAs), the government is taking a hard look at cafeteria plans and their taxation practices.

Use It or Lose It

In September we wrote about the “use-it-or-lose-it” rule vanishing from FSAs. The intent was simply to change proposed regulations and reduce the chance of employees losing unused dollars to the plan.

If you are not familiar with the FSA “use-it-or-lose-it” rule, it means that participants in the plan must make irrevocable elections during an open enrollment period – before the beginning of the plan year – in order to reduce their taxable income. The same applies to newly eligible participants entering the plan during the plan year. Permissible reasons to change elections during the year are few and strict. At the end of the plan year, if the participant has not incurred sufficient expenses to exhaust their annual FSA election, the money left in the account is forfeited to the plan.

I guess it’s just not as easy as Senator Grassley, author of the request for modification, thought it would be. The Treasury Department came back to say that the Department “Did not have sufficient legal authority to administratively change this long-standing rule.”

Taxation Changes for Flexible Benefits Plans

Wasn’t it enough to “just say no” to the use-it-or-lose-it rule? In late January 2005, the Joint Tax Committee of Congress issued *Options to Improve Tax Compliance and Reform Tax Expenditures*. Reforming tax expenditures sounds good, however, the Tax Committee didn’t intend to reduce government spending, and for FSAs, it means taxpayers and their employers will pay more money into the system.

FSAs provide savings to both the participant and the sponsoring employer. The employee generally does not pay federal taxes, state taxes (in most states), or FICA taxes on contributions made to the plan. The employer does not have to remit the matching FICA taxes that would have been withheld from participant’s compensation.

However, the Joint Tax Committee’s pitch for FSAs would change tax savings from the plan dramatically. Their recommendation would be for contributions to be FICA taxable. That means a tax saving of almost 8% for the participant and the employer would evaporate.

The authors of the particular proposal compare FSA salary redirection to 401(k) contributions. Currently, FICA is paid on employee contributions going into a 401(k) plan. But salary deductions should be where the comparison ends. The difference in the types of taxation is non-taxable versus deferred taxation.

While 401(k) plans defer taxes – you pay taxes on withdrawals. The benefits from an FSA plan are non-taxable. Plainly, they are not comparing apples to apples.

This proposal ends with, “Applying FICA tax consistently to salary reduction amounts may make payroll processing and employment tax compliance less complicated for some employers.” Thanks, but no thanks.

Daycare

The daycare credit issue is a little more complicated. Today’s daycare credit collides head on with the daycare benefit offered through an FSA. The daycare credit refunds federal taxes paid for qualifying dependent daycare expenses, while contributions to a daycare FSA escape federal and FICA taxes.

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The Joint Tax Committee's document suggests dumping the FSA daycare benefit since there is "inequity in the operation of the tax laws." Again, the tax credit they want to keep does not refund FICA taxes. And the daycare portion of a cafeteria plan escapes FICA taxes. Can you say "revenue enhancement?"

Social security may be in trouble, but these changes to increase the amount of FICA taxes going in to the coffers – to shore up the social security structure – would deter employers and employees from participating in FSAs completely.

Some say this catalogue of reform is just an exercise of "what ifs" and trial balloons. But once it is in writing, you never know who will pick it up and think it's a good idea. Soon, little attachments to legislative bills will start to appear, and will grow into individual bills being introduced in congress to "improve tax compliance" and "reform tax expenditures."

We will keep you abreast of any changes as they occur. ■

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