JOINT ECONOMIC COMMITTEE
Senator Sam Brownback, Ranking Republican

October 15, 2009

Senate Finance Bill Will Effectively Eliminate FSAs

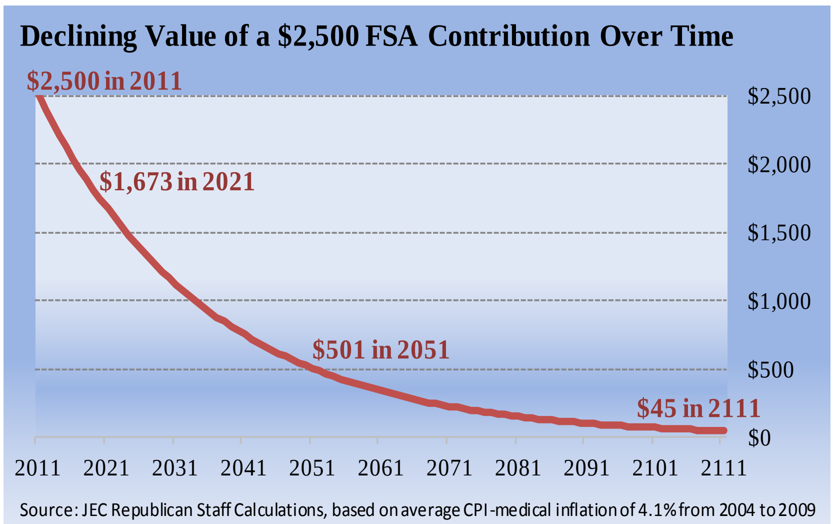
Employers Will Limit or Eliminate FSAs to Avoid High Cost Plans Excise Tax

The Value of Flexible Spending Accounts in Reducing Medical Costs

Flexible Spending Accounts (FSAs) help individuals and families to pay for out-of-pocket medical expenses that are not covered by their health insurance plans with tax-free dollars. There is currently no cap on FSA contributions, though employers must set their own limits (the cap for federal employees is $5,000). FSAs are particularly important for individuals and families who have high medical expenses, such as seniors, and those with chronic health conditions or disabilities. The option of using tax-free dollars can reduce their out-of-pocket medical expenses by 20% to 40%.

According to the Employers Council on Flexible Compensation, about 35 million Americans currently have FSAs, and the average salary of FSA participants is $55,000. These FSA users spend their FSA funds on core health care expenses: 43% of FSA claims are for medical expenses, 26% are for prescription and over-the-counter drugs, 21% are for dental expenses, and 10% are for vision expenses.

The "Real Value" of FSA Contributions Will Decline



Under legislation reported by the Senate Finance Committee, beginning in 2011, all FSAs will be limited to a maximum contribution amount of $2,500, for both individual and family plans. Unlike the high cost plans tax, which will be indexed for inflation plus one percent, the cap on FSAs will not be indexed at all. The result will be a decline in the real value of FSA contributions until they are worth essentially nothing. Within just the first ten years, the value of a $2,500 FSA contribution will decline to less than $1,700. And as the real value of the contribution declines, individuals and families will be able to deduct fewer and fewer out-of-pocket medical expenses, resulting in higher income and payroll taxes.

High Cost Plans Tax Will Lead to New Limits or Elimination of FSAs

In addition to capping FSA contributions at $2,500, the value of FSA contributions (as well as dental and vision plans) will be included in the total cost of employees' health insurance benefits for the purpose of calculating the high cost plans tax. This 40% tax on providers of high cost health insurance plans will apply to plans above $8,000 for individuals and $21,000 for families, beginning in 2013.[1] While a particular health insurance plan, in and of itself, may not exceed the threshold, adding on an FSA contribution and dental or vision benefits could push the total cost of health benefits above the high cost threshold.

For example, consider an individual plan which costs $7,500, and the individual makes an FSA contribution of $2,500. The total cost of the employee's health benefits is $10,000, which exceeds the $8,000 threshold by $2,000. Therefore, an $800 tax (40% of $2,000) is due. But who pays the tax—the insurance company or the FSA provider (i.e., the employer)? Because there are multiple health benefits, the tax is distributed proportionally to the providers of the benefits.

In the case above, the health insurance premium is 75% of total health benefits and the FSA contribution is 25% of benefits. The health insurance company will therefore pay $600 (75% of the $800 tax) and the employer will pay $200 (25% of the $800 tax). However, the employer and the health insurance company would avoid the excise tax if the employee was only allowed to contribute $500 to an FSA. Limiting FSA contributions would mean an increase in payroll and income taxes for the employee. The employer would also pay an additional $153 in payroll taxes for the employee, but this would be less than the $200 excise tax they would otherwise pay. And the $600 excise tax on the health insurance company would no longer apply.

As more and more plans become subject to the high cost plans tax (due to indexing provisions and new mandates on benefit levels), it will be in employers' best interest to eliminate FSA offerings altogether.

Will the Federal Government Pay the High Cost Plans Tax for Federal Employees?

Based on 2010 premium levels for Federal Employees Health Benefits (FEHB) plans, and assuming recent trends in inflation and premium growth continue, 12 out of 17 self-only FEHB plans with $2,500 FSA contributions and four out of 17 family plans with $2,500 FSA contributions would be subject to the high cost plans tax within five years of its enactment. The fact that employers are the providers of FSAs draws to light an important question: Will the federal government, as an employer, pay its portion of the 40% high cost plans tax to itself when the total health benefits of federal employees with FSA contributions exceed the high cost plans thresholds? Will the federal government pay itself a tax on behalf of its employees, will it exempt itself from the tax on FSAs, or will it eliminate FSAs altogether for federal employees?

[1] For retirees over age 55 and employees in high risk professions, the thresholds will be $1,850 higher for individuals and $5,000 higher for families. In the first years of the bill, transition relief will be provided, in the form of higher thresholds, to the 17 highest-cost states.