Flexible spending accounts offer tax break for health needs

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NEW YORK – In coming weeks, workers at many American companies will be given the chance to sign up for flexible spending accounts to cover some of their health and child care costs next year.

Experts say these accounts are a good deal because the money is subtracted from a worker's gross salary, thus reducing taxable income. Yet as with most good things, there's a catch: You have to be careful in calculating how much you set aside, because if you don't use it, you lose it.

Gary Kushner, head of the employee benefit consulting firm Kushner & Co. in Kalamazoo, Mich., said more than 90 percent of Fortune 500 companies offer flexible spending accounts – also known as employee reimbursement accounts – as a benefit to workers. Between 25 percent and 40 percent of smaller companies have them.

"Workers have to make their election before the start of the plan year, generally before January," Kushner said. "Unlike a lot of tax-favored programs, there are no income limits for participation."

Michael O'Toole, a senior director at the American Payroll Association, a trade group for company payroll managers, said the accounts "are something we encourage our members to promote."

He pointed out that in addition to helping workers cover some of the costs of medical and child care, the accounts can save employers money because the companies don't have to pay Social Security or Medicare taxes on the funds that are set aside.

"In most instances, the money comes out of every paycheck, so for most people it's almost painless," O'Toole said.

O'Toole also recommends that workers consider enrolling in TRIPs – transportation reimbursement incentive programs – if they're offered as a benefit. These allow pretax dollars to be set aside to cover up to $65 a month in mass transit or van pooling costs or $180 for parking.

Flexible spending accounts, established in 1986 under Section 125 of the Internal Revenue Service code, essentially are mechanisms through which workers agree to reduce their salaries in exchange for an employer-provided fringe benefit.

The health care account is the most straightforward. Companies generally allow workers to set aside $1,000 to $2,000 a year, although some permit accounts of up to $5,000, Kushner said.

That money can be used to pay anything the IRS would recognize as a legitimate health care expense that isn't reimbursed by an employer or insurance – copayments on medicines, eye glasses, orthodontic work, psychiatric care.

"People need to be a bit conservative in deciding how much to set aside, because if they don't use it, the money reverts at the end of the year to the plan," Kushner said.

He suggested that people try to divide anticipated spending into two categories – what they know they're going to spend and what they might spend.

"If you know you're going to need new glasses, setting money aside for that will be relative safe," he said. "But just because you spent $100 out of pocket last year for deductibles and copays doesn't mean you'll have the same amount next year. So be more conservative there."