



An Accountancy Corporation

(916) 483-8300

Year End Tax Savings Through Flexible Spending Accounts

As we approach the end of the year, we want to alert you to a potential tax savings opportunity related to medical expenses. Your out-of-pocket medical expenses are theoretically tax deductible if you itemize your deductions. However, for most taxpayers this is a hollow victory because only the expenses in excess of 7½% of your total income yield any tax savings. Fortunately, one of the easiest ways around this limitation is to take advantage of a flexible spending account (FSA)—if one is offered by your employer.

With a FSA, you generally must decide before the start of the year how much of your wages to put into the account. Then during the year, you're reimbursed for your out-of-pocket medical expenses up to this amount. The money you put in the FSA isn't subject to income taxes or Social Security taxes. Thus, the government effectively picks up a substantial part of your unreimbursed medical expenses (around 40% of the total costs for taxpayers in the highest tax brackets). The catch is that whatever amount you decide to put in the FSA has to be spent on qualifying medical expenses during the year. You forfeit any unused balance.

Because of the use-it-or-lose-it requirement, it's important to carefully project what you feel you'll have in unreimbursed expenses for the coming year. Once you decide on an amount, you normally aren't allowed to change it during the year unless you have what the tax rules refer to as a change in personal circumstances (such as a marriage, divorce, birth of a child, etc.).

Besides carefully choosing the amount to defer each year, the other key to successfully using a FSA is making sure you don't let any money in the account go to waste. Thus, as you're perhaps trying to use up funds you have in your 2003 account, we thought it might be helpful to go over some of the categories of expenses that the IRS has recently ruled are qualified medical expenses. Although most of the rulings were focused on whether the expenses could be claimed as itemized deductions, they should offer sufficient support to FSA plan administrators to allow them to approve reimbursement for a similar type of expense from an FSA.

- **Over-the-counter (OTC) Medicines.** This is the latest IRS change, and the one that will probably affect the most people. In a surprise move, the IRS recently said that the costs of OTC medicines such as antacids, allergy medicines, pain relievers, and cold medicines may be reimbursed out of a FSA (without creating taxable income for the

employee) because they count as expenditures for medical care. However, at the same time, the IRS said the costs of dietary supplements (such as vitamins) are not included in this changed position because such items are merely beneficial to an individual's general good health. (**Note:** Because of the way most FSA plans define reimbursable expenses, many of them may have to be amended before they can be used to reimburse for the cost of OTC medicines.)

- **Nonprescription Medical Equipment, Supplies, and Diagnostic Devices.** The IRS recently concluded that the cost of crutches and other medical equipment, supplies such as bandages, and diagnostic devices such as blood sugar test kits qualifies as medical expenses (and, thus, should be reimbursable under an FSA) even without a doctor's prescription.

- **Laser Eye Surgery.** Confirming what it has previously concluded in several private letter rulings, the IRS recently said that the costs of laser eye procedures such as LASIK and radial keratotomy to correct defective vision are qualified medical expenses.

- **Reconstructive Surgery.** Purely cosmetic surgery doesn't qualify as a medical expense. However, the cost of cosmetic surgery or other similar procedures necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or a disfiguring disease is deductible. Thus, the IRS recently concluded that reconstructive work necessitated by a mastectomy qualifies as a deductible medical expense.

- **Weight-loss Programs.** About a year ago, the IRS concluded that amounts paid to participate in a weight-loss program as treatment for a specific disease or ailment (including obesity, hypertension, and heart disease), and as diagnosed by a physician, are deductible medical expenses. When this ruling was released, there was some hope that the IRS would allow the amounts paid to join a gym, health club, or spa to be claimed as a medical expense-especially if the exercise was doctor recommended. However, the IRS now says these types of expenses don't qualify as a medical expense.

One final category of expenses that's often overlooked when seeking reimbursements from an FSA is medical-related travel costs. Most FSAs will reimburse 12 cents per mile for travel to doctor offices, hospitals, etc. In addition, amounts paid for lodging while away from home to seek medical care normally can be reimbursed up to \$50 per person per night (as long as there's no significant element of personal pleasure related to the trip).

Please call us if you have questions about using your FSA or if you'd like help in determining whether setting up a FSA might be right for your business.