



Episode 14:

Benefits Accounts: A deep dive into dependents and tax-favored accounts

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Stephen Durso: You know, Phil, tax plans can be a crazy world, and this is just an example where employer plan rules, Affordable Care Act rules, and tax status can lead to some unexpected outcomes different for each party.

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Philip Massey: Hello. My name is Philip Massey. I've spent over 20 years in employee benefits, and I'm excited to be hosting another episode in our Benefits with Purpose series, this episode entitled, Benefits Accounts: A Deep Dive into Dependents and Tax-Favored Accounts. With me today to discuss family, children, and all manner of dependents is our resident expert across the full spectrum of tax-favored accounts, Stephen Durso, Associate Director at WTW. Good morning, Steve.

Stephen Durso: Good morning, Phil.

Philip Massey: Steve, do you have any kids?

Stephen Durso: I do. I have two boys, 17 and 23.

Philip Massey: Oh, perfect. Those are good ages for today's discussion. When we're talking about tax-favored accounts, of course, we're really talking more about dependents than kids. So maybe let's start with definitions here. Steve, would you mind by just drawing a circle around what we mean when we say dependents in the context of tax-favored accounts. Who is and who is not included in that definition?

Stephen Durso: Yeah. So dependent children is going to be the easiest place to start. So, these are typically going to be defined as your natural-born children, your adopted children, or children for whom an employee is the legal guardian.

Philip Massey: Great. And, of course, how that applies to a given account can vary, but we'll get to that in a moment. Children, what we most commonly think of as dependents, but what other type of dependents might there be, and who else besides the employee may fall under a tax-favored account?

Stephen Durso: Well, beyond children we have two other categories. So, the first one is going to be spouses. So that includes also same-sex spouses. So, spouses aren't dependents, but they are eligible for most tax-favored accounts unless they're excluded by employer plan rules.

And then the second, maybe a little lesser-known, would be a disabled dependent. So that could be a child. It could be a spouse, or even a parent, anyone who's physically or mentally unable to care for themselves, but there are certain rules that would apply.

Like, they have to live with you in the same home for more than half of the year, for instance. So that is kind of how that works. And what both categories need to have in common for tax-favored benefit purposes, is they all need to be what we call tax dependents. So that's going to be the key.

And one other note, just on domestic partners, is they're usually not considered tax dependents. However, since that Obergefell Supreme Court decision in 2015 made same-sex marriage legal across all 50 states, we don't get nearly as many questions on this status.

Philip Massey: Oh, right. So now we're in a place where marriage is just marriage, and that's taken care of most of those type of questions. So, we have our criteria, then. It's spouses and tax dependents - children/tax dependents. and maybe exception than a disabled spouse could potentially fit both categories. So regardless, when we're talking about eligibility beyond the employee for tax-favored accounts, those need to fit that definition of tax dependent.

So OK. If we're looking to help working families, let's start in the most obvious place with dependent care flexible spending accounts, also called dependent care reimbursement accounts, or even dependent day care accounts, to try and avoid confusion with the related health care flexible spending account.

So, Steve, this is a bit of a softball for you, but walk us through the dependent day care benefit with regard to dependents here and what dependents we're talking about.

Stephen Durso: Yeah, sure. So, the dependent day care account allows employees to set aside up to \$5,000 pretax annually. And this benefit is specifically for the care of the child while the employee is either working or looking for work. So, it's going to be day care. It's not going to be things like boarding school, overnight camps, or even vacation without the kids. Those things would not qualify.

Then the next thing, a dependent child is going to be eligible for these types of plans up to the age of 13, meaning infant to the end of the time period when they're 12 years old, right up to their 13th birthday. Another thing just to point out here is that one disqualifier is that the employee can't pay one of their children to look after another. So, I can't pay my 17-year-old to look after my nine-year-old. That's just not something that the government allows.

And administrators will often ask for a tax ID number on a dependent care FSA claim form for reimbursement. It's just the same thing that an employee has to provide if they're filing for that deduction outside of the FSA. So that's going to be part of the process.

And then lastly, the lesser-known feature is that this can be used to care for disabled dependents. So, we talked about this a minute ago. Intention's the same here. Really, it has to be to allow the employee to work or look for work. But it could be either a child that's over 13, or even a partner.

Also, I'd just say that \$5,000 maximum is per household. So, if the parents are married and filing separately, the maximum would be \$2,500 each.

Philip Massey: All right. So, \$5,000 pre-tax. That's still a great benefit. If you apply a marginal tax rate of 30%, it essentially becomes a 30% discount on your dependent day care.

Stephen Durso: Yeah, that is true, Phil. However, you know, that \$5,000 amount is just not going as far as it used to towards day care. And that amount actually hasn't changed since 1986, which is so long ago that the New York Mets won the World Series that year.

Philip Massey: Ooh. That's cold. For you Met fans out there, I apologize. But there it is.

Stephen Durso: Yeah, for me, I'm a Red Sox fan. So that one haunted me for years.

Philip Massey: OK. So at least you're coming to it with some degree of humility. All right. So that's dependent day care. Let's shift our focus then to health care, starting with the health care flexible spending account, again with a focus on families, spouses, and dependents.

Stephen Durso: Yeah, sure. So, the health care FSA allows for up to \$3,050 to be put in in 2023 on a pre-tax basis, and it's used to reimburse out-of-pocket medical expenses. And then going a little further to define out-of-pocket medical expenses, that's going to be the portion that an employee has to pay. So most commonly, you'd think about anything paid towards a deductible, co-pays, coinsurance, doctor's office visits, hospital visits, or even prescription drugs. In the same way that your medical plan covers dependents and spouses, your Health Care FSA does likewise for your dependents up through the age of 26, or the tax year in which they turn 27.

So, prior to the Affordable Care Act, eligibility cut off at age 19 unless the child was a full-time student. And Affordable Care Act extended that eligibility.

Philip Massey: OK. So, we've got 3,050 up to age 26 - to 27, I guess, birthday year. So, is that amount, that \$3,050, is that a moving target?

Stephen Durso: In fact, it is. So that pre-tax limit for health care FSA is tied to inflation. So, unlike the dependent daycare plan, the health care FSA, being tied to inflation, it will update each year. And that also carries forward into updating the carryover amount increases each year as well. And one other thing that's funny about the Affordable Care Act is that before that, there actually was no limit. But now we get incremental increases generally each year for the health care FSA limit.

Philip Massey: Yes, I remember those days - the \$5,000 Health Care FSA. And it was so prevalent that that was the maximum. It was sort of assumed that that was statutory, but it was really just a sort of an employer standard to match the DCRA side.

So OK. So not so bad. So, our pretax benefit then is up to a full \$8,050 combined between the two-- dependent daycare and health care FSA. If we're trying to help working families, that's a pretty good start. Steve, so I know for you those were easy. Those were the softballs. Let's get into some murkier waters though with the health savings account.

Stephen Durso: Yeah. You know, Phil, I'm ready for that. HSA is my favorite type of account. So, let's just start with where it mirrors the health care Flexible Spending Account. So, the basic rules on dependent eligibility and expenses - so you cover dependents up through the age of 26 per the Affordable Care Act. That's still in place. But there's a couple places where it can get a little bit tricky.

So, under HSA, the adult child may lose their tax dependent status. And if they lose their tax dependent status, you can no longer use your HSA for their expenses. However, at the same time, they may still be able to stay on your medical plan because they don't need to be a tax dependent to stay on your medical plan. So, this could be the point where my son strikes out on his own and is no longer my tax dependent. So, there's a number of things that he can do. He can get a job, get married, and leave the country. And based on the Affordable Care Act, he's still allowed to stay on my medical plan. However, what the eligibility rules with HSA, he's not able to use my HSA for his expenses.

But what's kind of cool here is that since my son is still on my medical plan and he still has appropriate high-deductible health care coverage, he has the ability to open his own HSA. And since he's not my tax dependent, he can actually open that, and he can contribute all the way up to the family max.

Philip Massey: So that's interesting. So, I guess the logic is he's under an HDHP. He is, I guess, part of family coverage under your plan. He can't dip into your HSA, but he can open his own with the family maximum.

So that's interesting. A child can lose access to the employee's HSA, but then open their own. There's a lot going on in there, but still advantage to the working family. There's that much additional pretax benefit, I guess, available at the family level who's in that circumstance. We touched briefly on domestic partners. Do they have any options here?

Stephen Durso: Yeah, they do. The rules for domestic partners actually work similarly to a nontax dependent child. So, a domestic partner may be covered under the employer's health plan - very common. But they're not going to be covered under the employee's HSA because like we talked about before, domestic partners usually are not going to be tax dependents.

So just like that child that's not your tax dependent that can stay on the medical plan through 26, they, too, would have the ability to open and contribute to their own HSA in their own name.

So those same rules apply. The adult child and domestic partner - they need to still meet that criteria for HSA eligibility in that they're covered under a high-deductible health plan. And then given that the child or domestic partner has family coverage under the high-deductible health plan means they could actually contribute up to that family max in their own HSA.

You know, Phil, tax plans can be a crazy world. And this is just an example where employer plan rules, Affordable Care Act rules, and tax status can lead to some unexpected outcomes different for each party.

Philip Massey: Yeah, that is a tangled web, Steve.

Stephen Durso: Yeah. And, of course, there's more. So, these family examples for HSA can be stood on their head and actually become a disqualifier for the employee.

So, one thing that could happen is if that spouse is covered under their own health care FSA from one employer, that's actually considered first dollar health care coverage under a non-high-deductible health plan. So that would leave an employee ineligible to contribute to an HSA just because their spouse enrolled in a full-purpose health care FSA.

Philip Massey: Yeah. Well, I guess we're just coming up on our 20-year anniversary of HSAs in 2024. So, we give it another 20 years, we'll probably have all of this worked out.

Stephen Durso: Yeah. By the time we record our HSA anniversary episode, I'm sure this will all be fixed.

Philip Massey: Yeah. We'll bake a cake just for that one. Looking forward to it.

So OK. Let me tally us up here. So, for a given family, we had the \$5,000 in dependent daycare. We have the \$3,050 for the health care flexible spending account, and \$7,750 is the family maximum for HSAs in 2023.

Stephen Durso: Yeah, that's right, Phil. But remember, you can only have the health care FSA and the HSA at the same time if that FSA is limited purpose, meaning that it would cover dental and vision costs, or post-deductible medical expenses.

Philip Massey: That's right. So - but OK. Since this is a go-big podcast, we'll assume the full funding to account for eyeglasses, braces, all around the family. I know parents can identify with that. I know you can. I certainly can myself. That brings us to a pretax total of \$15,800.

So, sticking with our example, 30% marginal tax rate, that adds up to \$4,740 in savings that could have gone to taxes, but instead equate to additional dollars available for that day care or health care of an employee's family. That painted quite a picture for the active side of employee benefits. But to close this out, Steve, how about some thoughts on retiree accounts. Is there any family relief there?

Stephen Durso: Yeah. And you know, I'd like to talk about HSAs for that first. And it doesn't even necessarily have to be a retiree. It would just have to be someone of a little bit older age.

So, there's a \$1,000 catch-up contribution that's available annually once you turn age 55. But the stipulation there is that it can only be contributed to your own HSA. However, the great thing about that is your spouse, if they're covered under your high-deductible health plan, HSA qualified plan, they could open their own HSA to be able to contribute that \$1,000 on their own.

Philip Massey: And that's another hidden gem, isn't it? So, to combine this with your early example, you could be in a situation where you've got your HSA. Your spouse opens his or hers to start stacking up that \$1,000 annual. You've got a dependent that maybe has a couple of years head start under the family medical plan, but their own HSA. So, I'll add to our tally maybe \$2,000 per couple to give a narrow look here.

And if you meet each plan's criteria, going back to dependent daycare, we're up to \$17,800 a year that's moving straight from paycheck into a given account without taxes being deducted.

Stephen Durso: Yeah, that's true, Phil. I can't ever talk about HSAs without reminding our listeners that they come with a triple tax advantage. So, HSA contributions go in tax free. Distributions come out tax-free. And any earnings and interest over time of those investments also accrue tax-free.

Philip Massey: Right. So, the retiree, hopefully, has a nice nest egg waiting in retirement. Any other thoughts, that retiree landscape, Steve?

Stephen Durso: One last one. So, for employers that offer a retiree HRA, maybe it's in conjunction with enrollment in a retiree plan, or a medical plan through a retiree marketplace the employer has some flexibility to allow spouse and dependent reimbursement, as well as a survivor benefit to transfer the ownership of the account if the employee passes away.

So, retiree HRAs are generally employer-funded. One drawback-- there's not going to be any lowering of taxable income for retirees. But it's still a great benefit because those balances and distributions are tax-free for the former employee and their family.

Philip Massey: Interesting. Interesting. So, you have another tax-favored vehicle. It's the employer funding it rather than the retiree.

Well, Steve, you've definitely shed some light on opportunities for working families to save money on child care and health care as both actives and into retirement to the tune of what we tallied up here - over \$17,000. In case we've shared just enough to be dangerous here, we've thrown a lot at our audience today. Where can somebody turn to learn more on family eligibility and opportunities as we've discussed them here?

Stephen Durso: Yeah. So, the IRS actually provides some great resources to help with situations where you need more information about these types of accounts. So, the first one I'd point people to is Publication 969. And that's going to cover HSA, HRA, and health care FSA. And then a second one is going to be Publication 503 for dependent day care.

Both of these come out annually by the IRS. They have a number of examples. And they're really a great place to start for additional information. They're written for the taxpayer at large, so that content is going to be pretty easy to consume, and those two are going to answer most of your questions.

And then, again, there's some other rules that we didn't cover in today's podcast, like children of divorced spouses and custodial parents. Those answers can also be found in Publication 503.

And then lastly, we've discussed a number of tax benefits here. So would always point employees to a tax professional if they have any questions about their unique tax situation.

Philip Massey: Right. If one can believe it you can actually get to a deeper level than we've discussed here, the winds blow from the IRS in many different directions. So excellent insight, Steve. Thanks for shedding some light on the opportunities for families to save money through our favorite tax-favored accounts.

Stephen Durso: Yeah, you're welcome, Phil. It's always a pleasure.

Philip Massey: And thanks to all our listeners for tuning in again to Benefits with Purpose. Be well, all.

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