IRS Clarifies Two Rules for Health FSAs

The IRS recently released two Chief Counsel Memoranda clarifying rules for health FSAs. One memorandum describes the interaction between a health flexible spending account (“FSA”) with a carryover provision and the individual’s eligibility for a health savings account (“HSA”). The second clarifies correction procedures for improper health FSA claim payments.

IRS Office of Chief Counsel Memorandum (201413005) – FSA and HSA Eligibility

On October 31, 2013, the IRS published Notice 2013-71 which permits a carryover of unused amounts under a health FSA from one plan year to the following plan year up to a maximum of $500. The amount carried forward would not be limited to a 2 ½ month period like the grace period, but would be available for claims incurred anytime during the following plan year. Plans are permitted to include either a carryover or a grace period provision, but not both. More detailed information on Notice 2013-71 is contained in our Technical Bulletin 2013-06 (click here for a copy.) While the October 31 change was welcome, it left one important open question – how would a carryover provision affect an individual’s HSA eligibility?

In a memorandum dated February 2014, but not released until late March, the IRS addresses the following seven questions:

1. May an otherwise eligible individual contribute to an HSA if the individual participates in a general purpose health FSA solely as the result of a carryover of unused amounts from the prior year?

   Enrollment in a general purpose FSA\(^1\) with a carryover provision makes an individual ineligible to contribute to an HSA for the entire plan year. This includes an individual who has coverage under the general purpose health FSA only as the result of a carryover of an unused amount from the prior year.

2. May an otherwise eligible individual who participates in a general purpose health FSA solely as the result of a carryover of unused amounts from the prior year contribute to an HSA for any month after all of the carried over health FSA

\(^1\) A general purpose FSA is an FSA that covers a broad range of health care expenses – usually most or all deductible expenses – that reimburses expenses without the application of deductibles, copayments or coinsurance.
An individual who is covered by a general purpose FSA with a carryover provision is not eligible to make HSA contributions during the following plan year even for months during which no carryover amount is available.

3. May an individual who participates in a general purpose health FSA and elects for the following year to participate in an HSA-compatible health FSA also elect to have any unused amounts from the general purpose health FSA carried over to the HSA-compatible health FSA?

An individual who participates in a general purpose health FSA and elects for the following year to participate in an HSA-compatible health FSA may elect to have any unused amounts from the general purpose health FSA carried over to the HSA-compatible health FSA. There is no requirement that unused amounts from a general purpose health FSA be carried over only to another general purpose health FSA. However, the amounts may not be carried over to a non-health FSA or any type of cafeteria plan benefit.

4. May an individual who participates in a general purpose health FSA and elects the following year to participate in an HSA-compatible FSA and have any unused amounts from the general purpose health FSA carried over to the HSA-compatible FSA also contribute to an HSA during the following year?

An individual who participates in a general purpose health FSA and elects for the following year to participate in an HSA-compatible health FSA and have any unused amounts from the general purpose health FSA carried over to the HSA-compatible health FSA is eligible to contribute to an HSA during the following year if the individual is otherwise HSA eligible.

5. May a cafeteria plan that offers both a general purpose health FSA and an HSA-compatible health FSA automatically treat an individual who elects coverage in a high deductible health plan (“HDHP”) for the following year as enrolled in the HSA-compatible health FSA and carry over any unused amounts from a general purpose health FSA to the HSA-compatible health FSA for the following year?

A cafeteria plan that offers both a general purpose health FSA and an HSA-compatible health FSA may automatically treat an individual who elects coverage in an HDHP for the following year as enrolled in the HSA-compatible health FSA and carry over any unused amounts from the general purpose health FSA to the HSA-compatible FSA for the following year.

6. If a cafeteria plan provides that an individual who participates in a general purpose health FSA that provides for a carryover may decline the carryover for the following year, may the individual who so declines contribute to an HSA during the following year?

A cafeteria plan may provide that if an individual participates in a general purpose health FSA that provides for a carryover of unused amounts, the individual may elect prior to the beginning of the following year to decline or waive the carryover for the following year.
year. In that case, the individual who declines or waives the carryover under the terms of the cafeteria plan may contribute to an HSA the following year if the individual is otherwise eligible.

7. If an individual elects to carry over unused amounts from a general purpose health FSA to an HSA-compatible FSA, how do the uniform coverage rules which require the maximum reimbursement from a health FSA to be available at all times during the period of coverage apply during the run-out period of the general purpose health FSA?

If an individual elects to carry over unused amounts from a general purpose health FSA to an HSA-compatible FSA the uniform coverage rules may be applied during the run-out period of the general purpose health FSA as follows. During the general purpose health FSA’s runout period amounts may be used to reimburse amounts incurred prior to the end of the plan year. Any claims covered by the HSA-compatible health FSA must be timely reimbursed up to the amount elected for the HSA-compatible health FSA. Any claims covered by the HSA-compatible health FSA in excess of the amount elected may be reimbursed after the general purpose health FSA’s run-out period when the amount of any carryover is determined. The memorandum includes an example (click here for a copy of the IRS memorandum.)

This guidance should be helpful for employers that want to consider adding a carryover provision, but were unsure what effect the provision would have on employees’ eligibility for an HSA. Those employers now have several options available to them:

- Permit employees who enroll in a general purpose health FSA to enroll in an HSA-compatible FSA for the following year and carry over unused balances to the HSA-compatible FSA. This election must be made before the coverage period (usually the plan year) begins for the high deductible health plan and HSA-compatible FSA.
- If a cafeteria plan offers both a general purpose and an HSA-compatible FSA, when an employee enrolls in an HDHP for the following year a cafeteria plan may automatically treat the employee as enrolled in the HSA-compatible FSA for the following year and transfer unused funds (up to the $500 limit) to the HSA-compatible FSA.
- A cafeteria plan may permit employees enrolled in a general purpose health FSA to decline or waive the carryover of amounts to the next coverage period (usually the plan year). The waiver must be made before the next coverage period begins.

Unlike the guidance for plans with a grace period, the memorandum does not specifically state that an employee who exhausts her general purpose health FSA account on a cash basis before the end of the plan year will be HSA eligible for the following plan year. Based on the absence of a such a statement in this memorandum and the response in question #2 that an individual is not eligible even after his FSA account balance reaches zero, it would appear that plan sponsors will need to obtain a waiver or declination of the carryover before the end of the plan year for employees who want to be HSA eligible for the following year – including employees who have exhausted funds in their FSA accounts and would not have any funds available to carry over.
Previously the IRS had issued guidance on compliant methods for correcting improper payments from health FSAs for cafeteria plans that use debit cards. Improper payments may occur if a plan mistakenly reimburses expenses that are not qualified under IRC Section 213, are not included as eligible expenses by the particular FSA plan, are covered but have not been properly substantiated (these expenses should not be reimbursed, but mistakes are sometimes made), or are qualified expenses but are incurred by an ineligible individual - e.g., an individual who is not the employee’s spouse, child to age 26 (end of the calendar year) or tax dependent. In proposed cafeteria plan regulations issued in August 2007, the IRS provided rules for correction procedures for plan using debit cards. In that guidance the IRS listed five specific action steps that a plan was required to take to make a correction. Those five steps are:

1. Until the improper amount is recovered by the plan, the debit card must be deactivated and the employee must request payments or reimbursements through other methods – for example, by submitting a paper claim.

2. The employer must require the employee to repay the cafeteria plan the improper amount.

3. If after a demand for repayment, the employee fails to repay the required amount, the employer withholds the amount from the employee’s pay or other compensation (to the extent allowed by applicable law).

4. If any portion of the improper payment remains unpaid, the employer applies a claim substitution or offset against other claims incurred in the same coverage period. For example, if the amount of an improper payment is $200 and the employee submits a substantiated claim for $250 incurred during the same coverage period, the plan would pay $50.

5. If after applying all of the above procedures, there is still an unpaid balance; then the employer treats the improper payment as it would any other business indebtedness.

This new memorandum responds to the following three questions:

1. **May a health FSA that doesn’t use a debit card use the correction procedures provided for plans that use a debit card?**

   The procedures provided for plans using a debit card may also be used by plans to that do not use a debit card. The memorandum also states that the employer that sponsors the health FSA is responsible for compliance, but that a third-party administrator may apply the correction procedures on the employer’s behalf.

2. **May a plan alter the order of the five correction procedures provided in the previous guidance?**

   An employer may apply steps #2 through #4 in any order as long as all of the rules are applied until repayment is made and the same rules are applied to all participants. Step #5 – treating improper payments that have not been repaid as a business debt – is not
available until the first four steps have been used. The memorandum also notes that forgiveness of improper payments as business debts is intended to be a last resort and that a pattern of repeated inclusion of improper payments in income suggests that the plan may not have proper substantiation procedures in place or that the payments may be a method of impermissibly cashing out unused FSA amounts.

3. In cases where correction procedures have been exhausted and the employer treats the improper payment as a business debt, should the amount of the improper payment be reported on Form W-2 or Form 1099?

Improper payments that have not been recovered using the first four steps and are treated as business indebtedness must be included on Form W-2. These amounts are subject to FIT, FICA and FUTA taxes and are subject to withholding.

The flexibility in the order in which a plan applies correction methods should be welcome news to employers. For example, some employers may prefer to apply step #4 – an offset from another claim during the same coverage period – before using step #2 – requiring payment from the employee or #3 deducting the amount from the employee’s paycheck. Some employers (or third-party administrators) may have already adopted the debit card rules for their plans even if those plans do not have debit cards.

The clarification that amounts must be included on Form W-2 rather than Form 1099 may not be totally unexpected, but it is quite helpful. (Click here for a copy of the IRS memorandum.)

The intent of this Technical Bulletin is to provide general information on employee benefit issues. It should not be construed as legal advice and, as with any interpretation of law; plans sponsors should seek proper legal advice for the application of these rules to their plans.

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