May 2, 2014

Individuals with Health FSA Carryovers Can Preserve HSA Eligibility

The IRS has released a memorandum that answers key questions for employers who want to offer health flexible spending account (HFSA) carryovers while helping employees preserve their health savings account (HSA) eligibility. The memorandum describes some alternative approaches, such as allowing a carryover of unused amounts to an HSA-compatible HFSA and allowing individuals participating in a general purpose HFSA to decline or waive the carryover.

Background. Last year the IRS relaxed the longstanding “use-or-lose” rule for HFSAs. Under the relaxed rule, employers with HFSAs may allow participants to carry over up to $500 of unused amounts remaining at year-end into the next plan year. See our Update for more information. When the IRS changed this rule, questions arose about the impact of these HFSA carryovers on HSA eligibility, including what actions could be taken to preserve HSA eligibility for individuals with carryovers and how claims submitted during a general-purpose HFSA’s run-out period should be administered if unused amounts from that plan could be carried over to an HSA-compatible HFSA. The memorandum addresses these topics.

HSA Eligibility. To be HSA-eligible, an individual must be covered under a high-deductible health plan (HDHP) and generally may not be covered under a health plan that is not an HDHP. An individual who is covered by a HFSA is eligible for HSA contributions only if the HFSA is HSA-compatible (that is, an HFSA that only reimburses dental, vision, and preventive care expenses and/or only reimburses non-preventive medical expenses after satisfaction of the HDHP annual deductible). Thus, an individual who is covered by an HFSA that pays or reimburses all qualified medical expenses (that is, a general purpose HFSA) is not an eligible individual for purposes of HSA contributions. This disqualification extends to the entire plan year, even if the HFSA has paid or reimbursed all amounts prior to the end of the plan year.

To preserve HSA eligibility, plans can allow an optional or automatic carry over of unused amounts to an HSA-compatible HFSA and can also allow individuals participating in a general purpose HFSA to decline or waive the carryover. These alternative approaches are described below.

General Purpose HFSA Carryovers. An individual who carries over unused funds from a prior year to a current year under a general purpose HFSA will not be eligible for HSA contributions for the entire current plan year (even for months after the HFSA no longer has any amounts available to pay or reimburse medical expenses). To preserve HSA eligibility, the IRS provides that plans can allow individual participants in a general purpose HFSA that provides for a carryover the option to elect prior to the beginning of the following year to decline or waive the carryover for the following year. In that case, the individual who declines or waives the carryover may contribute to an HSA during the following year (assuming he or she meets the other tax rules for HSA eligibility).

Carryovers to HSA-compatible HFSAs. The IRS provides that plans can allow an individual who participates in general purpose HFSA and elects for the following year to participate in an HSA-compatible HFSA to have any unused amounts from the general purpose HFSA carried over to the HSA-compatible HFSA (the carryover amounts may not be carried over to a non-HFSA or another type of cafeteria plan benefit). This individual is eligible for HSA contributions during the following year (assuming he or she meets the other tax rules for HSA eligibility). A cafeteria plan that offers both a general purpose HFSA and an HSA-compatible HFSA may also elect to automatically treat an individual who elects coverage in an HDHP for the following year as enrolled in the HSA-compatible HFSA and carry over any unused amounts from a general purpose HFSA to the HSA-compatible HFSA for the following year.

The IRS provides that unused general purpose HFSA amounts that could be carried over to an HSA-compatible HFSA may be used during the general purpose HFSA's run-out period to reimburse any allowed expenses covered by the general-purpose HFSA that were incurred prior to the end of the general purpose HFSA plan year. During that run-out period, any claims covered by the HSA-compatible HFSA must be reimbursed in a timely fashion, but reimbursements may be limited to the participant's amount elected for the HSA-compatible HFSA plan year (i.e., without counting the carryover). Any HSA-compatible claims in excess of the elected amount can be delayed until the end of the run-out period, when the amount of any carryover is determined.

Example: Employer offers a calendar-year general purpose HFSA and a calendar-year HSA-compatible HFSA. Both HFSAs provide for a carryover of up to $500 and do not have a grace period. Pat has an unused amount of $600 in the general purposes HFSA on 12/31/13. Prior to 12/31/13, Pat elects $2,500 in the HSA-compatible HFSA for the 2014 plan year and elects to have any carryover go to the HSA-compatible HFSA. Pat also elects HDHP coverage for the 2014 year. On 1/20/14, Pat incurs and submits a $2,700 dental care claim covered by the HSA-compatible HFSA. The plan reimburses $2,500 (the amount elected for 2014). On 2/12/14, Pat submits and is reimbursed from the general purpose HFSA for $300 in medical expenses incurred prior to 12/31/13. At the end of the general purpose HFSA run-out period, $300 in the general purpose HFSA is unused and carried over to the HSA-compatible HFSA. Pat is then reimbursed $200 for the excess of the January $2,700 claim over the $2,500 elected for the HSA-compatible HFSA. Pat has $100 remaining in the HSA-compatible HFSA to be used for expenses incurred in the 2014 year or carried over to the 2015 year. Pat is allowed to contribute to an HSA for the 2014 plan year.

Although the IRS memorandum is not official guidance and does not bind the IRS, it helps clarify the IRS' position on HFSA carryovers and HSA eligibility. With this guidance, employers that postponed adding carryovers may now decide they know enough to add carryovers to their plans. Employers that offer both general purpose HFSAs and HDHPs with an HSA component should consider the available approaches, and plan documents and materials will have to be revised to implement whichever approach is selected.

Should you have questions regarding these rules or any other area of compliance, please contact your Conner Strong & Buckelew account representative. For a complete list of Legislative Updates issued by Conner Strong & Buckelew, please visit our online Resource Center.

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