

Legislative Update

IRS Clarifies - How Health FSA Carryovers Affect HSA

Provided by Kapnick Insurance Group

An individual who has coverage under a general purpose health FSA solely as a result of a carryover of unused amounts from the prior year is not eligible for HSA contributions

Quick Facts:

- A health FSA may allow for carryovers of up to \$500 in unused funds.
- Carryovers under general purpose health FSAs will disqualify individuals from HSA contributions
- The IRS has provided some carryover options that may preserve HSA eligibility, including carryovers to HSA-compatible FSAs and carryover waivers.

On March 28, 2014, the Internal Revenue Service (IRS) released an [Office of Chief Counsel Memorandum](#) to provide information on how health flexible spending account (FSA) carryovers affect eligibility for health savings accounts (HSAs). Although the IRS memorandum is not official guidance, it helps clarify the IRS' position on health FSA carryovers and HSA eligibility. In the memorandum, the IRS provides that an individual who carries over unused funds from a prior year to a current year under a general purpose health FSA will not be eligible for HSA contributions for the entire current plan year (even for months after the health FSA no longer has any amounts available to pay or reimburse medical expenses).

However, the memorandum offers some alternative approaches that allow health FSA carryovers while preserving HSA eligibility. These approaches include carrying over unused amounts to an HSA-compatible health FSA and allowing individuals participating in a general purpose FSA to decline or waive the carryover.

Health FSA Carryovers

In general, health FSAs are subject to a "use-or-lose" rule that requires any unused funds at the end of the plan year (plus any applicable grace period) to be forfeited.

On Oct. 31, 2013, the IRS released [Notice 2013-71](#), which relaxed the use-or-lose rule. Under the relaxed rule, employers with health FSAs may allow participants to carry over **up to \$500** in unused funds into the next plan year. The carryover of up to \$500 may be used to pay or reimburse medical expenses incurred during the entire plan year to which the health FSA is carried over. This carryover provision is different than a health FSA's run-out period, which is a period immediately after the end of the plan year when a participant may submit claims for expenses incurred during the plan year.

A health FSA may be amended to include the carryover feature only if the plan does not also incorporate the grace period rule. Also, a health FSA may specify a lower carryover amount than the \$500 maximum, and has the option of not permitting carryovers

at all. Any unused amount in excess of \$500 (or a lower amount specified in the plan) remaining at the end of the run-out period for the plan year will be forfeited.

For ease of administration, a health FSA is permitted to treat reimbursements of all claims for expenses that are incurred in the current plan year as reimbursed first from unused amounts credited for the current plan year and, only after exhausting these current plan year amounts, as then reimbursed from unused amounts carried over from the prior plan year.

HSA Eligibility

Only an eligible individual may establish an HSA and have HSA contributions made on his or her behalf. 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 health FSA is eligible for HSA contributions only if the health FSA is HSA-compatible (that is, a limited purpose health FSA or a post-deductible health FSA). Thus, an individual who is covered by a health FSA that pays or reimburses all qualified medical expenses (that is, a general purpose health FSA) is not an eligible individual for purposes of HSA contributions. This disqualification extends to the entire plan year, even if the health FSA has paid or reimbursed all amounts prior to the end of the plan year.

FSA Carryovers and HSA Eligibility

The IRS memorandum addresses how the carryover of unused amounts under a health FSA from a prior plan year affects an individual's HSA eligibility during the current plan year.

Carryovers to General Purpose Health FSAs

The IRS memorandum provides that an individual who has coverage under a general purpose health FSA solely as a result of a carryover of unused amounts from the prior year is not eligible for HSA contributions.

This rule applies regardless of the amount available from the health FSA for any month during the plan year. Thus, the individual's ineligibility for HSA contributions continues for the entire health FSA plan year, even for months in the plan year after the health FSA no longer has any amounts available to pay or reimburse medical expenses.

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. In that case, the individual who declines or waives the carryover under the terms of the cafeteria plan 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 Health FSAs

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**. This individual is eligible for HSA contributions during the following year (assuming he or she meets the other tax rules for HSA eligibility).

There is no requirement that the unused amounts in the general purpose health FSA only be carried over to a general purpose health FSA. However, the carryover amounts may not be carried over to a non-health FSA or another type of cafeteria plan benefit.

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 a general purpose health FSA to the HSA-compatible health FSA for the following year.

Administration During Run-out Period

If an individual elects to carry over unused amounts from a general purpose health FSA to an HSA-compatible health FSA, the uniform coverage rules may be applied during the run-out period of the general purpose health FSA as follows:

- The unused health FSA amounts may be used to reimburse any allowed medical expenses incurred prior to the end of the general purpose health FSA plan year.
- Any claims covered by the HSA-compatible health FSA must be reimbursed in a timely fashion up to the amount elected for the HSA-compatible health FSA plan year.
- Any claims in excess of the elected amount may be reimbursed after the run-out period when the amount of any carryover is determined.

Example: Employer offers a calendar-year general purpose health FSA and a calendar-year HSA-compatible health FSA. Both FSAs provide for a carryover of up to \$500 of unused amounts and do not have a grace period. Employee has an unused amount of \$600 in the general purpose health FSA on Dec. 31 of Year 1. Prior to Dec. 31 of Year 1, Employee elects \$2,500 in the HSA-compatible health FSA for Year 2 and elects to have any carryover go to the HSA-compatible health FSA. Employee also elects coverage by an HDHP for Year 2.

In January of Year 2, Employee incurs and submits a claim for \$2,700 in dental care covered by the HSA-compatible health FSA. The plan reimburses \$2,500, the amount elected, in a timely fashion. In February of Year 2, Employee submits and is reimbursed from the general purpose health FSA for \$300 in medical expenses incurred prior to Dec. 31 of Year 1. At the end of the run-out period, \$300 in the general purpose health FSA is unused and carried over to the HSA-compatible health FSA. Employee is then reimbursed \$200 for the excess of the January claim over the amount elected for the HSA-compatible health FSA. Employee has \$100 remaining in the HSA-compatible health FSA to be used for expenses incurred in the year or carried over to the next year. Employee is allowed to contribute to an HSA as of Jan. 1 of Year 2.