What You Need to Know about Health Flexible Spending Accounts

A health flexible spending account (health FSA) is a pre-tax account used to pay for out-of-pocket medical care costs for a participant as well as a participant's spouse and eligible dependents. Health FSAs are employer-established benefit plans and may be offered with other employer-provided benefits as part of a cafeteria plan. Self-employed individuals are not eligible for health FSAs.

Even though a health FSA may be extended to any employee, employers should design their health FSAs so that participation is offered only to employees who are eligible to participate in the employer's major medical plan. Generally, health FSAs must qualify as excepted benefits (unless they are integrated with another group health plan), which means other nonexcepted group health plan coverage must be available to the health FSAs participants for the year through their employment. If a health FSA fails to qualify as an excepted benefit, then this could result in excise taxes of $100 per participant per day or other penalties.

Employee FSA Contributions

A health FSA is similar to a bank account and is established for the employee's use to pay for eligible health care expenses throughout the year. Each year, employees must decide how much money will be deducted from their paycheck on a pre-tax basis and contributed to their account. The employee's salary reduction and contribution election is irrevocable unless the employee experiences a change in employment or change in family status as specified in the plan documents governing the health FSA. The account is then used to pay for eligible medical care expenses during the plan year.

For 2020, an employee's health FSA contributions may not exceed $2,750 (indexed annually). An employer may, however, impose a lower contribution limit.

Risk Shifting

Health FSAs have tax-favored status under the Internal Revenue Code (IRC) provisions that apply to insurance. Accordingly, health FSAs operate with an element of risk to the employer and employee. The amount of an employee's election must be immediately available for reimbursement as soon as the employee completes the salary reduction agreement. For example, if an employee elected to contribute $2,000 to the health FSA for 2020, on January 28, 2020, the employee's health FSA would have a balance

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of $167 ($2,000 ÷ 12). If the employee incurred an eligible medical expense in the amount of $2,000, the employer would be required to reimburse the entire expense. This represents a risk to the employer.

The employee's risk is that the unused balance in the health FSA after the end of the year cannot be used to reimburse qualifying medical expenses. After the close of the year, some employers allow an additional two and one-half months grace period in which to have additional qualifying medical expenses reimbursed from the unused balance. Some employers allow up to $500 to be carried over to the next year for use by the employee. Employers can implement the grace period or the carryover, but not both. If the employee fails to use the FSA account balance for the year, the remaining balance is forfeited: use it or lose it.

On May 12, 2020, in response to Executive Order 13877, the Internal Revenue Service (IRS) issued IRS Notice 2020-33. IRS Notice 2020-33 increases the $500 maximum carryover amount for a plan year to an amount equal to 20 percent of the maximum health FSA salary reduction contribution limit under IRC Section 125(i) for that plan year. Therefore, the maximum amount that may be carried over from a plan year beginning in 2020 to a plan year beginning in 2021 is $550 (20 percent of $2,750). Generally, a cafeteria plan amendment to increase the carryover limit must be adopted on or before the last day of the plan year from which amounts may be carried over. However, under IRS Notice 2020-33, amendments to the maximum carryover amount from the 2020 plan year to the 2021 plan year may be adopted on or before December 31, 2021, as long as eligible employees are informed of the changes. See our Advisor for more information on the Notice. Also, IRS Notice 2020-29 provides an exception to the use-it-or-lose-it rule that employers may implement for unused health FSA funds in 2020 that are used to reimburse qualifying medical expenses incurred through December 31, 2020. See our Advisor for more information on IRS Notice 2020-29.

Covered Expenses

Only eligible out-of-pocket medical care expenses can be reimbursed under the health FSA. As defined by the IRS, medical care includes items and services that are meant to diagnose, cure, mitigate, treat, or prevent illness or disease. Transportation is also included if it is primarily for medical care.

Participants may use health FSA funds for:

- Deductibles
- Copayments
- Prescription medications
- Over-the-counter (OTC) medications with a doctor's prescription. Under the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), OTC medications without a prescription are considered qualifying medical expenses for expenses incurred and amounts paid after December 31, 2019.
- Insulin
- Medical equipment (crutches, bandages, diagnostic devices like blood sugar test kits)
- Dental care (X-rays, cleanings)
- Vision care (exams, eyeglasses, contact lenses, laser eye surgery)
- Transportation primarily for medical care

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Participants may not use health FSA funds for:

- Insurance premiums
- Nonprescription drugs and medicines (aspirin) unless the participant has a valid prescription for the OTC medication (However, see the qualification noted above for OTC medication.)
- Prescription drugs imported from another country
- Herbs, vitamins, and supplements for general health, unless prescribed by a physician.

Expenses are incurred when the employee receives medical care and not when the employee is billed or charged for medical care.

Reimbursement

The plan documents governing the health FSA determine the frequency of reimbursement and the claims procedures that apply when an employee submits a claim for reimbursement. Expenses reimbursed under the health FSA cannot be reimbursed under any other health plan or program because double dipping is prohibited.

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