

What Happens to Unused Health FSA Funds

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Background & Purpose

Health Flexible Spending Arrangements (FSAs) are subject to the Use-or-Lose rule, meaning that any unused funds remaining in the FSA at the end of its plan year will be forfeited by the participant. This rule is derived from Section 125's prohibition on any cafeteria plan benefit that defers receipt of compensation. As with just about any other rule in compliance, there are also a few exceptions to the Use-or-Lose rule that can be implemented as part of a plan's design as described below.

The forfeited funds are referred to as 'experience gains,' and become available to the plan sponsor for restricted use. This article will describe the exceptions to the Use-or-Lose rule, and how plan sponsors may use experience gains.

Exceptions to the Use-or-Lose Rule

Carryovers and grace periods are optional plan design features a plan may implement that function as an exception to the Use-or-Lose rule. An FSA plan may choose to implement either a carryover or grace period, but cannot implement both. Further, both have a potential effect on a participant's HSA eligibility for the subsequent plan year that should be taken into consideration.

Carryovers

As a plan design feature, FSAs may offer carryovers of up to \$500 (indexed annually – \$570 for 2022) of any remaining unused funds at the end of a plan year to be carried over and available to reimburse qualified medical expenses incurred in a subsequent plan year. A plan may choose to set the maximum carryover limit lower than the indexed amount. The plan could also be designed to limit the ability to carryover unused funds. For example, some plans require an election to contribute the next plan year in order to carryover a previous year's balance, while other plans require a minimum unused balance to carryover (e.g., must have \$100 or more remaining in order to carryover with no new contribution election for the next plan year). Without such limit, the carryover balance could continue to be available indefinitely, as long as the employee remains eligible for the FSA. The carried over amount will not count against or otherwise affect the limit on annual FSA salary reductions in a subsequent plan year (i.e., an employee with a carryover balance from the 2021 plan year could still elect up to \$2,850 for the 2022 plan year). Further, the carried over amount cannot be cashed out or converted to any other benefit.

Any unused amounts remaining in the FSA at the end of the plan year that exceed the maximum carryover amount will then be forfeited.

For FSAs, when a qualifying event causes a loss of eligibility, COBRA continuation must be offered if the FSA is underspent (i.e., if the balance remaining in the FSA exceeds the COBRA premiums that would be required for the remainder of the plan year). In determining whether the account is underspent, guidance in IRS Notice 2015-87 (Q&As #21-23) indicates that the benefit still available includes the carryover amount, but the COBRA premium should not take the carryover into account. If the benefit still available for the plan year, including the carryover, exceeds the amount the employee would have to pay via COBRA premiums for the remainder of the plan year, COBRA should be offered. Further, if the account is underspent and the participant does elect COBRA, the carryover should be included in the COBRA coverage that the participant is entitled to receive during the remainder of the plan year in which the qualifying event occurs.

Grace Periods

In general, FSA funds can only be used to pay for or reimburse qualified medical expenses that are incurred during the FSA's plan year. However, as a plan design feature, FSAs may implement a grace period of up to 2.5 months after the end of a plan year. With a grace period, participants may access any remaining unused amounts at the end of the immediately preceding plan year to pay for qualifying medical expenses incurred during the grace period. The grace period may be up to 2.5 months, but a plan may choose to set the grace period for a shorter amount of time.

Any unused amounts remaining in the FSA at the end of the grace period will then be forfeited.

NOTE: The grace period is different than the plan run-out period. Whether the plan year offers a carryover or grace period feature, or neither one, the plan will typically provide a period of 60-90 days beyond the plan year to submit receipts for reimbursable expenses that were incurred during the FSA plan year. The run-out period does not provide any additional time to incur expenses.

Effects of FSA Carryovers and Grace Periods on HSA Eligibility

A participant will be ineligible for an HSA for the entire plan year of a general-purpose FSA unless the individual loses eligibility for the FSA prior to the end of the plan year. Regardless of whether an FSA features a carryover or a grace period (or neither), if the FSA has a zero balance at the end of the plan year, then the participant will be HSA-eligible immediately after the end of the FSA plan year. However, if there is a remaining balance in the FSA at the end of the plan year and the FSA features either a carryover or grace period, HSA eligibility will be affected.

If the FSA has a carryover, and there is a remaining balance in the FSA that is carried over, then the participant will be HSA-ineligible for the entire plan year immediately following the FSA's plan year. This is true unless the plan permits employees to either decline or waive their carryovers *prior* to the beginning of the next plan year, or permit individuals who have a year-end balance in their FSA to elect to participate in a HSA-compatible FSA (i.e., a limited-purpose FSA; a post-deductible FSA, or a combination of the two) and have any unused general-purpose amounts carried over to the HSA-compatible FSA.

If the FSA has a grace period, and there is a remaining balance in the FSA that can be spent during the grace period, then participant will be HSA-ineligible until the grace period is over. The employer could amend the plan and make it a limited-purpose and/or post-deductible FSA during the grace period only, but the amendment must be applied on a uniform basis for all (i.e., participants could not be given a choice between a limited-purpose or general-purpose FSA). Employees who have a significant balance or who are not participating in the HDHP may not like this option. Without making any changes, the problem may be somewhat alleviated by the "full-contribution" rule for HSAs, which allows an individual who is HSA-eligible for only a portion of the year to make a full year's worth of HSA contributions, so long as certain additional requirements are met (need to maintain eligibility in the next 12 months). Therefore, being ineligible for a few months due to a FSA grace period affects the timing of HSA contributions, but will not necessarily prevent making the full HSA contribution.

Experience Gains

For the FSA, some participants will underspend their accounts due to not incurring enough eligible expenses during the plan year, while others may overspend their accounts if they submit expenses for reimbursement up to the full annual election early in the plan year and then participation in the plan ends mid-plan year. The

forfeitures the employer obtains from the underspent accounts may be used to offset any losses from the overspent accounts. If there is money left over after covering the reimbursements provided during the plan year, those experience gains should be used by the employer in accordance with IRS and ERISA requirements. In general, there are four options for utilizing experience gains that comply with both IRS and ERISA requirements: (I) defray plan administration expenses; (II) reduce salary reduction amounts for the following plan year; (III) increase the annual coverage amount; or (IV) provide to employees as a cash refund. The following sections go further into the details of each of these options.

Defray Plan Administration Expenses

In order to constitute a reasonable administration expense, an expense must meet the following requirements:

- The payment must not be prohibited by the plan document (e.g., if the plan document requires the employer to pay administrative expenses, then forfeitures may not be used for those expenses);
- The expense must relate to health FSA administration and cannot be a “Settlor” expense or an expense related to another plan;
- The expense must otherwise be reasonable (i.e., direct expenses properly and actually incurred in the performance of a fiduciary’s duties to the plan); and
- Payment of the expense must not be an ERISA prohibited transaction.

Plan administration expenses may include expenses of a TPA or other service provider.

Reduce Required Salary Contributions

Reducing the required salary contribution is also sometimes referred to as a “premium holiday.” For example, the employer could use the experience gains to reduce the employees’ contributions by \$10 per month. In general, this option is generally most attractive to employers. It is administratively convenient and best complies with both IRS and ERISA requirements.

Keep in mind that allocation of experience gains must be on a reasonable and uniform basis, and NOT on the basis of individual claims experience.

Increase Annual Coverage Amount

The employer could increase the amount available for reimbursement for the plan year in addition to what was elected by the employee (similar to an employer contribution to the FSA). This could be above and beyond the annual contribution limit that applies to employee salary reductions (e.g. \$2,850 for 2022). However, this option may not be as attractive an option as decreasing salary reductions, as coverage may not stay at the higher level and may contribute to experience gains again for the following year.

Provide Cash Refunds

Another option is to allocate experience gains to participants in cash. If cash is returned, the amounts will be considered W-2 wages for purposes of FICA and federal income tax withholding.

If the employer chooses to distribute the experience gains to participants via a premium holiday, increase in the annual coverage amount, or as a cash fund, the employer must do so on a uniform basis and NOT on the basis of individual claims experience. In other words, the amount should be divided evenly amongst all participants or weighted to reflect their elected contribution, without taking actual utilization into account.

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