

Client Alert
from:

Proskauer >



Preferred Benefits, Inc.
967 Spaulding Ave, SE
Ada, MI 49301
(616) 956-1199
www.preferredbenefits.com

Guidance Released on Coordination of Health FSA Carryover with HSAs; FSA Correction Procedures

On March 28, 2014, the Internal Revenue Service's (IRS) Office of Chief Counsel released two memoranda that provide guidance on certain administrative issues affecting employers that sponsor health flexible spending arrangements (health FSAs).

Memorandum number 201413005 provides guidance on various issues relating to the [\\$500 health FSA carryover](#) and its effect on employees' health savings account (HSA) eligibility. The memorandum addresses several issues including the transfer of funds from a "general purpose" health FSA to a "limited purpose" health FSA for employees who wish to establish an HSA after participating in a health FSA the prior year.

Memorandum number 201413006 addresses common issues associated with health FSA claim substantiation requirements. Notably, it clarifies that Form W-2 (rather than Form 1099) is the correct form on which to report improper payments to an employee that the employer treats as includible in the employee's income.

Memorandum Number 201413005 – FSA Carryovers and HSA Eligibility

On October 31, 2013, the IRS modified the "use or lose" rule for health FSAs to allow a [\\$500 annual carryover](#) of unused contributions. However, several issues were left unaddressed at that time, including the effect of the carryover on an employee's HSA eligibility. The memorandum includes the following clarifications:

- An individual who is covered by a general purpose health FSA is not HSA eligible, even if the coverage is solely as the result of a carryover from the prior year. Moreover, an individual covered by a general purpose health FSA solely as the result of a carryover may not contribute to an HSA even for months in the plan year after the health FSA no longer has any amounts available to pay or reimburse medical expenses.
- However, an individual who elects to enroll in HSA-compatible FSA coverage in the following plan year may elect to have general purpose FSA funds carried over to a limited purpose FSA (i.e., an HSA-compatible FSA) in order to preserve the individual's HSA eligibility for that next plan year. An individual may also elect to decline or waive a carryover for the following year.
 - Plans may apply the HSA-compatible carryover automatically for an individual who elects coverage in an HDHP for the following plan year.
 - Carryover amounts may not be carried over to a non-health FSA or another type of cafeteria plan benefit.
- If an individual elects to carry over unused amounts from a general purpose health FSA to a limited-purpose FSA, the carryover amount is available after the general purpose FSA's run-out period.

Memorandum Number 201413006 – Health FSA Correction Procedures

Cafeteria plan rules provide that after an expense for a qualified benefit has been incurred under a health FSA, it must first be substantiated before the

Client Alert
continued:
Guidance
Released on
Coordination of
Health FSA
Carryover with
HSAs; FSA
Correction
Procedures

April 2014

expense is reimbursed. For paper reimbursement requests, the substantiation process always occurs before the expense is reimbursed. However, when a health FSA offers participants the use of a debit card, an expense may be incurred and paid via the debit card before it is substantiated (i.e., at the point of service). There are certain limited situations where health FSA claims are automatically substantiated at the point of service (e.g., under the copayment matching system), but in general the rules require employees to substantiate expenses within a reasonable amount of time after the transaction.

FSA Correction Procedures

Cafeteria plans are required to have the following procedures in place in the event employees do not timely substantiate health FSA expenses reimbursed through a debit card:

- i. The debit card must be deactivated until the claim is substantiated or the improper payment recovered (the employee may continue to submit paper claims);
- ii. The employer must demand that the employee repay the plan;
- iii. If the employee fails to repay plan after the employer's demand per (ii) above, the employer must withhold the amount from the employee's pay, to the full extent allowed by law;
- iv. If neither (ii) nor (iii) above result in full repayment, the employer must apply an offset against properly substantiated claims incurred during the same plan year; and
- v. If neither (ii), (iii) nor (iv) above result in full repayment, the employer may treat the improper payment as it would any other business indebtedness. In other words, it may include the improper payment in the employee's gross income.

The memorandum notes that the above correction procedure for debit cards may be applied to improper payments from a health FSA (e.g., an expense that is later identified as an ineligible expense).

Exhaustion of Correction Methods Required before Expense is Included in Income

The memorandum clarifies that an employer may alter the order of the above correction procedures as long as it does so consistently for all participants. However, the memorandum requires exhaustion of correction procedures (ii) through (iv) above before an employer may apply correction procedure (v) and include the improper payment in the employee's income. The IRS notes that including the improper payment in employees' gross income should be the exception rather than a routine occurrence, and that repeated inclusion in income of improper payments suggests that proper substantiation procedures are not in place or that payments may be a method of cashing out unused FSA amounts.

Corrections Occurring After the End of the Plan Year

The memorandum clarifies that in the event correction procedures (ii) through (iv) were not applied during the plan year in which the improper payment occurred, the employer should report the improper payment as wages on a Form W-2, which are subject to withholding for income tax, FICA and FUTA. Form 1099 should not be used for this purpose.

Client Alert
continued:

**Guidance
Released on
Coordination of
Health FSA
Carryover with
HSAs; FSA
Correction
Procedures**

April 2014

Next Steps

Employers that sponsor HDHPs and HSA-compatible FSAs should discuss the impact of these memoranda with their FSA vendors and benefit consultants to determine if any plan design changes are desired in light of this latest guidance.