Cafeteria Plans: Health FSAs & Health Savings Account Interaction

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Quick Facts:

- A health flexible spending account (Health FSA) allows employees to increase their spendable income by allowing them to pay qualifying medical expenses with pre-tax dollars.
- A health savings account (HSA) is a tax-favored account from which participants can pay for qualifying health care expenses. Individuals are eligible to make or receive contributions while enrolled in a high deductible health plan (HDHP).
- To be eligible to contribute to an HSA, employees cannot be covered by any other health plan that provides coverage before an individual meets his or her HDHP minimum deductible.
- Health FSA participation – including carryovers and grace periods – generally precludes HSA eligibility.
- Limited-purpose and post-deductible Health FSAs do not prevent HSA eligibility.

This article explains how Health FSAs and HSAs work together and provides answers to some common questions posed by employers with respect to the complex interaction between these two consumer-driven benefit designs.

What is a Health FSA?

A Health FSA is a qualified benefit that may be provided under an Internal Revenue Code (Code) section 125 cafeteria plan. Employees may make pre-tax contributions to Health FSAs to be reimbursed for expenses paid for eligible medical expenses not covered under a health plan. A Health FSA effectively allows employees to increase their spendable income by allowing them to pay these expenses with pre-tax dollars.

To be reimbursed under a Health FSA, eligible health expenses must be incurred:

- by the employee, employee's spouse or dependent; and
- during the current Health FSA plan year (unless the plan has a carryover or grace period provision).

The Health FSA annual limit for 2018 is $2,650, which the Internal Revenue Service (IRS) may adjust annually. Employers also may impose their own limits, as long as they do not exceed the IRS's maximum limit.

What happens to unused FSA funds?

Health FSAs generally are subject to a "use-it-or-lose-it" rule under the Code. This means that any money remaining in the Health FSA at the end of the cafeteria plan year is generally forfeited.

Can a Health FSA be designed to allow unspent funds to be used the next plan year?

Yes, an employer may draft its cafeteria plan to allow employees to carry over up to $500 of unused Health FSA amounts remaining at the end of a plan year to pay for qualified medical expenses incurred during the following plan year. The plan may specify a lower carryover amount or may opt not to allow carryovers However, a plan adopting a carryover provision may not also provide a Health FSA grace period.

What is an FSA grace period?

A grace period is a period following a plan year during which participants can access unused amounts from the prior plan year to pay for permitted medical expenses. Health FSAs may provide grace periods of up to 2½ months after the end of a plan year to be reimbursed for expenses incurred during the grace period.

An employer can offer a shorter grace period or choose not to offer one at all. However, the plan document must include the grace period if adopted. Any participant (including COBRA-qualified beneficiaries who participated in a Health FSA plan) must be allowed to take advantage of the grace period.

What is an HSA?

An HSA is a tax-favored, individually-maintained savings account to which the account holder or his or her employer can contribute money to pay for certain medical expenses as long as the account holder has simultaneous coverage under an HDHP. HSA participants may use the account to pay for their eligible medical expenses as well as those of their spouses and tax dependents.

How does Health FSA participation affect HSA eligibility?

To be eligible to make or receive contributions to an HSA, an employee generally cannot have health coverage other than through an HSA-qualified HDHP or certain otherwise-permitted insurance (e.g., preventive care, dental and vision). Put simply, this means that an HSA-eligible employee cannot be covered by any other health plan that provides coverage before he or she has met his or her HDHP minimum deductible.

Thus, traditional Health FSA coverage will prevent an employee from being eligible to contribute to an HSA. Additionally, employees are not HSA-eligible if they are also covered by their spouse's traditional Health FSA, because that Health FSA could reimburse the employee's medical expenses before the employee has met his or her HDHP deductible.

Employees may remain HSA-eligible if they participate in a Health FSA that is specially designed as follows:

- ***Limited-purpose Health FSA:*** A limited-purpose Health FSA reimburses only qualifying dental and vision expenses.

- ***Post-deductible Health FSA:*** A post-deductible Health FSA reimburses only costs for preventive care or for medical expenses incurred after an employee meets his or her minimum HDHP deductible.

Does coverage under a Health FSA grace period impact HSA eligibility?

Yes. When an employee has a Health FSA balance at the end a plan year, coverage under the Health FSA's grace period will prevent the employee from being HSA-eligible until the first calendar month following the end of the grace period.

However, when employees have no balance at year-end (i.e., they exhausted their Health FSA funds during the plan year), the employees may disregard their grace period coverage and may become HAS-eligible as of the start of the next plan year. Notably, this rule only applies to employees who had a $0 balance, determined on a cash basis. Cash basis means the balance was actually $0 as of the last day of the plan year. Therefore, employees who wish to disregard their grace period coverage should make sure all claims are submitted and settled to ensure their Health FSA balance is actually $0 by the last day of the plan year.

How does a Health FSA carryover affect HSA eligibility?

When a cafeteria plan includes a carryover provision, and an employee carries over a Health FSA balance to the next plan year, the employee is unable contribute to an HSA during the next plan year. This is true even if the employee does not elect to participate in a Health FSA or exhausts his or her carryover balance in the next plan year.

To combat this issue, an employer may design its cafeteria plan to allow employees to decline or waive their carryover balances prior to the beginning of the next plan year to enable employees to become HSA-eligible.

Employers may also design their cafeteria plans to allow employees to, prior to the beginning of the next plan year, elect to convert their traditional Health FSA carryover into a limited-purpose Health FSA carryover. All such special provisions must be included in the employer's cafeteria plan document.

Can individuals receive distributions while simultaneously covered under a health plan that is not a HDHP?

Yes, coverage under a non-HDHP does not prevent eligibility for HSA distributions. Non-HDHP coverage only precludes employees from making or receiving HSA contributions.

Can an employee contribute to a HSA, and later in the same plan year contribute to a general purpose Health FSA?

An individual can contribute to an HSA and a general purpose Health FSA during the same year…just not at the same time.

An employee recently got married, terminated her HDHP mid-year, stopped contributions to her HSA and enrolled under her spouse's plan. Can the employee participate in the Health FSA mid-year due to this change in status event? If yes, what is the maximum amount that be contributed towards the Health FSA?

When an employee ceases HSA contributions because he or she is no longer in a HDHP due to a change in status event, the employee may enroll in a Health FSA as long as the election is prospective only (there is a limited exception to this rule for birth or adoption). In such a case, the employee may enroll and elect coverage pursuant to the plan's rules governing Health FSA elections. The plan may permit the employee to elect the annual Health FSA maximum – or provide that the maximum election amount be reduced on a pro-rata basis based on the number of months remaining in the plan year. It's important to always check a plan's rules on election changes, timing and election amounts to determine what is permissible under a particular plan.

Should HSAs be included in employers' cafeteria plans?

The best practice is for an employer to include its HSA in its cafeteria plan. This allows employees to make contributions through payroll deductions and avoids having to follow the Code's complex HSA comparability testing rules. Instead, employee and employer HSA contributions are tested for nondiscrimination under the rules applicable to cafeteria plans, which are easier to pass than the HSA comparability rules.