
XXI. Selected Health FSA Plan Design and Administration Issues

- | | |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>A. Overview of Health FSA Sections in This Manual</p> <p>B. Minimizing the Employer’s Risk of Loss (Overspent Accounts)</p> <p>C. Minimizing the Participant’s Risk of Loss (Underspent Accounts)</p> <p>D. How Do Mid-Year Election Changes Affect a Participant’s Annual Coverage Limit?</p> | <p>E. Dealing With Experience Gains Arising From Participant Forfeitures</p> <p>F. Health FSA Insurance</p> <p>G. Electronic Payment Card Programs for Health FSAs</p> <p>H. Qualified HSA Distributions From Health FSAs</p> <p>I. Qualified Reservist Distributions</p> |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
-

A. Overview of Health FSA Sections in This Manual

A Note About the 2007 Proposed Cafeteria Plan Regulations. This Section XXI includes many references to the proposed cafeteria plan regulations that were issued on August 6, 2007. The 2007 proposed cafeteria plan regulations can be relied on for guidance until final regulations are issued. Moreover, many provisions of the regulations merely incorporate prior guidance. Thus, as a general matter, employers and administrators will want to conform current plan design and operations to the regulations’ requirements.

Health flexible spending arrangements (health FSAs) are subject to various legal requirements. This manual contains several separate Sections focusing solely on rules that apply to health FSAs. In this Section XXI, we explore selected health FSA design and administration issues. For a big-picture view of the various rules that apply to health FSAs, see Section XIX. For rules governing what expenses can be reimbursed under health FSAs, see Section XX. Section XXII discusses how laws other than the Code affect health FSAs. For nondiscrimination requirements applicable to health FSAs, see Sections XXX and XXXI (Sections XXVIII and XXIX also address nondiscrimination requirements for cafeteria plans in general).

B. Minimizing the Employer’s Risk of Loss (Overspent Accounts)

The uniform coverage rule causes a health FSA to operate like insurance, with the employer bearing risk as would an insurance company that provides coverage for a fixed monthly premium.¹ Under the uniform coverage rule, the employer must reimburse expenses up to the full amount of a participant’s annual coverage, even if such reimbursements exceed the participant’s year-to-date contributions. In most circumstances, this will be largely a timing issue. However, there may be an experience loss if a participant terminates employment after incurring large expenses, or otherwise makes a midyear election change in accordance with IRS regulations and the plan’s terms.

¹ See Prop. Treas. Reg. § 1.125-5(d). The uniform coverage rule is discussed in detail in Section XIX.

Example: Risk of Loss Due to Uniform Coverage Rule. Maya participates in her employer's health FSA. On her enrollment form for the current plan year (July 1–June 30), she elected \$2,400 of health FSA coverage. She resigns effective October 31. By the end of that month, she has paid \$800 into her health FSA account via salary reductions. On her last day of work (October 31), Maya submits her first-ever claim for reimbursement: a claim to be reimbursed for \$2,000 of medical expenses that she incurred for her recent knee surgery. Must Maya be reimbursed for the full \$2,000, even though she only contributed \$800 before her employment ended?

Yes—provided that the expenses are adequately substantiated and are incurred during the current plan year (i.e., if the knee surgery was performed during July–October of the current plan year). The uniform coverage rule causes a health FSA to operate like insurance that provides coverage for a fixed monthly premium. Thus, an employer that sponsors a health FSA must reimburse expenses up to the full amount of a participant's annual coverage limit (\$2,400 in this situation), even if those reimbursements exceed the participant's year-to-date contributions.

The risk of loss is compounded under COBRA, especially when the health FSA must offer COBRA extending beyond the current year (i.e., when the health FSA does not qualify for the limited COBRA obligation). See Section XXII for a general discussion of the COBRA continuation rules and the special COBRA limited obligation for health FSAs.

Despite the risks inherent in the uniform coverage rule, most employers with health FSAs do not suffer experience losses when looking at the experience of the plan as a whole for the entire plan year (i.e., most employers do not pay out more in claims reimbursements than they receive in contributions). Indeed, most employers have an experience gain (total contributions exceed total reimbursements for the year).

Uniform Coverage: The Big Picture. Few plan sponsors experience losses in connection with the uniform coverage rule, so long as their plans contain reasonable caps on health FSA elections and provide that forfeitures are used to reduce any experience losses. The risk decreases significantly as the number of health FSA participants increases. For example, assume that an employer has 101 participants in its health FSA. Early in the plan year, a participant terminates after contributing \$200 but incurring \$1,200 in covered claims. The employer's actual loss would be zero if the other participants forfeited an average of \$10 each ($\$10 \times 100 = \$1,000$, which equals the amount by which the \$1,200 reimbursement exceeded the \$200 contribution). Note that if the plan has a 2-1/2 month grace period, this will tend to increase the uniform coverage risk (by decreasing participant forfeitures).

Governmental Entities. Some state and municipal governmental entities (including school boards) may be prohibited by statute or ordinance from assuming any insurance-type risk—thus, they may be precluded from offering a health FSA. However, a governmental entity might be able to satisfy these provisions by purchasing commercially available health FSA risk insurance or by seeking indemnity from the third-party administrator (TPA) or insurer. See subsection F.

Nonetheless, some employers (particularly smaller ones) are concerned about losses as a result of the uniform coverage rule, and they attempt to address these concerns through various plan designs.

1. **Impermissible Plan Designs (Employer Not Allowed to Eliminate All or Substantially All Risk of Loss)**

Some plan designs that might otherwise reduce the employer's risk of loss are not permissible. The IRS has long taken the position that health FSAs must exhibit the risk-shifting and risk-distribution characteristics of insurance. Consequently, losses are expected. Indeed, an IRS Information Letter states that a health FSA "must not eliminate all or substantially all risk of loss to the employer maintaining the plan."²

a. **Limiting Reimbursements to the Amount of Contribution**

This type of design violates the uniform coverage rule, which requires the full annual coverage amount to be available at any time during the plan year.³ See subsection D, however, for a discussion of interesting issues raised by the Federal Flexible Benefits Plan design.

b. **Requiring Repayment of Excess Reimbursements**

A requirement that a participant repay any experience losses to the plan upon termination of employment would also, in effect, be a method of eliminating the employer's risk of loss, and it therefore would be a direct violation of the uniform coverage rule.⁴

Is Voluntary Reimbursement OK? Occasionally, a terminating employee whose reimbursements exceed his or her contributions will want to reimburse our plan for the difference. Can we accept these payments if they are made voluntarily?

No—additional contributions may be made only under a COBRA election. If the plan normally does not offer COBRA to participants with overspent accounts (because the health FSA qualifies for the special limited COBRA obligation), then the plan should not make an exception for the employee who wants to repay the plan for its experience loss—exceptions cannot be made to avoid the uniform coverage rule.

However, the plan could offer COBRA coverage to all terminating participants, regardless of whether they have overspent or underspent their accounts. (Most participants who have overspent their accounts will not elect COBRA.) If this were the plan's policy, an employee who wants to repay the plan could elect COBRA and pay COBRA premiums to the plan (but not beyond the current year, if the special limited COBRA obligation applies). See Section XXII regarding how COBRA applies to health FSAs.

c. **Requiring Departing Participants to Continue Coverage to Year-End**

See Section XXII for a discussion of the risks raised by this plan design.

2. **Permissible Plan Designs**

The following plan designs are permissible under the cafeteria and health FSA rules and, except as indicated, do not appear to implicate COBRA.

a. **Lower the Maximum Reimbursement Amount**

Lowering the maximum reimbursement amount reduces the risk of loss simply by reducing the amount that each participant may receive in medical reimbursements. Note that beginning in 2013, health FSAs must limit participants' annual salary reduction contributions to \$2,500 under health care reform (see Section XIX for further discussion).

b. **Extend the Eligibility Waiting Period**

Extending the eligibility waiting period reduces the risk of loss by reducing the number of participants. But be careful that in operation, this design does not violate the nondiscrimination rules. These

² See IRS Information Letter dated July 9, 1998. The requirement that a health FSA not eliminate all risk of loss was expressly stated in the now-withdrawn 1989 proposed cafeteria plan regulations. See Prop. Treas. Reg. § 1.125-2, Q/A-7(a) (withdrawn). The 2007 proposed regulations no longer use those terms, but there is no indication that the principle has changed.

³ Prop. Treas. Reg. 1.125-5(d)(1). See also IRS Chief Counsel Advice 201012060 (Dec. 17, 2009).

⁴ See IRS Chief Counsel Advice 201012060 (Dec. 17, 2009) (stating that if an employee's health FSA reimbursements exceed his contributions to the health FSA at the time of layoff or termination, "the employer cannot recoup the difference from the employee"); see also IRS Information Letter dated July 9, 1998.

rules are discussed in Part 5 of this manual. Note also that for plan years beginning on or after January 1, 2014, plans subject to health care reform generally may not apply a waiting period that exceeds 90 days.^{4.1} This rule will apply to health FSAs that do not qualify as excepted benefits. See Section XXII for a discussion of the conditions that must be met for a health FSA to be an excepted benefit.

c. Limit Health FSA Eligibility to Those Covered Under Primary Plan

Limiting health FSA eligibility to those covered under the primary medical plan is expressly permitted under the 2007 proposed cafeteria plan regulations.⁵ As discussed in Section XXII, this design may also allow the health FSA to qualify as an excepted benefit under the HIPAA portability rules and for the special limited COBRA obligation.

d. Limit the Categories of Medical Expenses That the Plan Will Reimburse

Some plans exclude items that could result in large expenses early in the plan year. A plan might also limit or exclude expenses that can be controlled by the participant (e.g., eyeglasses). The 2007 proposed cafeteria plan regulations specifically allow such an approach.⁶

e. Require Advance Payment of Premiums

Employees' salary reductions cannot be accelerated based on their claims or reimbursements under the plan.⁷ However, a plan may require premiums to be paid in advance for a period that is longer than one month. For example, a calendar-year plan could require 50% of the premium to be paid in January and another 50% in June. Note that any unused premiums must be repaid to the employee.⁸ Thus, if an employee were to terminate employment in February and the coverage ceased at the end of that month, then the employer would have to refund the unused premium (here, two-thirds of the premium paid in January). Thus, this plan design addresses cashflow issues (claims preceding premiums) but does not directly reduce an employer's risk of loss.

f. Narrow the Change in Election Rules (e.g., No Election Changes for Changes in Status)

A plan could choose not to permit health FSA elections to be changed on account of changes in status, or it could restrict the events that permit changes to be made (e.g., death and divorce) and only permit increases (not decreases) in coverage on account of changes in status. See Section XIV regarding the change in status rules. Also see subsection D for a discussion of related issues raised by the Federal Flexible Benefits Plan design.

g. Combine Voluntary Pre-Tax Final Paycheck Option With COBRA Waiver

See Section XXII for a discussion of the advantages of using this plan design.

C. Minimizing the Participant's Risk of Loss (Underspent Accounts)

The use-or-lose rule requires that any surplus of contributions over reimbursed expenses for the coverage period be forfeited by the participant.⁹ (For this purpose, the coverage period is usually the full plan year plus any grace period provided under the plan.) Under this rule, a participant who does not incur the anticipated claims will not receive reimbursements equal to the amount of contributions to the health FSA. (See Section XIX for further discussion.) Accumulated participant forfeitures create an experience gain for the plan. (See subsection E regarding how such experience gains may be used.)

The following plan designs are sometimes considered to minimize the participant's risk of forfeiting unused contributions.

1. Impermissible Plan Designs

a. Cannot Permit "Spend-Down" of Account; COBRA as an Option

Health FSAs can only reimburse eligible medical expenses incurred during the period of coverage.¹⁰ In other words, a plan may not reimburse expenses incurred after coverage ceases. For example, if a participant terminates employment midyear after contributing \$2,000 and incurring no claims, the plan must not permit the participant to avoid paying premiums while receiving reimbursements for expenses that are

^{4.1} PHSAs § 2708, as added by the Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 1201 (2010) (PPACA). For the effective date of this provision, see PPACA, Pub. L. No. 111-148, § 1255 (formerly PPACA § 1253) (2010).

⁵ Prop. Treas. Reg. § 1.125-5(g)(1).

⁶ Prop. Treas. Reg. § 1.125-5(k)(2).

⁷ Prop. Treas. Reg. § 1.125-5(d)(1).

⁸ Prop. Treas. Reg. § 1.125-5(d)(3). The proposed regulations do not provide details about how to calculate repayments, except that the employer must reimburse the employee for "any amount the former participant previously paid for coverage or benefits to the extent the previously paid amount relates to the period from the date the employee ceases to be a participant through the end of that plan year." If coverage could cease on any day, it appears that proration would be required based on the number of days in the period.

⁹ Prop. Treas. Reg. § 1.125-5(c).

¹⁰ Prop. Treas. Reg. § 1.125-5(a).