Flexible spending accounts' future uncertain as health care rules evolve

IRS allows new options for annual carryovers

Internal Revenue Service guidance resolves how to integrate health savings accounts with carry-over flexible spending accounts, but employer interest in carry-over FSAs appears limited.

The guidance, while welcomed by experts, comes as the future of FSAs in general is cloudy due to the health care reform law.

Unlike grace-period FSAs that allow employees to roll over up to $2,500 from a prior health plan year but require that it be used within the first 21/2 months of the next plan year or be forfeited, carry-over FSAs allow only $500 to be moved over from one plan year to the next but have no deadline on when the money must be used.

Under long-standing IRS rules, HSA contributions are not allowed when employees are enrolled in so-called general-purpose FSAs, which can be used for nearly all health care-related expenses. But HSA contributions are allowed for employees enrolled in limited-purpose FSAs to pay only dental, vision and preventive care expenses.

Under the recent guidance, the IRS said employees can carry over $500 from their general-purpose FSA and keep their ability to contribute to an HSA. It provided three ways that can happen:

• An employee with a general-purpose FSA can carry over unused balances to the next plan year to a limited-purpose FSA.

• Employers can design general-purpose FSAs so unused balances automatically carry over to a limited-purpose FSA the next year.

• And employers can allow employees to decline or waive a carry-over from their general-purpose FSA, allowing employees to contribute to an HSA the next year.

“This is very useful guidance,” said Janet LeTourneau, director of compliance services at FSA and HSA administrator WageWorks Inc. in San Mateo, Calif.

“The guidance is about as clear as it gets,” said A. Scott Sims, a senior vice president with Aon Hewitt in Washington.

The guidance comes as some employers have switched from grace-period to carry-over FSAs.

“Employers are embracing carry-over FSAs,” said Ms. LeTourneau, noting that without the “dreaded” use-it-or-lose-it requirement, employee usage has increased.

That can benefit employers, since FSA contributions are made with pretax dollars, reducing the amount of employees' salary subject to FICA tax, which is paid equally by employers and employees. Employers typically have used the resulting FICA tax savings to help pay the overhead associated with offering FSAs.

But others aren't so sure that employers will convert their grace-period FSAs to carry-over FSAs. One reason is that employees who know they face large health care-related expenses early in the next plan year could be worse off, since they would have at most $3,000 to use with a carry-over FSA vs. $5,000 with a grace-period FSA.

“Those employees would be disadvantaged,” said Jay Savan, a partner at Mercer L.L.C. in Atlanta.

With a carry-over FSA, “use-it-or-lose it is eliminated, but at a price,” said Rich Stover, a principal with Buck Consultants L.L.C. in Secaucus, N.J.

In addition, pending IRS clarification, the carry-over approach could saddle employers with additional administrative expenses. That is because even if employees stop contributing to their FSAs, the balance would be carried over year after year.

As a result, employers and administrators would have to track small amounts of money for extended periods of time, said Amy Bergner, managing director of human resource solutions at PricewaterhouseCoopers L.L.P. in Washington.

At least one big employer has decided to keep its current FSA offering.

“We are sticking with a grace-period FSA,” said Gregg Nevola, vice president of total rewards at North Shore-LIJ Health System in Lake Success, N.Y. “We want to offer employees maximum flexibility in how they can use their FSAs.”

Meanwhile, the future of all FSAs — regardless of their design — is growing murkier due to the growth of HSA-linked high-deductible health plans, where HSA balances can be rolled over indefinitely.

In addition, the health care reform law's so-called “Cadillac” plan tax puts the future of FSAs in doubt.

Under the Patient Protection and Affordable Care Act, a 40% excise tax will be imposed on health insurance premiums that exceed $10,200 for single coverage and $27,500 for family coverage effective in 2018. That calculation must include employees' FSA contributions.

“You will see reduced employer interest in FSAs as the Cadillac tax nears,” said Mercer's Mr. Savan.

As employers attempt to stay below the Cadillac tax limit, “FSAs could be the first to go,” said Andy Anderson, a partner specializing in employee benefits at Morgan, Lewis & Bockius L.L.P. in Chicago.

Changes also could be in the offing, experts say, in the way employers offer HSAs. Employers could redesign their HSAs so employees would make after-tax contributions to the HSA. Employees still would receive a tax deduction for the contribution, but it would be excluded in calculating premium costs for excise tax purposes, Ms. Bergner said.

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