

COMPLIANCE OVERVIEW



Health FSA Carryovers

A health flexible spending account (FSA) is an employer-sponsored account that employees can use to pay for or reimburse their qualifying medical expenses on a tax-free basis, up to the amount contributed for the plan year. Health FSAs are subject to a **“use-or-lose” rule** that generally requires any unused funds at the end of the plan year (plus any applicable grace period) to be forfeited.

As an exception to the use-or-lose rule, employers may allow participants to carry over up to \$500 in unused funds into the next year. The carry-over amount may be used to pay or reimburse medical expenses incurred during the entire plan year to which it is carried over. Also, the carry-over amount does not count toward the Affordable Care Act’s (ACA) limit on employees’ salary reduction contributions to a health FSA.

On Nov. 10, 2021, the IRS released [Revenue Procedure 2021-45](#), which increases the limit for unused health FSA carry-over amounts from \$500 to a **maximum of \$570**, as adjusted annually for inflation. This increase is effective for plan years beginning on or after **Jan. 1, 2022**.

LINKS AND RESOURCES

- [IRS Notice 2013-71](#), establishing health FSA carryovers as a permissible plan option
- [Revenue Procedure 2021-45](#), increasing the health FSA carry-over limit for inflation for 2022
- [IRS’ Office of Chief Counsel Memorandum](#) regarding impact of health FSA carryovers on HSA eligibility

Plan Design Issues

- A health FSA may specify a lower amount as the maximum carryover (and has the option of not permitting any carryover at all).
- A health FSA may permit carryovers only if it does not also incorporate the grace period rule.
- The same carry-over limit must apply to all plan participants.
- The health FSA carry-over limit is adjusted annually for inflation.

Impact on HSA Eligibility

- An individual who has coverage under a general-purpose health FSA as a result of a carryover is not eligible for HSA contributions.
- Carryovers from a general-purpose health FSA to an HSA-compatible health FSA (that is, a limited purpose health FSA or a post-deductible health FSA) preserve an individual's HSA eligibility.

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Health FSA Rules

The “use-or-lose” rule generally prohibits any contribution or benefit under a health FSA from being used in a later plan year or period of coverage. Employees must generally use health FSA funds by the end of the plan year or the funds will be lost. The IRS allows employers to offer an extended deadline, or grace period, of 2 ½ months after the end of a plan year to use remaining health FSA funds.

In addition, the ACA imposes a dollar limit on employees’ annual pre-tax salary reduction contributions to a health FSA offered under a cafeteria plan. The ACA set this limit at \$2,500, effective for plan years beginning on or after Jan. 1, 2013 (indexed for cost-of-living adjustments in later years). An employer may impose its own dollar limit on employees’ salary reduction contributions to a health FSA, as long as the employer’s limit does not exceed the ACA’s maximum limit in effect for the plan year.

COVID-19-Related Change—Extended Period for Incurring Claims

Due to the COVID-19 outbreak, employees may be more likely to have unused amounts in their health FSAs. [IRS Notice 2020-29](#) and [IRS Notice 2021-15](#) allow employers to permit employees to apply unused amounts remaining in a health FSA at the end of a plan year ending in 2020 or 2021 (or a grace period ending in 2020 or 2021) to pay or reimburse expenses incurred through the immediately subsequent plan year.

In addition, the [Consolidated Appropriations Act of 2021](#) (CAA) provides temporary special rules for health and dependent care FSAs that give employees additional time to use these funds. For plan years ending in 2020 and 2021, the CAA allows employers to permit employees to **carry over unused amounts** remaining in these FSAs to the next plan year, and **extend the grace period** to 12 months after the end of such plan year. In addition, the CAA allows employers to permit employees who **cease plan participation** during 2020 or 2021 to continue to receive reimbursements from unused amounts through the end of the plan year in which their participation ended.

Carryovers

An employer, at its option, may amend its Section 125 cafeteria plan document to allow up to \$500 of unused funds remaining at the end of a plan year in a health FSA to be paid or reimbursed to plan participants for qualified medical expenses incurred during the following plan year. For this purpose, the remaining unused amount as of the end of the plan year is the amount unused after medical expenses have been reimbursed at the end of the plan’s run-out period for the plan year. *For plan years beginning on or after Jan. 1, 2022, the limit on health FSA carryovers increases from \$500 to \$570.*

The IRS has provided the following rules for health FSA carryovers:

- A health FSA may specify a lower amount as the maximum (and has the option of not permitting any carryover at all);
- A health FSA may permit carryovers only if it does not also incorporate the grace period rule;
- The carryover may be used to pay or reimburse medical expenses incurred during the entire plan year to which it is carried over;
- A health FSA may limit the ability to carry over unused amounts to a maximum period (for example, a health FSA can limit the ability to carry over unused amounts to one year); and

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- A cafeteria plan is not permitted to allow unused amounts relating to a health FSA to be cashed out or converted to any other taxable or nontaxable benefit.

In addition, if an employer amends its plan to adopt a carryover, the **same carry-over limit must apply to all plan participants**. However, an employer may limit the availability of health FSA carryovers to individuals who have elected to participate in the health FSA in the next year, even if the ability to participate in the health FSA requires employees to make a minimum salary reduction election.

In [Notice 2015-87](#), the IRS provided the following example to help explain how this eligibility rule works:

Example: Employer sponsors a cafeteria plan offering a health FSA that permits up to \$500 of unused health FSA amounts to be carried over to the next year, but only if the employee participates in the health FSA during that next year. To participate in the health FSA, an employee must contribute a minimum of \$60 (\$5 per calendar month). As of Dec. 31, 2019, Employee A and Employee B each have \$25 remaining in their health FSA. Employee A elects to participate in the health FSA for 2020, making a \$600 salary reduction election. Employee B elects not to participate in the health FSA for 2020. Employee A has \$25 carried over to the health FSA for 2020, resulting in \$625 available in the health FSA. Employee B forfeits the \$25 as of Dec. 31, 2019, and has no funds available in the health FSA thereafter.

Carryover Amount

With respect to a participant, the amount that may be carried over to the following plan year is equal to the lesser of:

- Any unused amounts from the immediately preceding plan year; or
- \$500 (\$570 for plan years beginning on or after Jan. 1, 2022), or a lower amount specified in the plan.

Any unused amount in excess of the carry-over amount remaining at the end of the run-out period for the plan year will be forfeited. Any unused amount remaining in an employee's health FSA as of termination of employment will also be forfeited (unless the employee elects COBRA coverage with respect to the health FSA).

Annual Increases to Health FSA Carry-over Limit

On June 24, 2019, President Trump issued an [executive order](#) that required the IRS to issue guidance that would increase the health FSA carry-over limit. On May 12, 2020, the IRS issued [Notice 2020-33](#) to increase the maximum \$500 carry-over amount for a plan year to an amount equal to 20% of the maximum salary reduction contribution for that plan year. Thus, the maximum unused amount from a plan year starting in 2022 allowed to be carried over to the immediately following plan year beginning in 2023 is \$570 (20% of \$2,850, the indexed 2020 contribution limit).

As a general rule, an amendment to a Section 125 cafeteria plan to increase the carry-over limit must be adopted on or before the last day of the plan year from which amounts may be carried over and may be effective retroactively to the first day of that plan year. However, there is a special amendment timing rule for the 2020 plan year. Employers that implement indexing of the maximum carry-over amount for 2020 may adopt an amendment to their Section 125 cafeteria plans by **Dec. 31, 2021**, effective retroactively to Jan. 1, 2020, provided that the employer informs all individuals eligible to participate in the cafeteria plan of the changes to the plan.

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Effect on the ACA Dollar Limit and Grace Period

Health FSA carryovers do not affect the ACA's dollar limit on salary reduction contributions. This means the plan may permit the individual to elect up to \$2,500 (as adjusted for inflation) in salary reductions in addition to the amount that may be carried over.

According to the IRS, this carry-over option provides an alternative to the current grace period rule and administrative relief similar to that rule. A plan adopting this carry-over provision may not also provide a grace period with respect to health FSAs. Also, for any plan year, the plan may not:

- Allow an individual to reduce his or her salary for qualified health FSA benefits more than the ACA's indexed salary reduction limit; or
- Reimburse claims incurred during the plan year that exceed the ACA's salary reduction limit (and any non-elective employer flex credits) plus the carry-over amount.

The Uniform Coverage Rule

The uniform coverage rule continues to apply for plans that allow carryovers. This rule requires the maximum amount of reimbursement from the health FSA to be available for claims incurred at all times during the period of coverage.

Administration

For ease of administration, a cafeteria plan is permitted to treat reimbursements of all claims for expenses that are incurred in the current plan year as reimbursed first from unused amounts for the current plan year, and, only after exhausting these current plan year amounts, as then reimbursed from unused carry-over amounts from the preceding plan year. Any carry-over amounts that are used to reimburse a current year expense:

- Reduce amounts available to pay prior plan year expenses during the run-out period;
- Must be counted against the permitted carryover of up to \$500 (or \$570 for 2022 plan years); and
- Cannot exceed the permitted carryover.

Written Cafeteria Plan Amendment Required

To allow health FSA carryovers, a cafeteria plan offering a health FSA must be amended to include the carry-over provision. The amendment must be adopted on or before the last day of the plan year from which amounts may be carried over, and may be effective retroactively to the first day of that plan year, provided that the cafeteria plan operates in accordance with the rules in the notice and informs participants of the carry-over provision.

If a plan has provided for a grace period and is being amended to add a carry-over provision, the plan must also be amended to eliminate the grace period provision by no later than the end of the plan year from which amounts may be carried over. The ability to eliminate a grace period provision previously adopted for the plan year in which the amendment is adopted may be subject to non-Code legal constraints.

In addition, as explained above, an amendment to a Section 125 cafeteria plan to increase the carry-over limit must be adopted on or before the last day of the plan year from which amounts may be carried over and may be effective retroactively to the first day of that plan year. However, there is a special amendment timing rule for the 2020 plan year. Employers that implement indexing of the maximum carry-over amount for 2020 may adopt an amendment to their

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Section 125 cafeteria plans by **Dec. 31, 2021**, effective retroactively to Jan. 1, 2020, provided that the employer informs all individuals eligible to participate in the cafeteria plan of the changes to the plan.

Carryovers and HSA Eligibility

The IRS released an [Office of Chief Counsel Memorandum](#) to provide information on how health FSA carryovers affect eligibility for health savings accounts (HSAs). Although the IRS memorandum is not official guidance, it helps clarify the IRS' position on health FSA carryovers and HSA eligibility.

Carryovers to General Purpose Health FSAs

The IRS' Office of Chief Counsel Memorandum provides that an individual who has coverage under a general-purpose health FSA solely as a result of a carryover of unused amounts from the prior year is not eligible for HSA contributions.

This rule applies regardless of the amount available from the health FSA for any month during the plan year. Thus, the individual's ineligibility for HSA contributions continues for the entire health FSA plan year, even for months in the plan year after the health FSA no longer has any amounts available to pay or reimburse medical expenses.

A cafeteria plan may provide that if an individual participates in a general-purpose health FSA that provides for a carryover of unused amounts, the individual may elect prior to the beginning of the following year to decline or waive the carryover for the following year. In that case, the individual who declines or waives the carryover under the terms of the cafeteria plan may contribute to an HSA during the following year (assuming he or she meets the other tax rules for HSA eligibility).

Carryovers to HSA-compatible Health FSAs

An individual who participates in a general-purpose health FSA and elects for the following year to participate in an HSA-compatible health FSA may elect to have any unused amounts from the general-purpose health FSA carried over to the HSA-compatible health FSA (that is, a limited purpose health FSA or a post-deductible health FSA). This individual is eligible for HSA contributions during the following year (assuming he or she meets the other tax rules for HSA eligibility).

There is no requirement that the unused amounts in the general-purpose health FSA only be carried over to a general-purpose health FSA. However, the carry-over amounts may not be carried over to a non-health FSA or another type of cafeteria plan benefit.

A cafeteria plan that offers both a general-purpose health FSA and an HSA-compatible health FSA may automatically treat an individual who elects coverage in an HDHP for the following year as being enrolled in the HSA-compatible health FSA and carry over any unused amounts from a general-purpose health FSA to the HSA-compatible health FSA for the following year.

Administration During Run-out Period

If an individual elects to carry over unused amounts from a general-purpose health FSA to an HSA-compatible health FSA, the uniform coverage rules may be applied during the run-out period of the general-purpose health FSA, as follows:

- The unused health FSA amounts may be used to reimburse any allowed medical expenses incurred prior to the end of the general-purpose health FSA plan year.
- Any claims covered by the HSA-compatible health FSA must be timely reimbursed up to the amount elected for the HSA-compatible health FSA plan year.

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- Any claims in excess of the elected amount may be reimbursed after the run-out period when the amount of any carryover is determined.

Example: Employer offers a calendar year general purpose health FSA and a calendar year HSA-compatible health FSA. Both FSAs provide for a carryover of up to \$500 of unused amounts and do not have a grace period. Employee has an unused amount of \$600 in the general-purpose health FSA on Dec. 31 of Year 1. Prior to Dec. 31 of Year 1, Employee elects \$2,500 in the HSA-compatible health FSA for Year 2 and elects to have any carryover go to the HSA-compatible health FSA. Employee also elects coverage by an HDHP for Year 2.

In January of Year 2, Employee incurs and submits a claim for \$2,700 in dental care covered by the HSA-compatible health FSA. The plan timely reimburses \$2,500, the amount elected. In February of Year 2, Employee submits and is reimbursed from the general-purpose health FSA for \$300 in medical expenses incurred prior to Dec. 31 of Year 1. At the end of the run-out period, \$300 in the general-purpose health FSA is unused and carried over to the HSA-compatible health FSA. Employee is then reimbursed \$200 for the excess of the January claim over the amount elected for the HSA-compatible health FSA. Employee has \$100 remaining in the HSA-compatible health FSA to be used for expenses incurred in the year or carried over to the next year. Employee is allowed to contribute to an HSA as of Jan. 1 of Year 2.

Application to Excepted Benefits

Excepted benefits provided under a group health plan or health insurance coverage generally are exempt from HIPAA and the ACA's market reform requirements. Effective for 2014 plan years, health FSAs must generally qualify as excepted benefits to satisfy the ACA's market reforms. Health FSAs generally constitute excepted benefits if:

- The employer also makes available group health plan coverage that is not limited to excepted benefits for the year to the class of participants by reason of their employment; and
- The arrangement is structured so that the maximum benefit payable to any employee participant in the class cannot exceed:
- Two times the employee's salary reduction election for the arrangement for the year; or
- If greater, \$500 plus the amount of the participant's salary reduction election.

An [FAQ](#) issued by the Department of Labor (DOL) clarifies that unused carry-over amounts remaining at the end of a plan year in a health FSA that satisfies the modified "use-or-lose" rule **should not be taken into account** when determining whether the health FSA satisfies the "maximum benefit payable limit" prong under the excepted benefits regulations.