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Potential COVID-19 Impacts on Health Flexible Spending Arrangements (FSAs) and Recent Health FSA Changes

Health flexible spending arrangements (FSAs) are an optional benefit employers may offer that allow their employees to set aside money, on a tax-advantaged basis, to pay for certain out-of-pocket medical expenses. The rules of such arrangements may affect an individual's ability to use or modify their FSA in light of the Coronavirus Disease 2019 (COVID-19) pandemic and corresponding recession.

This product provides a brief overview of health FSAs and some potential ways that the COVID-19 pandemic may affect individuals with such arrangements. It concludes with a description of recent COVID-19-related executive branch and congressional activity around health FSAs.

Health FSAs are one type of health-related, tax-advantaged account/arrangement and are one type of flexible spending arrangement. As such, some health FSA rules are different than the rules for other health-related tax-advantaged accounts/arrangements (e.g., health savings accounts [HSAs]) and other FSA types (e.g., dependent care FSA).

Health FSAs

Health FSAs are generally offered by employers through a *cafeteria plan*, which allows employees to reduce their taxable salary and instead put such money, pre-tax, toward a qualified benefit. Participation in a health FSA is tied to a set period of time (*plan year*), which generally lasts 12 months and does not need to follow the calendar year. Plan years are associated with the year in which the plan starts (e.g., a health FSA with a plan year that begins in July 2020 follows 2020 health FSA rules).

When FSAs are funded through a cafeteria plan, employees elect an annual amount to contribute to their FSA prior to the start of a plan year, which generally cannot be changed during the plan year except for limited circumstances (e.g., change in family status). The employee then contributes amounts to the FSA over the course of the plan year that would total to the elected amount. The maximum amount that an employee can contribute to a health FSA is \$2,750 in 2020. Employers may also provide limited contributions.

The total health FSA election amount must be made available to employees at the start of the plan year, even though the contributions are typically spread throughout the year. For example, an employee who elects to contribute \$2,400 to his/her health FSA for a given plan year (\$200 a month) would be able to access all \$2,400 on the first day of the plan year (even if he/she has only contributed \$200).

Employees can generally only use health FSAs to reimburse the *qualifying medical expenses* of the employee, his/her spouse and dependents, and his/her children younger than

27 at the end of the tax year. *Qualified medical expenses* generally include amounts paid for “the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body,” as well as certain transportation and lodging expenditures. They do not include health insurance premiums, long-term care insurance premiums or expenses, amounts covered under another health plan, and expenses for any medical care that the employer has precluded from reimbursement.

When offered as a cafeteria plan benefit, health FSAs are generally subject to cafeteria plan rules. One such rule is a “use-or-lose” rule that prevents any cafeteria plan benefit from providing “deferred compensation.” As such, health FSA plans have only a limited ability to permit unused health FSA balances to be used after the end of the plan year. In general, employers must incorporate one of three mutually exclusive policies for the treatment of an employee's unused health FSA balances at plan year's end:

1. employees forfeit unused balances;
2. employees have a grace period for additional claims of up to 2½ months after the end of the plan year (e.g., medical expenses incurred by March 15, 2021, could be reimbursed from FSA contributions from a January-December 2020 plan year); or
3. employees may carry-over a limited amount of unused health FSA funds into the next FSA plan year (up to \$500 in 2019 plan year contributions and \$550 in 2020 plan year contributions).

To the extent that an individual has a health FSA balance after the end of the grace period or has a balance that exceeds the allowable carry-over amount (where applicable), such amounts are forfeited to the employer.

Since health FSAs are generally only available to current employees of employers offering such benefit, if an employee is terminated, they may forfeit their FSA balance. In some instances, individuals may be able to retain access to their health FSA through Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) continuation coverage. Inversely, if an employee is terminated mid-plan year having withdrawn more money than contributed, they generally cannot be charged for the negative balance.

Potential COVID-19 Impacts

As designed, health FSAs provide limited ways that individuals can account for unexpected medical costs or changes in medical care availability. Individuals determine

the amount of contributions prior to the plan year, generally cannot change such amount during the plan year, and may only carry-over limited amounts into future plan years (if at all). Considering this structure and the recency of the COVID-19 pandemic and corresponding recession, many individuals may have determined how much to contribute to their FSA without factoring in changes in the medical care that would be needed or accessible during the COVID-19 pandemic. This would be particularly relevant for those individuals currently enrolled in a health FSA that began prior to the detection of COVID-19. As such, the COVID-19 pandemic may have unexpectedly increased the probability that individuals over- or underfunded their health FSAs relative to prior years. Examples of this impact can be demonstrated in the following three situations:

Each example assumes a July 1, 2019-June 30, 2020 health FSA plan year and that the plan allows for a \$500 carry-over to the subsequent plan year beginning on July 1, 2020. These examples are based on the law and regulations as they existed on January 1, 2020, and do not account for subsequent congressional and executive branch activity responding to these potential impacts (discussed in the following sections).

Example 1: An employee decided to contribute \$1,200 to an employer's health FSA to help pay for a nonemergency procedure the employee anticipated having in March 2020. As a result of the COVID-19 pandemic, the nonemergency procedure was postponed to the end of 2020. If the employee does not have any other medical expenses over the course of the health FSA plan year beginning in 2019, then \$500 will roll over to the plan year beginning in 2020, and the remaining \$700 would be forfeited.

Example 2: Another employee also decided to contribute \$1,200 to an employer's health FSA to help pay for a nonemergency procedure. In this instance, the employee had the procedure in August 2019 and applied all \$1,200 in the health FSA to the nonemergency procedure. This employee was subsequently diagnosed with COVID-19 in April 2020 and does not have any funds left in his/her health FSA to help cover the cost of treatment. As such, the employee will need to wait until he/she can elect a new health FSA contribution for the subsequent plan year (i.e., July 1, 2020) and new funds become available for costs incurred during that plan year.

Example 3: Another employee decided to contribute \$1,200 to an employer's health FSA. As a result of the economic effects of the COVID-19 pandemic, the employee stopped working for this employer in April before utilizing any funds. The employee forfeited his/her FSA balance unless the employer was obligated to offer, and the employee enrolled in, health FSA COBRA continuation coverage.

Recent FSA Changes

In response to the potential impacts caused by the COVID-19 pandemic, both the Administration and Congress have taken steps to provide flexibilities to individuals with FSAs. Specifically, employers have been allowed to provide flexibilities regarding certain FSA rules and the list of items considered qualified medical expenses has been expanded.

Executive Branch Activity

In May, the Internal Revenue Service provided employers with the ability to offer two types of temporary flexibilities.

Employers may provide employees with the ability to make prospective, midyear changes (during calendar year 2020) to the amount the employee contributes to his/her health FSA. Such changes include allowing employees to increase or decrease the amount contributed to an FSA, revoke an election to an FSA, or decide to start contributing to an FSA. In *Example 2* above, the employer could allow the employee to make additional midyear contributions to replenish the health FSA, up to the 2019 annual limit.

If an employer decides to offer such midyear changes, the employer may provide only a subset of the aforementioned midyear changes and generally may determine the extent to which such changes are permitted. For example, an employer is allowed to limit the time frame that such election may be made and may prevent health FSA contributions from being reduced below amounts that have already been withdrawn from the FSA.

In addition, employers that offer health FSAs with plan years (or grace periods) that end in 2020 may extend the time frame in which employees may access such funds through December 31, 2020. Using *Example 1* above, the employer could allow the employee to use any remaining balances available at the end of June 2020 for medical expenses incurred through December 31, 2020. If any balances remain after December 31, 2020, the employee could subsequently carry-over up to \$500 in funds to the July 2020-June 2021 plan year (per the terms of the plan).

Not all health FSAs may be eligible to benefit from the December 31, 2020, extension flexibility. For example, a health FSA that goes from November 1, 2019, through October 31, 2020, and provides a 2½-month grace period would not benefit from the extension since the plan already allows employees to utilize those FSA amounts through the first half of January 2021.

Congressional Activity

The Coronavirus Aid, Relief, and Economic Security Act (CARES Act; P.L. 116-136) permanently expanded the list of health FSA qualified medical expenses to include, beginning in 2020, over-the-counter medicines and drugs (without a prescription) and menstrual care products.

Congress may determine that the COVID-19 pandemic warrants further modifications to health FSAs and may decide to provide additional temporary or permanent flexibilities. Such changes could include further modifying the treatment of unused health FSA balances, how terminated employees access health FSAs, or other health FSA rules (e.g., §§20151, 20154, 20155, and 20156 of the HEROES Act, H.R. 6800).

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