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HSA/FSA/HRA

Congress has a HEART, Allows Health FSA Cash-Outs

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Congress cut our citizen-soldiers a huge break recently when it passed legislation permitting employees called to extended military service to cash out the residual balances of their health flexible spending accounts (FSA). The IRS will need to provide guidance and a framework within which the cash-outs may be made, however.

Many employers hitched the FSA wagon to their initial forays into consumer-driven plan design, but found FSAs to be imperfect partners because of the FSA "use it or lose it" rule. Under that rule, dollars left unspent in an employee's FSA at year's end are forfeited, and employers are prohibited from making up the forfeiture in cash or other benefits. The rule frightens away many employees from participating in health FSAs and denies employers the Federal Insurance Contributions Act tax savings they otherwise would gain from employee participation.

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No Need for Soldiers to Forfeit Benefits

By passing the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART), Congress punched a welcome hole in the "use it or lose it" rule. Under HEART, an employer simply may permit the unused health FSA account of an employee called to active duty for a period of at least 180 days to be cashed out. The "cashed-out" payments are called qualified reservist distributions.

The cash-out option became law when President Bush signed HEART in late June. The mechanics of the payments remain cloudy, however. Happily, because the cash-outs are merely permissive, employers may indeed be free to fashion their own rules as long as they are consistent with the statutory scheme.

Cash-Out Rules Open to Interpretation

For example, what is a cash-out? In a health FSA an employee elects a given benefit for the year (say, $1,200) that he or she intends to fund over the balance of the year (e.g., $100 per month). The entire FSA benefit is required to be available to the employee immediately.

Say, for example, the above employee electing a $1,200 health FSA benefit for the calendar year is called to active duty on January 31, after contributing $100. What is the cash-out amount?

The statute says the cash-out amount is "all or a portion of the balance in the employee's account" as of the date of the payment. Thus, in the example above, it appears the FSA could distribute $1,200 less claim payments already made to the employee for the year. However, it is also clear the employer may allow a cash-out of only a portion of that account balance. Applying the facts in the example above, employers might prefer to pay $100 (the employee's contribution to the FSA, as of the date of the cash-out) to the employee, less FSA claim payments. Consider, however, that existing health FSA rules prohibit employers from making a benefit available only in an amount equal to the employee's actual contributions to that point, as of a given date in the year. Whether the IRS applies similar reasoning to qualified reservist distributions remains to be seen.

The cash-out should be taxable, subject to income and FICA tax withholding. According to the statute, it must be made between the date the employee is called to active duty and the last date by which the FSA may make a reimbursement for the plan year during which the employee received his or her orders. It's not clear what Congress means by this payment deadline. It might mean the end of the FSA coverage period (the legislative history suggests this), or it might mean the claim submission deadline under the FSA (usually, 90 days after the end of the year, but sometimes sooner for former employees). We eagerly await IRS guidance on these issues.

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In 2005 the IRS authorized grace periods for FSAs under which health care expenses incurred in the first 2 months of the ensuing year could be paid from the prior year's residual balance. HEART continues to erode the "use it or lose it" rule. CDHC

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