SO YOU WANT TO INSTALL AN
HSA-COMPATIBLE PLAN MIDYEAR
(BUT YOU HAVE A HEALTH FSA IN PLACE)

From time to time, we’ll encounter an employer that offers a traditional health flexible spending account (FSA) to employees, and then wants to add a new high-deductible health plan (HDHP) option with a health savings account (HSA). Sparks fly when the employer’s FSA runs on a calendar year basis but the employer’s medical plan does not.

The employer typically wants to install the HDHP at the time of the medical plan’s renewal, which means the HDHP will come online partway through the FSA’s plan year. The employer, of course, hopes that employees enrolled in the FSA will have the chance to enroll in the HDHP and make HSA contributions right away.

What’s the Issue?

Employees who have coverage under a traditional or “full-service” FSA (one that reimburses more than just dental, vision and preventive care expenses) are ineligible to make, or even accrue the right to make, HSA contributions for any month they begin while enrolled under the traditional FSA.

This is true even if they’ve burned through their entire FSA benefit before the end of the FSA plan year. For example, if an employee under a calendar year FSA consumed his entire FSA benefit by September 15, he’s still deemed to have the FSA coverage for October, November and December, even though he exhausted his FSA benefit before those months begin.

FSA “COVERAGE” DURING GRACE PERIODS

For FSAs with a grace period (the two-and-a-half-month period after the end of the FSA plan year during which the employee may incur covered claims to soak up a residual, year-end FSA account balance), a similar rule applies to the grace period. Let’s continue to assume the FSA runs on a calendar-year basis. If the employee carries even a penny of residual, year-end FSA benefits into the grace period (the grace period would extend from January 1 to March 15), she’s considered ineligible to accrue the right to make HSA contributions until the first day of the month—April 1—after the grace period ends.

On the other hand, if she zeroes out her FSA balance by the end of the FSA plan year, and carries nothing into the grace period, she is deemed to have no FSA coverage with respect to the grace period and, if she had not reenrolled in the traditional FSA for the new plan year, could be eligible to make HSA contributions beginning in January.
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What’s the Solution?

The best answer: Avoid these midyear HDHP/HSA implementations, if at all possible. This means getting way out in front of the issue, maybe 6–12 months early.

The best approach is to synch the FSA plan year with the health plan year at the earliest opportunity, before the HDHP/HSA program goes in. That way, when the HDHP/HSA program is installed, there are no new HDHP enrollees also covered under the traditional FSA and thus frozen out of the right to make HSA contributions.

Other possibilities, from safest/most common (and most likely to be accommodated by an FSA administrator) to the most aggressive/least common:

1. **Freeze out from HSA participation, at least through the end of the FSA plan year, those HDHP enrollees who are FSA participants.** Under this approach, FSA participants are simply treated as ineligible to make HSA contributions, at least through the end of the FSA plan year.

   **Grace periods:** If the FSA has a grace period, and the employee zeroes out his FSA by the last day of the FSA year, he can become eligible to make HSA contributions beginning in January. If HDHP enrollees carry FSA balances into the FSA grace period, the employer is permitted to unilaterally make the FSA a “limited purpose” FSA for everyone during the grace period, which would allow HSA participation to begin in January, even for those carrying FSA balances into the grace period. The IRS has not expressly permitted treating the FSA as limited purpose during the grace period just for HDHP enrollees, or allowing HDHP enrollees to waive their FSA benefit during the grace period.

   **Carryovers:** The IRS offers more flexibility for FSA carryovers. The employer can amend the cafeteria plan to allow participants to transfer carryover balances to a limited-purpose FSA, or waive the balance altogether. These things can occur at the employee’s election or automatically upon enrollment in an HDHP.

2. **Keep the FSA plan year as the calendar year, but unilaterally convert the FSA to a limited-purpose or high-deductible FSA for all participants.** This means that for out-of-pocket expenses incurred after the conversion, the FSA will only reimburse dental, vision and preventive care expenses. There will be a failure of expectations here for participants who enrolled in the FSA expecting it to operate as a traditional FSA for the entire 12-month plan year.

3. **Terminate the traditional FSA midyear.** This is a difficult choice, because employees with unused FSA balances will forfeit them.

4. **Amend the FSA to declare a short FSA plan year for the current year, with a new 12-month FSA plan year to coincide with the HDHP plan year.** The amended FSA will be “limited purpose” for the new plan year, or at least offer a limited-purpose option for those enrolled in the HDHP. This is a difficult choice as well. The maximum annual FSA benefit will need to be prorated for the short year, and some employees might have already exceeded it. Employees who elected a large FSA benefit, expecting the FSA year to last 12 months, will be caught by surprise and might end up forfeiting a significant portion of their benefit.
5 Unilaterally convert the FSA for HDHP enrollees to a limited-purpose or high-deductible FSA. Some arguments support this approach, but the IRS might not agree. Informally, some IRS officials have expressed skepticism, although the reasoning is not entirely clear. IRS guidance has addressed this unilateral conversion approach with respect to FSA grace periods, and in that context has required the employer to amend the grace period to make it limited purpose for all participants, not just those enrolled in the HDHP.

6 Allow FSA participants to transfer the benefit midyear to a limited purpose FSA. The IRS would have the same or more skepticism here, most likely because the FSA participants are given a midyear choice to make the transfer. The IRS does allow this kind of choice with respect to FSA carryovers but may have different reasons for allowing the choice during an FSA plan year’s carryover period as opposed to during the plan year itself.

7 Allow participants to waive the FSA benefit for the remainder of the FSA year. The IRS would clearly object to this approach, because it is basically a midyear election to cancel coverage without a legitimate FSA qualifying event.