

A Mid-year Checkup for Your Health FSA

By Rich Glass, JD

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When I entered my 40s, the need for an annual checkup was made abundantly clear to me from many quarters. I was given three main reasons:

- It is the preventive thing to do. Many serious or fatal diseases can be treated when found at an early stage.
- It is the proactive thing to do. Warning signs can be heeded so that bad habits can be curbed, and good habits can be resumed (or started).
- It is the protective thing to do. My long-term future depends on getting checked from head to toe.

The same principle applies to employer-provided benefits; based on these same three reasons, plan administrators should perform an annual checkup on their health flexible spending accounts (FSAs). The best time to conduct such an exam is before the onslaught of year-end and open enrollment activity. In other words, examine how your health FSAs are performing this summer so there is no "winter of discontent" for your plan later.

Conducting the Checkup

The starting point for the checkup is to look at participation rates. It is not unusual for enrollment levels to not be as high as one may like. When this is the case, it hurts both employer and non-participating employee alike. When employees do not participate, both miss out on FICA savings and employees miss out on (1) additional federal tax savings as well as (2) improved cash flow for paying out-of-pocket medical expenses, due to the uniform coverage rule. Consider surveying your nonparticipants to determine what the major obstacles are.

Reasons Employees Don't Participate

Can't afford it. Chances are many employees will tell you that

they believe they simply cannot afford to contribute. If that is true, examine your minimum contribution levels — perhaps they are too high. It may be that more education is needed outside of open enrollment, when the company's major medical plan options and features take center stage. Often, people do not realize how much they spend on medical care that is not covered by their major medical plan. Every doctor's visit, prescription drug or cough medicine purchase is coming out of their wallet. Instead, these individuals and their families could see a discount equal to their effective income tax rate.

Another way for an employer to increase participation is to provide seed money to the health FSAs of all employees in a specific classification (for example, full-time employees). You could make the seed money contingent on employees making a minimum health FSA contribution. This also helps if the health FSA has a difficult time passing the Code Section 105 eligibility test for nondiscrimination testing purposes. More on that subject a little later.

Use-it-or-lose-it rule. Another common excuse for not participating is the use-it-or-lose-it rule (see ¶323 of the *Handbook*), which requires unused FSA balances to be forfeited at the end of the plan year. There are a few plan features that employers can add to alleviate these concerns.

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First, an employer can amend its plan to add another two months and 15 days to the plan year, commonly known as a grace period. The plan amendments must be in place before the end of the original plan year.

Second, an employer can make sure that all medical care expenses — as defined in Code Section 213(d) — are eligible for reimbursement. Sometimes, we see health FSAs that still have not been updated to include over-the-counter drugs and medicines, as permitted by the six-year-old Revenue Ruling 2003-103.

Third, understand that in two situations a plan may allow certain expenses to be reimbursed when paid in the current plan year, even when the care is going to extend over multiple plan years: (1) orthodontia and (2) durable medical equipment. More situations may be approved when the final regulations are issued, but these are the only two approved categories right now.

Finally, something as simple as a calculator can overcome fear of the use-it-or-lose-it rule. Perhaps you still have one of those on your desk, collecting dust or serving as a paperweight. Let's look at an example: An employee elects \$1,000 but only uses \$900. The natural conclusion is that this person lost \$100. Not so. This person does not have to pay federal income taxes (assume a 28-percent rate) or FICA (7.65 percent) on the \$1,000. Add those tax savings (28 percent + 7.65 percent = 35.65 percent) and multiply it by the election amount (\$1,000), and you easily see that the employee comes out ahead. The savings (\$356.50) more than offset the lost balance (\$100).

Inconvenience. Add a third excuse to the previous two: inconvenience. This also is a complaint common among participants. Of course, one rule of health FSAs is that all reimbursed expenses must be substantiated, both by the participant and by the health care provider. What this means in practical terms is that you must complete the plan's claim form, itemizing each expense, along with receipts that show the date, amount and description of the medical service or product and the name of the health care provider. This is why an electronic payment card (aka debit card) sometimes proves invaluable, well worth the additional administrative fees they entail. The IRS has been very helpful the last several years in expanding the ways that health FSA debit card expenses can be substantiated automatically. Auto-substantiation rates of more than 90 percent are increasingly commonplace.

Additional Considerations

There are other mid-year considerations for health FSAs. For example, plans can be amended to allow for qualified reservist distributions (QRDs) when an employee is called to active military duty. Under the Heroes Earnings Assistance and Relief Tax Act of 2008, a plan may make a taxable QRD to such an employee in the amount of the unused balance, which can be calculated using a couple of different methods.

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Health FSAs are subject to nondiscrimination testing under Section 105: the eligibility test and the benefits test. Mid-year is a good time to run a preliminary test to ensure that the health FSA is still passing these tests. If you do not conduct such a test, undertake preventive measures to avoid a taxable event for highly compensated individuals at the end of the year.

A survey of nonparticipants was mentioned above, but canvassing participants' opinions also can be helpful. What is and is not working with the current health FSA? What ideas do participants have to make it work better? Some suggestions may be off the wall (or even illegal), but the feedback you receive may pleasantly surprise you. Maybe employees are not aware of some of the plan features that could make reimbursement easier.

Communication Is Key

Many of these ideas may seem straightforward or are may already be part of your health FSA. If so, simply focus on two-way communication, getting suggestions from your work force on how to improve the plan and discussing with them how to optimize their use of the plan.

In addition, you can hold at least one information-sharing session that focuses on the current state of health care reform. Many employees have probably heard the "sky-is-falling" report that health FSAs will be eliminated by the end of this year. The reality is that, while nothing is certain, health FSAs should continue to be a viable option for many years to come. Even the worst-case scenario has their elimination occurring several years from now. 🏠

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