

¶326 Other Health FSA Requirements

In addition to the major health FSA requirements described in ¶322-¶325, there are several other rules that apply to health FSAs:

- timing of the expense and reimbursement;
- the 12-month period of coverage rule;
- the need to reimburse health expenses and dependent care expenses through separate spending accounts; and
- the disposition of experience gains.

These rules are described below.

Timing of expense and reimbursement

Generally, reimbursements for an employee's medical and dependent care expenses which are paid from an FSA must relate to medical or dependent care that is actually provided during the plan year (or, if shorter, the period that the participant was covered under the cafeteria plan).⁴¹ An expense is treated as "incurred" for this purpose when the care is actually *provided*, not when the participant is billed or pays for the care.⁴²

To comply with this rule, a flex plan administrator should carefully review all expense reimbursement requests to ensure that participants have not submitted bills or paid expenses that relate to care provided in a previous (or subsequent) plan year. The flex plan administration system should be designed to spot claims for such expenses and reject them.

Also, employees who face the potential of forfeiting large FSA account balances at the end of a plan year have an incentive to submit bills for care provided in another plan year. The flex administration system must be able to spot these claims and reject them.

Reimbursement may occur during a "run-out" period after the end of the coverage period, as long as the expense was actually incurred during the coverage period. However, medical expenses incurred either before the existence of the health FSA or before the employee's enrollment in the plan, may not be reimbursed. Unlike qualified plans, which may be established with a retroactive effective date, health FSAs under a flex plan must always operate prospectively.⁴³ Employers should leave enough time so that the FSA may be designed and established, and participant enrollments obtained, prior to the desired effective date.

Orthodontia and obstetrical care

This timing requirement presents some difficulties regarding certain medical expenses. In particular, orthodontic services usually span more than one year. Obstetrical services also will span two years for many mothers who become pregnant after the first quarter of the plan year. In both cases the patient is often billed in installments or in a lump sum, and there is little proximity between when the billing occurs and the actual performance of the services. Either circumstance could violate the flex plan timing requirement, threatening the status of the flex plan under Section 125.

The health FSA plan administrator should request the practitioner to allocate the payments to the services rendered. Alternatively, the health FSA plan administrator could request that the practitioner certify that the value of the services provided during a year exceed the amounts paid, if applicable. However, as a practical matter, many practitioners will not provide this information. The health FSA administrator and the patient should impress upon the practitioner the importance of maintaining the qualified status of the flex plan and the adverse consequences to the patient if the plan is disqualified.

This requirement may cause the operation of a health FSA to conflict with the underlying health insurance plans. For example, the underlying plan may permit retroactive coverage after a 30- or 60-day grace period. Even though coverage applies retroactively under the health insurance plan, reimbursement under the health FSA would not be permitted with respect to expenses incurred prior to the employee's date of enrollment in the health FSA.

12-month period of coverage

Health FSAs may not operate so that employees may participate only when the coverage is needed.⁴⁴ Accordingly, under proposed regulations, the coverage period under an FSA must be 12 months.⁴⁵ The only exception to this rule is with respect to a short plan year (that is, the first plan year or a year in which the plan year is changed — see ¶343 of the *Handbook*). In that case, the duration of coverage is the entire short year period.

The IRS proposed regulations do not specify what the 12-month period must be. Some possibilities include the plan year, the calendar year, the employer's fiscal year or the 12-month period coinciding with annual insurance premium adjustments. Except for certain changes in status (see ¶563), elections to increase or decrease health FSA coverage during the coverage period are prohibited.⁴⁶ Also, the 12-month period applies even with respect to employees who terminate employment during the year.⁴⁷ However, the health FSA may provide that the coverage period will cease with respect to a terminated employee if the employee stops paying premiums. If the employer's FSAs are subject to COBRA, the employee also may elect COBRA continuation coverage under the health FSA.⁴⁸ Note that the any COBRA rights are in addition to the 12-month period of coverage rules. (Note that most FSAs are not subject to the COBRA rules — see ¶327.)

No dependent care expenses under health FSAs

The IRS proposed regulations clarify that health FSAs can only reimburse "medical expenses" as that term is defined in Section 213 of the tax code (see ¶322 and Appendix A of the *Handbook*.)⁴⁹ Accordingly, dependent care expenses may not be paid from a health FSA, and vice versa.⁵⁰

To comply with the prohibited reimbursement rule, a flex plan administration system must provide for separate health FSAs and dependent care FSAs. Although it may be possible to pay medical and dependent care FSA reimbursements with a single check, this is not a good idea. If an employee receives a single reimbursement check, he or she may forget that more than one FSA exists, resulting in an unwelcome surprise, which can lead to unwelcome consequences for the plan sponsor. Proper tracking and recharacterization of reimbursed amounts by the flex plan administrator can avoid these problems.