Flexible Spending Arrangements

Flexible spending arrangements (FSA) are a type of cafeteria plan commonly used by many employers. In an FSA, participating employees generally elect to have their salary reduced each month. The employer then uses these funds to pay for certain benefits with pretax dollars. There are three types of FSAs:

- Medical expenses not otherwise covered.
- Dependent care expenses for both children and parents.
- Adoption expenses.

Tax Benefits

The payment of the benefit is tax deductible for the employer and is non-taxable to the employee. As these dollars are not considered to be wages, they are not subject to either FICA or FUTA tax.[1]

Health Benefits

If an FSA provides health benefits (like medical or dental expenses) to participants, it must be ready to pay the full year's benefits to an employee who qualifies for the benefit.

For example, if the employee has contributed for only one or two months at the time of the claim, the employer must pay for the entire expense up to the amount projected for the full year of contributions by the employee. If the employee then terminates employment before the amounts are deducted from his or her paycheck, the employer must suffer the loss.

In 2022, the maximum amount available to reimburse incurred medical expenses may not exceed $2,850. For 2021 this limit was also $2,750. The limit is subject to adjustment for inflation in future years.

"Use-Or-Lose" Rule

Any unused funds remaining in an FSA at the end of the year will be forfeited by the employee. At the beginning of the year, a careful estimate of future expenses is helpful in

[1] The discussion here concerns federal income tax law. State or local income tax law may differ.

avoiding this “use-it-or-lose-it” problem. However, employers may (but are not required to) establish a grace period of 2 ½ months after the end of a plan year. During this grace period, any unused funds may be paid or reimbursed to the employee for qualified expenses incurred during the grace period.[1]

In Notice 2013-71, the IRS allowed (but did not require) an employer to amend its plan to provide for the carryover to the immediate plan year of up to $500 of any amount remaining unused at the end of the plan year in a health FSA.

The carryover amount may be used to pay or reimburse medical expenses under the health FSA incurred during the entire plan year to which it is carried over. A plan adopting this carryover provision may not also provide for a grace period with respect to a health FSA.

In 2021, the maxium carry over amout was $550. For 2022, the maxium carry over amount is $570.

Consolidated Appropriations Act, 2021 Provisions

In response to the COVID-19 pandemic, the Consolidated Appropriations Act, 2021 (CAA-2021) liberalized a number of the provisions generally applicable to health and dependent care flexible spending accounts, including:

- **Remaining year-end balances:** A plan may allow any balance remaining at the end of the 2020 plan year to be rolled over to 2021. Similarly, any balance remaining at the end of the 2021 plan year may be rolled over to 2022.
- **Grace period:** For plan years ending in 2020 and 2021, a sponsor may extend the grace period to disburse un-used balances for up to 12 months.
- **Terminating plan participation:** An employee who discontinues participating in a flexible spending plan in 2020 or 2021 may have until the end of the plan year to use up any remaining balance.
- **Dependent care expenses:** The maximum age for a qualifying child for dependent care expenses may be increased from 13 to 14.

[1] See proposed regulation Sec. 1.125-1 (e)

Qualified Reservist Distribution

Under the provisions of the Heroes Earnings Assistance and Tax Relief Act of 2008, for distributions after June 17, 2008, a "qualified reservist distribution," of all or part of any unused balance remaining in a health FSA may be made to an employee who is called to active duty for a period of more than 179 days, or indefinitely. The distribution must be made during the period beginning with the date the individual is called to active duty and ending on the last date that reimbursements could be made under the arrangement for the plan year that includes the date of call to active duty.

Qualified reservist distributions are not required. If a plan sponsor decides to allow them, they must be available to all eligible plan participants and the plan must be amended.