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IRS MODIFIES HEALTH FSA “USE OR LOSE” RULE TO ALLOW UP TO A \$500 “CARRYOVER” OF UNUSED AMOUNTS TO THE FOLLOWING PLAN YEAR

In Notice 2013-71 the IRS modifies the “use or lose” rule applicable to health flexible spending accounts (FSAs) to permit section 125 cafeteria plans to be amended to allow up to a \$500 “carryover” of health FSA unused amounts remaining at the end of a plan year to be reimbursed to plan participants for qualified medical expenses incurred during the following plan year. A section 125 cafeteria plan that incorporates a carryover provision may not also provide for a grace period in the plan year to which the unused health FSA amounts may be carried over.

The “use-or-lose” rule is well known by most and requires that unused benefits or contributions remaining as of the end of the health FSA plan year be forfeited. The IRS Notice refers to these amounts as “unused amounts”.

In 2005, the IRS modified the use-or-lose rule by adopting the “grace period” rule. Under the grace period rule, a section 125 cafeteria plan may permit an employee to use amounts remaining in a health FSA from the prior year to pay qualified health expenses incurred during the period of up to two months and 15 days immediately following the end of the plan year.

Now, employers sponsoring health FSAs have three design options¹:

- A traditional health FSA following the use or lose rule;
- A health FSA with a use or lose rule modified by the grace period rule; or
- A health FSA with a use or lose rule modified by a “carryover” of up to \$500 of unused amounts in the immediately following plan year.

Employers that wish to carryover unused health FSA amounts from the 2013 plan year to the 2014 plan year can adopt this new carryover rule even though the 2013 plan year has begun. See the plan amendment discussion later below.

BASICS OF THE NEW HEALTH FSA CARRYOVER RULE

- An employer, at its option, is permitted to amend its section 125 cafeteria plan document to provide for the carryover to the immediately following plan year of up to \$500 of any amount remaining unused as of the end of the plan year in a health FSA.

¹ In all three cases, the health FSA may also contain a run-out period (not to be confused with the “grace period”), which is a period immediately following the end of a plan year during which a participant can submit a claim for reimbursement of expenses incurred for qualified benefits during the plan year.

- The plan may specify a lower amount as the permissible maximum (and the employer sponsor has the option of not permitting any carryover at all).
 - The same carryover limit must apply to all plan participants.
 - Unused amounts relating to a health FSA are not permitted to be cashed out or converted to any other taxable or nontaxable benefit.
 - Any unused amount in excess of \$500 (or a lower amount specified in the plan) that remains unused as of the end of the plan year (that is, at the end of the run-out period for the plan year) is forfeited.
- Any unused amount remaining in an employee's health FSA as of termination of employment is also forfeited (unless, if applicable, the employee elects COBRA continuation coverage with respect to the health FSA).
 - The amount remaining unused as of the end of the plan year is the amount unused after medical expenses have been reimbursed at the end of the plan's run-out period for the plan year.
 - Unlike the grace period modification, the carryover of up to \$500 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.
 - The carryover of up to \$500 does not count against or otherwise affect the indexed \$2,500 salary reduction limit on employee contributions applicable to each plan year.
 - A plan adopting this carryover provision is not permitted to also provide a grace period with respect to health FSAs.
 - The uniform coverage rule, which requires that the maximum amount of reimbursement from the health FSA be available for claims incurred at all times during the period of coverage (regardless of the actual amount contributed by the employee to date), continues to apply to section 125 cafeteria plans adopting the carryover rule.

COORDINATION OF THE CARRYOVER RULE MAY BE TRICKY

Employers now have a new option for their health FSA plans, but how does it actually work? There is the prior plan year from which the unused amount is carried from. There is also the current/subsequent plan year to which the unused amount is carried over to. There is also a run-out period for the prior plan year. There are expenses incurred in the current plan year submitted in the current plan year. Finally, there are expenses incurred in the prior plan year that are submitted for reimbursement in the current plan year during the run-out period for the prior plan year.

Here is the key to understanding the coordination issues involved with the new carryover rule: The final amount remaining unused as of the end of the plan year is the amount unused after medical expenses have been reimbursed at the end of the plan's run-out period for the plan year.

Thus, for plans using the new carryover option, a participant's unused health FSA balance at the end of the prior plan year may be used:

- For expenses incurred in the prior plan year, but only if claimed during the plan's run-out period that begins at the end of the prior plan year (in effect retroactively reducing the unused amount as of the end of the prior plan year); or
- To the extent of any final, unused carryover amount (of up to \$500) from the prior plan year, for expenses that are incurred at any time in the current plan year.

In contrast, employee salary reduction amounts credited to a health FSA for the current plan year may be used only for expenses incurred in the current plan year (unless and to the extent that these current plan year amounts may later be carried over to the following plan year).

The bottom line on calculating the unused amount to be carried over from the prior plan year is that the actual, final unused amount will not be known until the end of the run-out period for the prior plan year (which takes place some three months into the current plan year). If any unused amounts from the prior plan year are used first to reimburse a current year expense, then such reimbursement:

- Reduces the amount available to pay prior plan year expenses during the run-out period for the prior year,
- Must be counted against the permitted carryover of up to \$500, and
- Cannot exceed the permitted carryover amount.

So, for ease of administration, the Notice provides that a section 125 cafeteria plan may treat reimbursements of all health FSA claims for expenses that are incurred in the current plan year as reimbursed:

- First from amounts elected/credited for the current plan year, and
- Second, only after exhausting these current plan year election amounts, from unused amounts carried over from the prior plan year.

WRITTEN PLAN AMENDMENT IS REQUIRED

To utilize the new carryover option, a section 125 cafeteria plan offering a health FSA must be amended in writing to adopt and describe the carryover provision.

In general, the plan amendment must be adopted on or before the last day of the plan year from which any unused amounts may be carried over. The amendment may be effective retroactively to the first day of that plan year, so long as:

- The employer informs participants of the carryover provision; and
- The section 125 cafeteria plan operates in accordance with the guidance under IRS Notice 2013-71.

Special amendment rule for plans years beginning in 2013. A plan may be amended to adopt the carryover provision for a plan year that begins in 2013 at any time on or before the last day of the plan year that begins in 2014.

EFFECTIVE DATE

Employers can begin using the new carryover rule right away -- for the current 2013 plan year (meaning that unused amounts from the 2013 plan year can be carried over to the 2014 plan year). An employer may adopt the carryover provision (of up to \$500) to health FSAs for the current section 125 cafeteria plan year (and/or subsequent section 125 cafeteria plan years) by amending its written section 125 cafeteria plan document as described in the section above.

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Please contact me if you have any questions.

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