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IRS Modifies the Health FSA "Use It or Lose It" Rule By Allowing Small Carryovers

On October 31, 2013, the Internal Revenue Service (**"IRS"**) issued guidance modifying the so-called "use it or lose it" rule for health flexible spending accounts (**"Health FSAs"**). The timing of this new guidance (Notice 2013-71) – on Halloween – was actually fitting, as it is difficult for some to determine whether the IRS changes to Health FSAs are best characterized as a trick or a treat.

By way of background, Health FSAs allow employees to set aside up to $2,500 of their salary on a pre-tax basis and then use those funds to pay for certain medical expenses. There are two critical limitations on Health FSAs:

(1) **"Uniform Coverage Rule."** The entire annual amount elected by an employee must be fully available from the start of the year, even though the full amount will not yet have been withheld from the employee's compensation; and

(2) **"Use It or Lose It Rule."** The total amount elected by an employee must be used to pay medical expenses incurred during the plan year (including any grace period that may be available under the plan) or the unused portion is forfeited.

The new IRS rule, however, allows employers to amend their Health FSA to permit up to $500 of any unused amounts in an employee's Health FSA to be carried over into the next plan year.

Although the latest IRS guidance may seem relatively straightforward, it is actually deceptively complicated. As this Alert explains, there are pros and cons to the carryover rule, and employers need to consider their specific circumstances carefully before deciding whether to allow carryovers in their plans. What follows is an explanation of the new carryover rule and some of the key considerations associated with it.

Q-1: Exactly what does the new IRS guidance allow in terms of Health FSA carryovers?

A-1: The new IRS guidance permits an employer to amend its plan to allow an employee to carry over to the next plan year up to $500 of unused funds in the employee's Health FSA. Under the current Health FSA rules, these funds would be forfeited if not used by the end of the applicable time period. The new carryover rule, however, authorizes employers to allow a portion of these unused funds (up to $500) to be used to reimburse expenses *incurred* in the next plan year. In contrast to the grace period rule (discussed below), the new carryover rule does not put an expiration date on the carryover money. In other words, the unused funds that are carried over to the next plan year are available for the entire duration of the next plan year, not just the grace period.

Q-2: Remind me, how does the current "grace period" rule work?

A-2: An employer may, but is not required to, offer a "grace period" as part of the Health FSA arrangement under its plan. A "grace period" is a period of up to 2½ months that immediately follows the end of a plan year during which a participant may use any amounts remaining in his/her Health FSA from the prior plan year to pay for qualifying medical expenses that were incurred during that 2½ month time period.

Q-3: What is the difference between a "grace period" and a "run-out period"?

A-3: A "run-out period" is a period of time (usually 2-3 months) immediately following the end of a plan year during which a participant may submit claims for reimbursement of expenses incurred for qualifying medical expenses during the prior plan year. Any new expenses incurred during the run-out period count for the new (i.e., current) plan year, not the prior plan year. By contrast, a participant may incur *new* expenses during the "grace period," and those expenses can apply to the limit for the *prior* plan year.

For example, assume a participant has elected to defer $2,500 into his Health FSA in the 2014 plan year. At the end of 2014, he had only used $2,300 of the $2,500 he set aside in the Health FSA. If the plan has a grace period, the participant could incur up to $200 in qualifying medical expenses during the first 2½ months of 2015 and submit those claims to count towards the 2014 limit. If, on the other hand, the plan only had a run-out period (and not a grace period), and that run-out period runs through March 15, 2015, any claims for reimbursement that the participant submitted during the run-out period would have to have been incurred no later than December 31, 2014.

Q-4: Can a Health FSA allow carryovers *and* have a grace period?

A-4: No. The carryover rule is *in lieu of* the grace period. Employers thus must choose between following the new carryover rule, having a grace period, or not having any special rule (other than a run-out period).

Q-5: Do carryover funds affect the $2,500 annual contribution limit for Health FSAs?

A-5: No. Under federal health care reform, the maximum amount that an individual can contribute to a Health FSA is $2,500 per year (adjusted for inflation). Carryovers are not taken into account when calculating this amount. For example, if a participant carries over $500 from 2014 to 2015, the participant can still contribute $2,500 in new money for 2015. The result is that a participant in that scenario would have up to a total of $3,000 available for reimbursement out of his/her Health FSA for the 2015 plan year.

Q-6: Can an employer allow carryovers of less than $500?

A-6: Yes. Under the IRS guidance, the maximum amount that can be carried over is $500, but a plan that allows carryovers can cap them at a lower amount.

Q-7: Will employees benefit more from the carryover rule than from the grace period?

A-7: It depends. On the one hand, the carryover rule gives employees an extra year (or more) to spend unused amounts, whereas the grace period rule only gives an employee an extra 2½ months. On the other hand, the carryover rule limits the amount that can be carried over to $500, whereas the grace period is not subject to any dollar limit. This distinction is best illustrated with some examples.

> *Example 1.* Sally is a participant in a calendar year Health FSA. She has $2,500 in her Health FSA, and she plans to use those funds to pay for Lasik eye surgery in December 2014. However, because of a scheduling issue, her surgery has to be postponed until January 2015. If her plan has a grace period, Sally's entire $2,500 balance from 2014 is still available to reimburse her expenses for the January 2015 surgery. But if the plan instead adopts the carryover rule, Sally can only keep $500 of her 2014 money, and she forfeits the remaining $2,000. In this example, the grace period is clearly more favorable to Sally.
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> *Example 2.* Assume the same facts, except Sally has only $400 left in her account at the end of 2014. In this scenario, if the plan has a grace period, Sally must spend the remaining $400 by the end of the grace period on March 15, 2015. However, if the plan uses the carryover rule, the $400 amount remains available for all of 2015.

In general, the carryover rule is best for participants who have less than $500 left in their Health FSA at the end of the plan year. To the extent that a participant has more than $500 left over in his/her account, the grace period may be preferable.

Q-8: Do carryover funds "expire"?

A-8: Technically speaking, the answer is no. The key point, though, is that no more than $500 can be carried over from one plan year to another. In other words, carryovers cannot be accumulated to allow for more than a total of $500 to be carried over from one year to the next.

> *Example.* Claude carries over $500 from the 2014 plan year into 2015, and makes a $2,500 Health FSA election for 2015, giving him a total of $3,000 in Health FSA funds available for reimbursement in 2015. During the 2015 plan year, Claude receives $2,300 in Health FSA reimbursements. Only $500 of the remaining $700 in unused money may be carried forward into the 2016 plan year.

Incidentally, it may be possible for an employer to amend its plan to include an expiration date for carryover amounts, but without further guidance from the IRS, it's not clear yet.

Q-9: Does the carryover rule have any effect on an employee's eligibility to contribute to a Health Savings Account?

A-9: Yes, it does. While the IRS did not directly address the issue in its recent guidance, it would appear that employees with Health FSA carryovers will <u>not</u> be eligible to contribute to a Health Savings Account (**"HSA"**). The reason is that, because the carryover funds will be available to the participant for the entire plan year, the Health FSA would constitute a "disqualifying plan" that would prevent the participant from contributing to an HSA. It is possible that the IRS will issue additional guidance to allow participants to maintain a so-called "limited purpose health FSA" (which may be used for reimbursing only very limited medical expenses) while taking advantage of this carryover rule, but no such guidance has come out yet.

A similar issue exists under the grace period rule, but only until the end of the grace period. In other words, if a participant has leftover Health FSA funds during the grace period, he/she cannot contribute to an HSA until the end of that grace period. Once the grace period expires, though, the participant can then contribute to an

HSA up to the full annual HSA limit for that year (assuming the participant remains a participant in his/her employer's plan for the remainder of the year). In contrast, if the plan instead allows carryovers, and the participant has carryover funds, the participant would appear to be ineligible for HSA contributions for the entire year. The IRS may issue clarifying guidance on this in the future.

Q-10: How can an employer add the carryover provision to its Health FSA?

A-10: If an employer wishes to add a carryover feature to its Health FSA, it must amend its plan document. The deadline for adopting such an amendment is the last day of the plan year from which amounts may be carried over. For example, if an employer with a calendar year plan wants to offer this carryover feature for the first time in 2015 (so that leftover funds in a participant's Health FSA from 2014 can be carried over to 2015), the plan document must be amended no later than December 31, 2014. There is also a one-time special transition rule allowing for a plan to be amended to adopt the carryover feature for a plan year that begins in 2013. That amendment can be made at any time on or before the last day of the plan year that begins in 2014. So, for example, an employer with a calendar year plan that wanted to allow its employees to carry over unused Health FSA funds from 2013 into 2014 could adopt its plan amendment as late as December 31, 2014.

Q-11: If a plan has a grace period and wants to switch to a carryover rule, what must it do?

A-11: As noted above, if a plan has a grace period, the plan document will need to be amended to remove the grace period *prior* to the plan year to which unused Health FSA funds may be carried over (since plans cannot have both a grace period and a carryover feature). This could make for tight timing. For example, if an employer with a calendar year plan wants to make the carryover feature available immediately so that certain unused funds from 2013 can be carried over to 2014, that employer would have to amend its plan to eliminate any grace period no later than <u>December 31, 2013</u>.

The fact that a plan had a grace period in the year prior to the year in which the Health FSA funds are being carried over is okay. For example, assume that a calendar year plan wants to have a carryover feature in the 2015 plan year (allowing up to $500 in Health FSA funds that remain from the 2014 plan year to be carried over to 2015). The plan could not have a grace period in 2015, but it would be permitted to have a grace period during the first 2½ months of 2014. The plan would simply have to be amended by December 31, 2014 to eliminate the grace period feature.

Bear in mind that eliminating a grace period at the end of a plan year may not be too popular with some employees and could even potentially expose the employer to litigation. After all, employees with Health FSA balances over $500 in plans with grace periods may have set the money aside for expenses like orthodontia or Lasik eye surgery to be used early the next year. Those employees will be none too happy if their employer amends the plan at the last minute to eliminate the grace period and instead adopt a carryover feature that allows only $500 to be carried over into the next year.

Q-12: Will carryovers affect the cost of plan administration?

A-12: It's possible. Many employers use forfeitures to help pay the costs associated with administering the Health FSA arrangement, including fees to third party administrators. Allowing carryovers may reduce the amount of forfeitures, which in turn could leave less money available to pay for plan administration. It is also possible that administering a Health FSA that allows carryovers will be more costly and difficult for claims administrators, who will, in turn, charge higher fees for their services.

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Q-13: Should an employer amend its plan now to adopt the new carryover rule?

A-13: This is a tricky issue because there are a lot of unanswered questions arising out of the IRS guidance. We do not yet know, for example, exactly how the carryover rule will impact HSA contribution rights. Nor do we know the effect of the Health FSA carryover feature on COBRA rules. It's also unclear how third-party administrators are going to implement this new feature and what kind of prices they are going to charge for doing so. It appears that the IRS drafted the new guidance in haste and, while there will assuredly be additional regulatory guidance in the future, there is no indication when the guidance will come.

Having said all that, for Health FSA arrangements that do *not* currently have a grace period, the carryover rule may be a good fit. Employers should check with their third-party administrator to determine the cost of administering this new feature, taking into account such issues as how much of a decline there may be in participant forfeitures and what impact, if any, that will have on the employer's Health FSA operating costs.

If, on the other hand, your Health FSA *does* have a grace period, the analysis is more complicated. As noted above, eliminating that grace period for the 2013 plan year could be unwise. Many employees may have certain expectations about using the funds in their Health FSA during the grace period, and yanking the rug out from underneath them at the eleventh hour is bound to lead to problems. So employers with grace periods in their plans are probably better off taking a wait-and-see approach before making any changes. The deadline for allowing carryovers into the 2015 plan year is not until December 31, 2014, so there would be plenty of time.

Furthermore, as mentioned earlier, regardless of whether your Health FSA arrangement currently has a grace period, it is important to consider the implications of the carryover rule on HSA eligibility. Many employers are going through open enrollment right now, or are about to do so. If you offer a high-deductible health plan (**"HDHP"**) in tandem with HSA contributions, adopting the carryover rule for your Health FSA could significantly affect your employees' ability to switch (or at least interest in switching) to the HDHP/HSA option, because an employee with Health FSA carryovers will almost certainly be ineligible for HSA contributions for the entire year. This may weigh in favor of waiting until next year before adding carryovers to your Health FSA.

Concluding Thoughts

The new carryover rule was unexpected, especially this late in the year. It is also far more complicated than it first appears. Whether to adopt the carryover rule now, wait a year, or stick with a grace period, is not an easy decision and will involve many different considerations.

Whatever you end up doing, clear communication with your employees is going to be more critical than ever. The carryover feature can bring both advantages and disadvantages to employees, and it's essential that they understand the implications it will have, not only on their Health FSA, but also on their other employer-sponsored welfare benefits.

If you have any questions about the new Health FSA carryover rule, or would like help in evaluating your options, please feel free to call Eric Namee, Steven Smith, or Brad Schlozman at (316) 267-2000.

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