

ALERT

**Employee Benefits &
Employment Law**

HINKLE

L A W F I R M L L C

hinklaw.com 316.267.2000

JUNE 19, 2020

IRS INCREASES “CARRYOVER” LIMIT FOR HEALTH FSAs

If you offer a Health Flexible Spending Account (“Health FSA”) to your employees, you are probably already familiar with the rules that apply, including the following:

- (1) Participants must make an election during open enrollment as to how much, if anything, they will contribute to their Health FSA.
- (2) They can’t elect more than the dollar limit established by Congress. As adjusted for inflation, that limit is currently \$2,750.
- (3) The money in their Health FSA cannot be used except to reimburse them for otherwise unreimbursed medical expenses.
- (4) If the amount they contribute for a given plan year is more than the amount of the unreimbursed medical expenses they incurred during that same plan year, the amount in their Health FSA that is left at the end of the plan year must be forfeited, unless an exception applies.

The last of these four rules is commonly known as the “use it or lose it” rule. It is not an optional rule. It is specifically required under Internal Revenue Service Regulations.

Problems with the Use It or Lose It Rule

The “use it or lose it” rule can sometimes put an individual participant into a difficult position. If the amount left in a participant’s Health FSA near the end of a plan year is not all that large, he/she might be able use that amount by stocking up on something like contact lenses, to use an example that is probably fairly common in the real world. Using up money that would otherwise be forfeited in this way is not something the IRS has ever encouraged, but it is something many participants did and probably still do.

Wichita Office

1617 North Waterfront Parkway, Suite 400 ▪ Wichita, Kansas 67206-6639 ▪ 316.267.2000 ▪ Fax 316.630.8466

Kansas City Office

Lenexa City Center – Penn I ▪ 8711 Penrose Lane, Suite 400 ▪ Lenexa, Kansas 66219 ▪ 913.345.9205 ▪ Fax 913.345.4832

But participants could find themselves in a much more difficult position if, for example, they had put money into their Health FSA with the expectation that their child would need to be getting braces before the end of the year, but the orthodontist had subsequently decided that the child was not quite ready for braces.

Two Exceptions - Employers Can Use One or the Other But Not Both

At one time, there weren't any exceptions to the Health FSA's use it or lose it rule. Claims for a given year could be submitted for reimbursement after that year had ended, but the claims themselves had to be *incurred* before the end of the year.

Over time, however, the IRS has recognized two different exceptions to the "use it or lose it" rule. Employers are not required to use either of these exceptions, but, in our experience, most do. Employers that do use an exception must decide which of these two exceptions they want to use. They can use one exception or the other, but they are not permitted to use both.

Exception #1 - 2-1/2 Month "Grace Period"

The IRS announced the first exception in 2005. Under this exception, a Health FSA can provide a "grace period" at the end of a plan year for the unused amounts, if any, in a participant's account. Those unused amounts may then be used to reimburse the participant for claims incurred by the participant after the end of the previous plan year but before the end of the grace period. The grace period is limited to 2-1/2 months, but the amount that may be reimbursed during the grace period out of funds remaining from the previous year is not limited.

Exception #2 - \$500 "Carryover"

The IRS announced the second exception in 2013. Instead of providing a 2-1/2 month grace period, a Health FSA may allow unused amounts remaining in a participant's account as of the end of a plan year to be "carried over" into the participant's account for the new plan year. The amount that is carried over would then be available to the participant for the entire new plan year and not just for the first 2-1/2 months of the new plan year (assuming, of course, that the participant otherwise remained eligible to participate in the Health FSA during the new plan year). However, until last month, the amount that could be carried over was limited to \$500.

Changes to Exception #2

Last month, the IRS announced a change to the \$500 limit for the second exception. In brief, since the \$500 carryover limit represented 20% of the original dollar limit for making contributions to a Health FSA before that limit was increased for inflation, the IRS determined that it was appropriate to do the following:

- (1) Re-set the carryover limit to 20% of the adjusted contribution limit, which causes that limit to become \$550; and
- (2) Going forward, automatically re-set the carryover limit to 20% of the adjusted contribution limit whenever the contribution limit is adjusted for inflation.

Plan Amendment Required

Importantly, the application of the new carryover limit is not automatic. For it to be used, the plan document for the Health FSA will need to be amended.

Effective Date

Although it is possible to adopt an amendment that will apply to amounts that are left over at the end of the current plan year, it may be simpler for many employers if an amendment is drafted to apply for the first time to amounts that will be left over at the end of the next plan year.

Why? Because of the burdensome notice requirements the IRS imposed in connection with this change:

- (1) If an amendment is adopted before the first day of the first plan year to which that amendment will apply, your enrollment materials and forms and your Summary Plan Description will need to reflect the increased limit, but there are no other special notice requirements.
- (2) If, however, an amendment is adopted after the first day of the first plan year to which it will apply – in other words, if the amendment will apply to amounts that will be left over at the end of the current plan year – the IRS requires that the employer must communicate the change not just to current plan participants, but to “all employees eligible to participate in the plan.”

For some employers, communicating the change to “all employees” who are eligible to participate in the Health FSA, regardless of their actual participation, may not be that hard. But for other employers, communicating this type of change can be quite the ordeal.

So, if it is going to be difficult for you to communicate this change to all of your employees who are “eligible to participate” in your Health FSA, it will be simpler if you approach this change in the following way:

- (1) Adopt an amendment to the plan document for your Health FSA before the end of the current plan year, but specify in the amendment that the increased carryover limit will not apply until the next plan year;
- (2) Communicate the availability of the increased limit for amounts remaining at the end of the next plan year to your eligible employees when you are going through your next open enrollment. For newly eligible employees, this can be communicated when they are offered the opportunity to enroll in anticipation of becoming eligible or shortly after they have become eligible; and
- (3) Continue to apply the existing \$500 carryover limit to amounts that are remaining at the end of the current plan year.

Finally, if we prepare plan documents for you and you would like for us to amend your plan so that the maximum carryover amount will be established administratively each year, please let us know. This will avoid the need to amend the plan each time the IRS announces a change in the maximum carryover limit.

We hope this information is helpful. If you have any questions, please do not hesitate to call the Employee Benefits and Employment Law team at Hinkle Law Firm at (316) 267-2000.

Employee Benefits

[Eric Namee](#)

[Steven Smith](#)

[Brad Schlozman](#)

[Ruhe Rutter](#)

Employment Law

[Jim Spencer](#)

[Eric Barth](#)