
IRS Relaxes Use-or-Lose Rule for Health FSAs

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On October 31, 2013, the Internal Revenue Service (“IRS”) issued guidance relaxing the Use-or-Lose Rule applicable to Health FSAs under employers’ cafeteria plans. Now an employer may amend its cafeteria plan to permit plan participants with unused Health FSA balances remaining at the end of a Plan Year to carry over up to \$500 to reimburse qualified medical expenses incurred in the next Plan Year. Employers with calendar-year plans that want to adopt this carryover provision for unused Health FSA balances remaining at the end of 2013 will need to act quickly. Suggested steps for evaluating and implementing the new rules are provided below. Also, the Notice clarifies the scope of IRS regulations issued earlier this year permitting mid-year election changes under cafeteria plans with non-calendar year Plan Years.

Background: Key Terms

Health FSA: A “flexible spending arrangement” permits an eligible participant to elect, before the beginning of each Plan Year, to have up to \$2,500 (as indexed) automatically deducted in equal amounts from his or her pay over the course of the Plan Year. The maximum reimbursement amount elected by the participant (minus any prior reimbursements) is available to reimburse the participant for qualified medical expenses incurred during the Plan Year. Salary deductions are made on a pre-tax basis, and medical expense reimbursements under a Health FSA are generally nontaxable. A Health FSA is part of a “cafeteria plan” and must satisfy the requirements of section 125 of the Internal Revenue Code.

Use-or-Lose Rule: Unused amounts remaining in a Health FSA at the end of a Plan Year must be forfeited. That is, if the participant’s Health FSA deductions exceed his or her reimbursements for the Plan Year, the tax laws require that the unused excess be forfeited.

Run-Out Period: During a limited period at the beginning of a Plan Year, a participant may receive Health FSA reimbursements for qualified expenses incurred in the prior Plan Year, up to the participant’s unused Health FSA deductions for that year. The Run-Out Period is optional – whether the Health FSA offers this feature is up to the sponsoring employer.

Grace Period: An exception to the Use-or-Lose Rule. A Health FSA may permit a participant to receive, from unused Health FSA deductions from the prior Plan Year, reimbursements for expenses incurred through the first two months and 15 days of the current Plan Year. The Grace Period is optional – whether the Health FSA offers this feature is up to the sponsoring employer.

Plan Year: The 12-month period designated by the Health FSA as its plan year. For instance, if the calendar year is designated, the Plan Year would span January 1 - December 31.

The Carryover Rule: An Alternative Exception to the Use-or Lose Rule

On October 31, 2013, the IRS issued Notice 2013-71, permitting a Health FSA to offer a new carryover feature. Like the Grace Period, the carryover rule is an exception to the Use-or-Lose Rule. Following are highlights of the IRS's guidance:

- **Optional feature:** The carryover rule is optional. The employer may decide to offer -- or not offer -- the feature under its Health FSA.
- **\$500 maximum:** Under the rule, up to \$500 of a participant's unused Health FSA deductions from a Plan Year may be carried over to the next Plan Year. Amounts carried over to a Plan Year will not count against the Health FSA's deduction limit for that Plan Year. For instance, if a Health FSA has a \$2,500 annual limit for 2015, a participant with \$500 in unused Health FSA amounts carried over from 2014 to 2015 could still elect to contribute up to \$2,500 for 2015, in which case the participant would have \$3,000 (\$2,500 plus the \$500 carried over) available for reimbursement of medical expenses in 2015.
- **Administration of carryover:** For ease of administration, if a participant with carryovers from the prior Plan Year incurs reimbursable expenses during the current Plan Year (including during the Run-Out Period), the reimbursements may be treated as paid first from the participant's Health FSA deductions for the current Plan Year and then, when the current Plan Year deductions are exhausted, from the prior Plan Year's carryovers.
- **Run-Out Period pairing permitted:** The carryover rule does not affect a Health FSA's ability to offer a Run-Out Period. A Health FSA may offer either feature, or both.
- **No pairing with Grace Period:** A Health FSA may not offer both the carryover rule and the Grace Period. Thus an employer may choose to offer either feature under its Health FSA, but not both.
- **Amendment required for carryover:** To implement the carryover rule, an employer must adopt an amendment to the Health FSA component of its cafeteria plan. To permit carryovers of Health FSA deductions made in a Plan Year beginning in 2013, the amendment must be adopted by the last day of the Plan Year beginning in 2014. For amendments first effective in a Plan Year beginning after 2013, the adoption deadline is the last day of the Plan Year from which amounts may be carried over.

Employers now effectively have three options for addressing the Use-or-Lose Rule: (i) adopt the carryover rule, (ii) use the Grace Period rule, or (iii) not allow either the carryover rule or Grace Period.

Suggested Action Items for Employers

In light of the new carryover rule, employers with Health FSAs may wish to do the following:

- Evaluate whether to adopt the carryover. Generally, the carryover rule would have the effect of reducing employees' Health FSA forfeitures. On the other hand, implementing the rule would increase the employer's costs of operating the Health FSA. Amplifying this effect, after terminating from employment,

employees could elect COBRA coverage in order to reach their remaining carryover funds if any. Thus, before adopting the carryover, employers may want to evaluate the likely cost impact.

The following items apply only if the employer decides to adopt the carryover rule:

- Amend the cafeteria plan document to add the carryover rule. (The applicable deadline for the amendment is discussed above.)
- Eliminate any Grace Period. If the Health FSA offers a Grace Period, the amendment adding the carryover should simultaneously eliminate the Grace Period. Before implementing the carryover for the current Plan Year, employers should evaluate how many employees will likely have unused Health FSA balances over \$500 at the end of the Plan Year. If the Grace Period is eliminated, those employees will forfeit any unused Health FSA amounts in excess of \$500 (or such lower limit as the employer may decide to implement).
- Notify employees. The employer should update all relevant employee communications to reflect the carryover rule, including enrollment materials for the Health FSA, the cafeteria plan's SPD, COBRA forms, and other relevant communications. Further, if the rule is implemented mid-Plan Year (e.g., in November for a Plan Year ending December 31), the employer should inform affected employees as soon as possible about the change and its effect on Health FSA deductions for the Plan Year.
- Update administrative procedures. Employers that self-administer their Health FSAs will need to update their systems to reflect the rule. For instance, if the Health FSA has a Run-Out Period and the carryover rule is adopted, the systems must be reprogrammed to reflect the administration of claims submitted during the Run-Out Period (e.g., whether such claims will be treated as reimbursed from current-year Health FSA contributions or from amounts carried over from the prior Plan Year, as discussed above). If an outside vendor administers the Health FSA, the employer should coordinate the changes with the vendor.

Transition Rule Permitting Mid-Year Election Changes Under Non-Calendar Year Cafeteria Plans

Earlier this year, the IRS issued proposed regulations affecting employers that offer group health coverage through a cafeteria plan with a non-calendar Plan Year (i.e., a Plan Year that begins on a date other than January 1). The regulations are intended to reconcile rules governing the timing of elections under the cafeteria plan with provisions of the Affordable Care Act that become effective January 1, 2014, specifically, the individual mandate and the healthcare exchanges.

Under the proposed regulations, an employer may – for a non-calendar Plan Year beginning in 2013 – permit participating employees to make the following mid-year changes to their elections under the cafeteria plan, regardless of whether the employees have a “change in status” event:

- If the employee previously elected group-health coverage for the Plan Year, he or she may make a one-time election to prospectively drop or change the coverage.
- If the employee did not previously elect group-health coverage under the plan for the Plan Year, he or she may prospectively enroll in that coverage.

To permit these changes, the employer must amend the plan by December 31, 2014. Notice 2013-71 clarifies that the amendment may be more restrictive than the changes authorized by the proposed regulations, but not less restrictive. For instance, the amendment may permit a one-time election to drop or change coverage, but only during a limited period (e.g., the first month of 2014 only, rather than the entire Plan Year as permitted by the regulations).

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