

November 6, 2013

IRS Allows Health FSA Carryovers

The Internal Revenue Service (IRS) recently issued [Notice 2013-71](#) which modifies the longstanding “use-or-lose” rule for health flexible spending arrangements (FSAs). For the first time, at the plan sponsor’s option, employees participating in health FSAs will be allowed to carry over up to \$500 of unused amounts remaining at year-end.

General Health FSA Rules. Many employers sponsor a health FSA to allow employees to be reimbursed on a tax-favored basis for certain medical expenses that are not covered by the employer’s health plan. Health FSAs may be offered in conjunction with other employer-provided benefits as part of a section 125 cafeteria plan. They are commonly funded by employees through voluntary salary reduction contributions, and employers may also contribute. Contributions to an FSA can not be included in the employee’s income, and reimbursements from an FSA that are used to pay qualified medical expenses are not taxed. Generally, employees decide before the beginning of the plan year how much money they want to contribute to the FSA. Throughout the year, they can draw from this account for qualified medical expenses that are not covered by their employer’s health plan. This can include copays, deductibles, and various medical services and products – from dental and vision care to eyeglasses and hearing aids.

Use-or-Lose Rule. For the past 30 years, health FSAs have been subject to a “use-or-lose” rule, meaning that any funds left unused at the end of the year are forfeited. One exception, under a special [grace period rule](#), permits plans to allow employees to use amounts remaining from the previous year to pay expenses incurred for certain qualified benefits during the period of up to 2-1/2 months immediately following the end of the plan year. Also, beginning in 2013, a plan must limit each employee’s salary reduction contributions to the health FSA to no more than \$2,500 per plan year (as indexed for cost-of-living adjustments).

Modification of the Rule. In response to requests for additional flexibility with respect to the operation of the use-or-lose rule, the IRS has now modified the rule to allow employees to use up to \$500 of unused health FSA amounts in the next year, instead of forfeiting the unused amounts. Plan sponsors of health FSAs now have the choice of either allowing employees a carryover of up to \$500, or allowing them a grace period of up to 2-1/2 months (though employers are not required to allow either). A health FSA cannot, however, have both a carryover and a grace period. See the recently released [Fact Sheet](#) and [News Release](#).

Employer Plan Design Choices. Effective immediately, an employer sponsoring a health FSA

can do one of the following as a matter of plan design:

1. maintain a traditional health FSA with no carryover or grace period feature,
2. adopt or continue a grace period feature, or
3. adopt a carryover feature.

No action is needed for an employer that chooses either (1) to continue to maintain a traditional health FSA with no carryover or grace period feature, or (2) to continue to maintain a grace period feature. The remainder of this Update addresses considerations and next steps for an employer that chooses to adopt a carryover feature.

Employers Adopting a Carryover Feature. Considerations and next steps for an employer adopting a carryover feature are as follows:

- If a plan sponsor adopts the carryover, it cannot also provide a grace period.
- The plan sponsor should determine the amount of the carryover and the same carryover limit must apply to all plan participants. The plan can allow a carryover into the following plan year of up to \$500 of unused health FSA funds (the plan sponsor can choose to set a lower maximum amount of carryover).
- The plan must inform participants of the carryover provision. Once the decision has been made to allow the carryover, a communication should be provided to participants as soon as possible in order to give them time to plan for expenses.
- The plan can still have a run-out period following the plan year during which plan participants can submit (and be reimbursed for) expenses from the prior plan year. The amount that is to be carried over for a participant is determined after all expenses have been reimbursed for that plan year after the end of the plan's run-out period.
- The \$2,500 limit on health FSA salary reduction contributions also still applies, as well as the uniform coverage rule requiring that the maximum amount of health FSA reimbursement be available throughout the plan year (minus reimbursements). So for a given plan year, a health FSA participant can have up to \$3,000 available in his/her health FSA to reimburse health expenses, plus amounts that the plan sponsor contributes during the plan year (if any). For example, if a plan participant has \$500 of carryover and elects \$2,500 of salary reduction for the plan year, the plan must make the full \$3,000 available for reimbursements at the beginning of the plan year. The uniform coverage rule may cause amounts to be incurred and claims to be submitted for the next plan year before the carryover amount for the first plan year is determined.

Example: Employer sponsors a health FSA with a calendar plan year and an annual run-out period from 1/1 to 3/31. Participants can elect a salary reduction amount (not to exceed \$2,500) for the year and the plan is timely amended to provide for a \$500 carryover. The plan does not provide for a grace period and the plan also does not provide for non-elective employer flex credits. In November 2014, Pat elects a salary reduction amount of \$2,500 for 2015. By 12/31/14, Pat's unused amount from the 2014 plan year is \$800. On 2/1/15, Pat submits claims and is reimbursed with respect to \$350 of expenses incurred during the 2014 plan year, leaving a carryover on 3/31/15 (the end of the run-out period) of \$450 (\$800 - \$350) of unused health FSA amounts from 2014. The \$450 amount is not forfeited; instead, it is carried over to 2015 and available to pay claims incurred in that year so that \$2,950 (that is, \$2,500 + \$450) is available to pay claims incurred in 2015. Pat incurs and submits claims for expenses of \$2,700 during the month of July 2015, and does not submit any other claims during 2015. Pat is reimbursed with respect to the \$2,700

claim, leaving \$250 as a potential unused amount from 2015 (depending upon whether Pat submits claims during the 2015 run-out period in early 2016). See [Notice 2013-71](#) for more examples.

Plan Amendment Required for Carryover. Before an employer may permit an employee to carry forward any unused health FSA contribution into the next plan year, it must first amend its plan to allow for the carryover as well as amend the plan to remove any existing grace period feature (if applicable). A special transition rule permits an employer interested in applying this change for the 2013 plan to amend its plan to add the carryover feature anytime on or before the last day of the plan year that begins in 2014. Details of the plan amendment requirement are as follows:

- The plan sponsor must amend SPDs, plan documents, and enrollment materials to address the carryover feature.
- If a plan sponsor wishes to allow carryover of 2013 plan year amounts, it must adopt a plan amendment accordingly on or before the last day of the plan year that begins in 2014 (for example, a calendar year plan can allow carryover of unused 2013 health FSA funds into 2014 as long as it adopts a plan amendment by 12/31/14).
- *Special rule for employers offering health FSAs containing a grace period and electing to allow a carryover:*
 - The sponsor must amend the plan to eliminate the grace period by no later than the end of the plan year from which amounts may be carried over. For example, a calendar year plan can allow carryover of unused 2013 health FSA funds into 2014 as long as it adopts a plan amendment to allow the carryover by 12/31/14, but the plan must be amended to eliminate any grace period by 12/31/13.
 - The plan should inform participants of the elimination of the plan's grace period.
 - Note that participants with year-end balances greater than \$500 may benefit from a grace period feature that contains no cap but has a shorter duration for incurring and submitting claims, while participants with year-end balances of \$500 or less may benefit from a carryover feature having a longer duration to submit and incur claims.
- A plan sponsor can delay adopting the carryover until future plan years, provided that for all years after 2013, the plan sponsor adopts the plan amendment to allow the carryover before the last day of the plan year from which amounts are carried over, retroactive to the first day of that plan year. The plan sponsor also must amend the plan to eliminate any grace period by no later than the end of the plan year from which amounts may be carried over.

Special Consideration for HSAs: Employers that offer high-deductible health plans (HDHPs) with health savings account (HSA) features will need to assess how the grace period and carryover features affect an individual's eligibility to make and receive HSA contributions. The IRS guidance did not address this issue.

- Individuals who are covered by traditional, general-purpose health FSAs (GPHFSAs) or health reimbursement arrangements (HRAs) are not eligible for HSA contributions. A participant with a GPHFSA that contains a grace period, and who has a year-end balance, is ineligible for HSA contributions until the first calendar month after the grace period ends (e.g., 4/1/14, in the case of a 1/1/13 – 3/15/14 plan year, including grace period). The same is true for the participant's spouse, if the spouse's medical expenses are eligible for reimbursement from the GPHFSA. It is likely that IRS rules regarding eligibility for HSA contributions will apply to the new carryover feature as well. Thus, if a participant is

covered under a GPHFSA with a carryover feature, and amounts are remaining in the GPHFSA at the end of the plan year, the individual will be ineligible to make HSA contributions for the following plan year during which he or she is eligible to access carryover amounts. Further guidance from the IRS on this issue would be welcome.

- The impact of the new carryover rule on limited-purpose health FSAs (LPHFSA) and HRAs (limited to reimbursement for dental, vision and post-deductible expenses) was also not addressed in the guidance. Under prior IRS guidance, individuals covered by LPHFSAs and HRAs are eligible to make HSA contributions. Thus, if it is permissible for an employer that sponsors a LPHFSA and/or HRA to adopt a carryover feature, presumably participants who have LPHFSAs and HRAs with such features should be eligible to make HSA contributions while covered under such arrangements.

Health FSA sponsors will need to consider this new guidance and decide whether adding a new carryover feature would be desirable. While the new guidance offers welcome flexibility, implementing either the carryover or the grace period feature can be administratively challenging as well as difficult to communicate. There also remain some unanswered questions, such as how this impacts eligibility to make HSA contributions.

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