PALEY ROTHMAN
ATTORNEYS AT LAW

Health Flexible Spending “Use or Lose” Rule Amended

By Arnold Sherman

On October 31, 2013 in Notice 2013-71 the IRS announced a modification to the “use or lose” rule for Health Flexible Spending Arrangements (Health FSAs).

Health FSAs permit employers to reimburse employees for health care expenses, such as deductibles and co-pays. In general, these plans are funded by employees through salary reduction agreements. Historically, if an employee did not use the entire amount in his or her account during the plan year, the employee lost the unused amount. In 2005, however, the IRS modified the “use or lose” rule by providing an optional grace period that allows Health FSAs to permit qualified health care expenses incurred in the first 75 days of the *following* plan year to be treated as incurred during the *previous* plan year. Any funds remaining at the end of the grace period were forfeited to by the employee.

The Affordable Care Act of 2010 set the maximum amount that may be contributed to a Health FSA at $2,500 (indexed for inflation after 2013). The Act does not prevent cafeteria plan sponsors from setting the annual contribution cap at an amount lower than the $2,500 maximum.

Under the recently issued Notice 2013-71, the IRS modified the “use or lose” rule to allow plan sponsors to permit participants to carryover up to $500 of unused amounts to the next plan year. (Prior to this modification, any amount not used at the end of a year would be forfeited to the employer.) 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 amount carried over does not count against or otherwise affect the next year’s indexed $2,500 salary reduction limit, and any unused amount in excess of $500 is forfeited. Notice 2013-71 emphasized that the plan sponsor may specify a lower amount as the permissible maximum carryover, or can decide not to allow any carryover at all.

Why the change? The IRS adjusted the “use or lose” rule in response to its 2012 request for comments on whether the rule should be modified in conjunction with the $2,500 limit. Among the reasons cited were the difficulty in predicting future needs for medical expenses, the desirability of minimizing incentives for unnecessary spending at the end of a plan year or grace period, the possibility that lower- and moderately-paid employees are more reluctant than others to participate because of an aversion to even modest forfeitures of their salary reduction contributions and the opportunity to ease and potentially simplify the administration of Health FSAs.

To implement this new carryover option, a plan sponsor must adopt a written plan amendment providing for the carryover on or before the last day of the plan year from which amounts may be carried over. The amendment may be effective retroactively to the first day of that plan year, so long as the plan operates in accordance with the guidance in Notice 2013-17 and informs participants of the adoption of the carryover provision. The Notice further provides that 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.

A Health FSA that adopts a carryover provision may not also provide for a grace period in the plan year to which unused amounts may be carried over to the following year. Accordingly, if a plan has provided for a grace period and is being amended to add a carryover provision, the plan must also be revised to eliminate the grace period provision.

For ease of administration, a Health FSA plan may treat reimbursements of all claims for expenses that are incurred as reimbursed first from the current plan year and, only after exhausting these current plan year amounts, as then reimbursed from unused amounts carried over from the preceding plan year. Any unused amounts from the previous plan year that are used to reimburse a current year expense (a) reduce the amounts available to pay prior plan year expenses during the run-out period, (b) must be counted against the permitted carryover of up to $500 and (c) cannot exceed the permitted carryover.

So, as we’ve outlined here, sponsors of Health FSAs now have three options - provide a grace period, allow a carryover or neither. Each has its own advantages and disadvantages. Plan sponsors should review each option carefully and determine which works best for their employees before making a final decision.

 | 4800 Hampden Lane, 6th Floor, Bethesda, MD 20814-2930 | 301-656-7603 | 301-654-7354 fax www.paleyrothman.com