

IRS Changes Health FSA "Use-or-Lose" Rule; Clarifies Transition Relief for 2013-14

November 11, 2013

On October 31, 2013, the Internal Revenue Service (IRS) released Notice 2013-71 (Notice), which modifies the "use or lose" rule for health flexible spending accounts (health FSAs) to allow a \$500 annual carryover of unused contributions, provided that the cafeteria plan offering the health FSA does not incorporate the "grace period" rule. The Notice also clarifies the ongoing application of prior IRS transition relief for non-calendar year cafeteria plans that provides these plans flexibility on allowing employees to make changes in cafeteria plan elections.

As to the "use-or-lose" rule, the Notice is intended to encourage employees to participate in health FSAs by watering down the strict "use-or-lose" rule familiar to health FSA participants, and reduce unnecessary spending at the end of the year to avoid forfeiture of contributions. As discussed below, effective immediately, employers may amend their health FSAs to allow an annual carryover of up to \$500. Employers wishing to adopt the carryover provision for the 2013 plan year must amend their cafeteria plans by the end of the 2014 plan year (e.g., by December 31, 2014 for calendar year plans). The Notice does not extend the carryover provisions to dependent care FSAs.

Background

In general, a cafeteria plan may not provide for the deferral of compensation from one year to the next (e.g., a pre-tax contribution made in one year may not be used to purchase a benefit that will be provided in a subsequent year). With respect to health FSAs, this concept manifests in the form of the so-called "use-or-lose" rule, which requires that contributions not used by the end of the plan year (or any applicable "grace period") be forfeited. In 2005, the IRS modified the "use-or-lose" rule to permit cafeteria plans to allow up to a 2½-month grace period, during which employees could continue to be reimbursed for qualified medical expenses incurred during the "grace period" with funds remaining from the prior plan year.

The Affordable Care Act (ACA) also changed the rules for health FSAs, including limiting elective employee contributions to health FSAs to \$2,500 per plan year starting in 2013, as indexed for inflation (prior to the ACA, there was no federal limit on health FSA contributions). In light of the ACA's limit on health FSAs, the IRS has concluded that it is appropriate to offer additional administrative relief beyond that provided by the grace period rule. Thus, the Notice modifies the "use-or-lose" rule applicable to health FSAs to permit an annual carryover of up to \$500.

\$500 Carryover Permitted

The Notice permits, but does not require, an employer to amend its Internal Revenue Code Section 125 cafeteria plan to allow for a carryover of up to \$500 of any amount remaining unused at the end of a health FSA's plan year. The carryover does not count against or otherwise affect the indexed \$2,500 salary reduction limit applicable to each plan year. Employers may specify a carryover limit lower than \$500 or decline to permit any carryover at all. An employer adopting the carryover must amend its cafeteria plan to remove any grace period that applies to the health FSA by the end of the plan year from which amounts will be carried over (e.g., before the start of the first plan year in which the carryover will be available).

The carryover amount may be used to pay claims incurred during the entire plan year to which it is carried over. Amounts remaining at the end of the plan year that are available for carryover are net of reimbursements made during the plan's run-out period (the period of time following the end of the plan year during which claims incurred during that plan year may continue to be submitted for reimbursement). Any unused amounts relating to a health FSA may not be cashed out or converted to any other taxable or nontaxable benefit. Any unused amount in excess of \$500 remaining at the end of the plan year (after adjustments for run-out claims) is forfeited.

Employers may continue to use run-out periods following the end of a plan year; however, amounts reimbursed during the run-out period effectively will reduce the amount available for carryover (e.g., if there is \$700 available at the end of the 2013 plan year and an employee submits \$500 in claims during the run-out period that were incurred in 2013, the amount available for carryover after the run-out period is \$200). Importantly, the Notice clarifies that the carryover amount does not have to be spent in the year following the year for which it was created. That is, once the carryover amount is established for a year, it could remain available for an indefinite number of future years as illustrated by the following examples.

Example 1:

An employer offers a health FSA on a calendar year basis with an annual run-out period from January 1–March 31 in which participants can submit claims incurred during the prior year. The plan has a \$2,500 annual limit and has been amended to adopt the \$500 carryover; therefore there is no grace period.

- Unused amount in employee's health FSA on December 31, 2013: \$800
- Employee's 2014 health FSA election: \$2,500
- Employee submits a claim for \$350 in March 2014 that was incurred in 2013
 - Employee's unused amount is reduced to \$450 (\$800-\$350)
- If no other claims are submitted by March 31, 2014: \$450 carries over to 2014
- Employee has \$2,950 available for claims incurred in 2014
- Employee submits a claim for \$2,700 incurred July 15, 2014
- Plan pays the claim (\$2,500 from 2014, plus \$200 from the 2013 unused amount)
 - Employee's unused amount is now reduced to \$250 (\$450-\$200)
- If no other claims are incurred in 2014: \$250 carries over to 2015

Example 2:

Same facts as above. This example illustrates the carryover rules when an employee incurs claims in 2013 but waits to submit them until after being reimbursed for claims incurred in 2014.

- Unused amount in employee's health FSA on December 31, 2013: \$800

- Employee's 2014 health FSA election: \$2,500
- Employee submits a claim for \$2,700 incurred January 15, 2014
- Plan pays the claim (\$2,500 from 2014, plus \$200 from the 2013 unused amount)
 - Employee's unused amount is reduced to \$600 (\$800-\$200)
- Employee submits a claim for \$350 in March 2014 that was incurred in 2013
 - Employee's unused amount is reduced to \$250 (\$600-\$350)
- If no other claims are submitted by March 31, 2014: \$250 carries over to 2014
- If no other claims are incurred in 2014: \$250 carries over to 2015

Plan Amendment Required; Grace Period Must Be Removed

To utilize the new carryover option, a cafeteria plan offering a health FSA must be amended on or before the last day of the plan year from which amounts may be carried over. The amendment may be made retroactively to the first day of that plan year, provided that the employer informs participants of the carryover provision. Special relief for 2013 permits a cafeteria plan to 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 (e.g., by December 31, 2014 for calendar year cafeteria plans).

The Notice prohibits cafeteria plans from incorporating both a carryover provision and a grace period. For example, a plan permitting a carryover to 2014 of unused 2013 health FSA amounts would not be permitted to have a grace period in 2014, but would be permitted to have had a grace period during the first 2½ months of 2013. The grace period also must be eliminated by the end of the plan year from which amounts may be carried over.

The Notice does not appear to permit retroactive amendment of a plan to remove a grace period. Therefore, it appears that an employer wishing to add a carryover option for 2013 will need to amend its cafeteria plan by the end of the 2013 plan year to remove the grace period.

Clarification of Transition Rule on Changes to Cafeteria Plan Elections

In the preamble to the proposed ACA employer mandate "pay or play" regulations, the IRS provided transition relief for non-calendar year cafeteria plans. That relief recognized the fact that employees generally would not be able to make or change pre-tax salary reductions under non-calendar year plans to (a) enroll in an employer's group health plan coverage effective January 1, 2014 to comply with the ACA's "individual mandate" or (b) drop employer-sponsored group health plan coverage and enroll in coverage through an Exchange effective January 1, 2014. Subsequent to that relief, the IRS extended the deadline by which individuals had to enroll in coverage when they were in non-calendar year cafeteria plans. The IRS also provided relief from the individual mandate so that enrollment in coverage is not required until March 31, 2014.

Accordingly, the IRS permits an employer, at its election, to amend its cafeteria plan to allow employees to make either or both of the following changes in salary reduction elections, whether or not the employee experienced a change-in-status event:

1. An employee who made an election for accident and health plan coverage with a non-calendar plan year beginning in 2013 may prospectively revoke or change his or her election with respect to the accident and health plan once during that plan year; and
2. An employee who failed to enroll in accident and health plan coverage with a non-calendar plan year at the start of the 2013 plan year may make a prospective election to enroll in such coverage once during the 2013 plan year.

Note that it does not appear that changes to health or dependent care FSA elections are permitted as part of this transition relief.

The Notice clarifies that although cafeteria plan transition relief appeared to be available only to employers subject to the "play or pay" mandate (generally those with 50 or more full-time equivalent employees) it is in fact available to employers of any size. Employers allowing changes to salary reduction elections in accordance with the transition relief are free to adopt an amendment that is more limited than the two options described above. For example, the plan may require that changes made without a change in status event must be made within a certain time frame (e.g., during the first month of the 2014 plan year). A cafeteria plan amendment made in connection with this transition relief may be made retroactively; however, it must be made by December 31, 2014, and be effective retroactively to the date of the first day of the 2013 plan year of the cafeteria plan.

Other Considerations

The Notice does not clearly address the many issues that could arise when applying COBRA to health FSAs. The Notice merely provides that "unused amounts" (the term used in the Notice for carryover balances) are forfeited upon termination of employment, unless the employee elects COBRA. Nothing in the Notice explains what happens if an employee (or other qualified beneficiary) elects COBRA coverage under a health FSA that includes a carryover provision.

As a general rule, a typical health FSA does not have to offer COBRA coverage to any qualified beneficiary beyond the end of the year in which a qualifying event occurs. In addition, COBRA coverage does not have to be offered at all to a specific qualified beneficiary if, at the time of the qualifying event, the health FSA is "overspent" as to the qualified beneficiary. An "overspent" situation occurs if the amount to be paid for the remainder of the plan year exceeds the amount that could be reimbursed for the rest of the year.

One question that arises with respect to carryover amounts is whether a COBRA qualified beneficiary can benefit from a carryover amount. Based on IRS guidance related to the health FSA grace period rules, an argument could be made that if a COBRA qualified beneficiary continued COBRA coverage under the health FSA through the end of the plan year, the qualified beneficiary could benefit from the carryover of \$500 to be used in the following year without having to pay any additional COBRA premium after the end of the year in which the qualifying event occurred. Without any further guidance, it is not clear whether this argument would prevail. Moreover, it is not clear whether the carryover could continue for future years even if it applies during the year after the qualifying event (as it otherwise continues for similarly situated non-COBRA beneficiaries, such as active employees).

A more troubling issue arises if an active employee with a carryover balance decides not to elect anything for a future year and retains a right to the carryover balance. To illustrate the problem, assume an employee with no health FSA election in place terminates employment when the employee can benefit from a \$500 carryover amount. It is not clear whether that terminated employee could (a) continue the use of the \$500 carryover or (b) elect COBRA coverage in order to use the \$500 carryover. Neither of these alternatives is addressed in the Notice and the resolution of this issue will require additional IRS guidance.

Employers adopting the carryover provision into their cafeteria plans also should consider the impact on employees' eligibility for health saving accounts (HSA). The Notice is silent on the issue; however, it appears that employees' (and spouses') HSA eligibility could be disrupted if amounts carry over from year to year. Employers may want to consider adding the ability to terminate participation in the health FSA at the end of the plan year (i.e., an opt-out) along with the carryover provision, in case an employee wishes to enroll in an HSA-eligible high-deductible health plan.

Finally, it is worth noting that recent Internal Revenue Service (IRS) and Department of Labor (DOL) guidance (Notice 2013-54 and Technical Release 2013-03, respectively) essentially requires all health FSAs to be offered as part of a cafeteria plan in order to avoid the ACA's prohibition on annual dollar limits, and also to be "excepted benefits" under HIPAA in order to be exempt from the ACA's preventive care requirements. For a health FSA to be HIPAA-excepted, an employer must: (1) offer non-HIPAA-excepted group health plan coverage to all employees eligible for the health FSA; and (2) limit the amount available for reimbursement to the greater of \$500 or two times the employee's salary reduction election. This effectively prevents employers from offering health FSA coverage to any employee who is not eligible for the employer's major medical group health plan. It also effectively limits any employee's health FSA balance to a maximum of \$5,500 (prior to indexing): \$2,500 in elective employee contributions, \$2,500 in employer contributions, and \$500 as a carryover.

Action Steps for Employers

- Employers that would like to incorporate the carryover for the 2013 plan year have some time to amend their cafeteria plans (they may do so by the end of the 2014 plan year); however, if the plan has a grace period, an amendment to eliminate the

grace period is required by the end of the 2013 plan year.

- **CAUTION:** Employers should review employees' health FSA balances and consult with counsel before adopting the carryover provision for 2013, particularly for calendar year health FSAs with grace periods, as it is close to the end of the plan year and employees already may have planned to use amounts in excess of the \$500 carryover during the grace period.
- Consider whether to require a minimum balance (e.g., \$25) for carryovers.
- Employers adopting the carryover provision should notify employees of the carryover, including its impact on HSA eligibility, and consider whether to add an opt-out feature so that employees may terminate their participation in the health FSA at the end of any plan year. The opt-out would be similar to the opt-out feature now required to be included in health reimbursement arrangements (HRA) as part of the IRS and DOL guidance mentioned above.
- Employers with non-calendar year plans should consider whether to amend their cafeteria plans for the transition relief from the change in status rules, and whether to add additional restrictions or limitations on election changes.

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