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Guidance Permits Carryover of Up to \$500 of Unused Health FSA Balances

On October 31, IRS and Treasury issued new guidance (Notice 2013-71) that modifies the “use or lose” rule that applies to health flexible spending arrangements (“FSAs”). Under the guidance, employers may now allow employees to carry over up to \$500 of unused FSA balances to the next plan year. The Notice permits employers to adopt the carryover provision as early as the current 2013 plan year. The Notice also clarifies the transition relief provided in earlier proposed regulations so that employers of all sizes can permit certain changes in salary reduction elections for their non-calendar year cafeteria plans.

Background

Under the IRS’ proposed regulations under Code section 125, unused FSA balances at the end of a plan year cannot be used to reimburse expenses in the next plan year and must be forfeited. This “use or lose” rule was intended as a means of meeting the requirement under Code section 125 that a cafeteria plan not provide for deferred compensation. An employer may, however, adopt a run-out period immediately following the end of the plan year in which the employee may submit claims for reimbursements incurred during the plan year.

In 2005, the IRS relaxed the use-or-lose rule and permitted employers to provide a grace period of up to 2 months and 15 days following the end of the plan year in which participants could continue to incur expenses and received reimbursements for those expenses from the unused amounts in the FSA at the end of the plan year. An employer adopting a grace period was also permitted to provide a run-out period after the end of the grace period.

Prior to the Affordable Care Act (“ACA”), there was no statutory limit on the amount of FSA salary reduction contributions that an employee could elect, although many employers imposed limits in the plan. The ACA limited the amount of salary reduction elections to an FSA to \$2,500 per taxable year.¹ In earlier guidance (Notice 2012-40), the IRS recognized that the potential for using FSAs to defer compensation was restricted with the application of the limits on FSA salary reduction elections and requested comments on whether it should modify the use-or-lose rule. <http://www.groom.com/resources-675.html>. The new Notice states that the IRS received an overwhelming majority of comments that favored modification of the use-or-lose rule. As a result, the IRS has adopted the new carryover rule.

Groom note: The \$2,500 limit applies for cafeteria plan years beginning after December 31, 2012. As a reminder, employers must amend their cafeteria plans offering health FSAs to provide for the \$2,500 limit (or other lower limit the employer chooses) by December 31, 2014.

¹ The \$2,500 is indexed for the cost of living for years after 2013 – the IRS recently issued guidance that keeps the limit at \$2,500 for 2014.

Below is a summary of the key takeaways from the Notice.

Carryover of Unused FSA Balances

- *Permitted Carryover* – The Notice permits an employer to allow an employee to carryover up to \$500 of any unused amount remaining in the FSA after the end of the run-out period to the next plan year. The carryover does not reduce the permitted \$2,500 salary reduction election limit in the next plan year, and thus, an employee with a carryover may still choose salary reduction elections for the next plan year of up to \$2,500 (or other lower limit provided for in the plan). If the employer decides to allow a carryover, the same carryover limit must apply to all participants.
- *Permitted Reimbursements* – Consistent with the general cafeteria plan rules, the amount carried over may only be used to pay or reimburse permitted medical expenses. The carryover amounts may be used to reimburse expenses during the run-out period that were incurred during the previous plan year or may be used to reimburse expenses incurred in the current plan year. The salary reduction election in the current plan year, however, may only be used to reimburse expenses in the current plan year (unless carried over to the next plan year) and may not be used to reimburse expenses for the prior plan year during the run-out period. The Notice provides that for ease of administration, a plan is permitted (but not required) to treat reimbursements of all claims for expenses incurred in the current plan year as reimbursed first from the amounts credited from the current plan year and then as reimbursed from carried over amounts.

Although the Notice modifies the long-standing “use or lose” requirement, the universal coverage rule – the maximum amount of reimbursement must be available at all times during the period of coverage – is still required for FSAs.

- *Removal of the Grace Period* – Significantly, the Notice provides that a plan that adopts the carryover provision may not also provide a grace period for the FSA. Thus, an FSA may either provide for the carryover or provide for a grace period, but cannot provide for both.
- *Informing Participants* – The employer must inform participants of the carryover provision. Employers that adopt the carryover provision for the 2013 plan year should inform participants of both the new carryover feature and the removal of the grace period as soon as possible.

Cafeteria Plan Amendment

- *Timing of Amendment* – An employer has until the last day of the plan year from which amounts may be carried over to amend its cafeteria plan to adopt the new carryover option, and the amendment may be retroactive to the first day of that plan year. (But see Grace Period Amendment rules below for the deadline if the current plan has a grace period.)
- *Special Rule for 2013 Plan Years* – Recognizing that for many plans, employers would only have a few months to amend their cafeteria plans for the 2013 plan year, the Notice contains a special rule for the 2013 plan year that permits an employer to amend its cafeteria plan 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. For a calendar year plan, this means that an employer could amend its cafeteria plan as late as December 31, 2014 to adopt a carryover from the 2013 plan year to the 2014 plan year.
- *Grace Period Amendment* – An employer adopting the carryover must also amend its cafeteria plan to remove the grace period no later than the end of the plan year from which amounts may be carried over.

This means that an employer with a calendar year cafeteria plan that provides a grace period that wishes to adopt the carryover for the 2013 plan year should amend its cafeteria plan to eliminate the grace period and provide for the carryover before the end of the 2013 plan year.

The removal of the grace period could raise issues for employers that want to adopt the carryover for the 2013 plan year because many employees rely on the extra 2 ½ months to incur expenses. These employers should weigh the benefits of the carryover against the benefits of the grace period – e.g., employees may prefer the carryover to having to spend remaining FSA amounts during the grace period. As noted by the IRS, we caution that there could be other non-Code legal restraints that limit an employer’s ability to eliminate a grace period for the current plan year. For example, there may be ERISA issues or there could be a separate contractual obligation not to change the terms of the plan during the plan year. Thus, it may be more practicable for some employers to wait to amend their plans until the 2014 plan year.

FSA and HSAs

The ability for an employer to provide for a carryover and also permit employees newly eligible for a health saving account (“HSA”) to contribute to the HSA is uncertain. Generally, an individual who is covered by a general purpose FSA may not make contributions to an HSA. However, an individual may be covered under certain types of FSAs, such as a limited purpose FSA that pays or reimburses expenses only for preventive care and certain “permitted coverage” or a post-deductible FSA that pays or reimburses preventive care and other permitted medical expenses only if incurred after the minimum annual deductible for the high deductible health plan is satisfied.

We have asked the Treasury and IRS for additional guidance to outline how an FSA rollover would impact eligibility for an HSA. We discussed informally whether an employer may amend its cafeteria plan to provide that amounts remaining in participants’ FSAs who want to participate in the employer’s HSA program the next year may be carried over to a limited-purpose or post-deductible FSA. The IRS staff agreed that the amount could be carried over to an HSA-compatible FSA and reminded us that the FSA plan could provide that a participant who wanted to be eligible for an HSA in the following year could also opt out of the carryover.

Cafeteria Plan Salary Reduction Election Transition Rule

Generally, cafeteria plan elections must be made before the start of the plan year and are irrevocable during the plan year unless the employee or his/her spouse or dependents experience certain changes in status. The availability of health coverage through an Exchange is not a permitted change in status, and thus, employees generally cannot change their salary reduction elections for health coverage to cease salary reductions and purchase coverage through an Exchange. Similarly, employees generally cannot elect to begin salary reduction elections mid-year to purchase the employer’s health coverage and avoid the individual mandate penalty. This is a concern for non-calendar year cafeteria plans because individuals can begin purchasing Exchange coverage effective January 1, 2014 and the individual mandate penalty applies beginning in January 2014.

In the preamble to the Code section 4980H proposed regulations, which apply to applicable large employers (those who employ on average 50 or more full-time and full-time equivalent employees during the previous calendar year), the IRS provided transition relief from the cafeteria plan election rules for an employer-provided accident and health plan with a non-calendar year plan year that begins in 2013. Under this transition relief, an employer can amend its cafeteria plan to permit employees to make the following changes in salary reduction elections, even if the employee did not experience a change in status event: (1) if the employee elected to salary reduce for accident and health plan coverage, prospectively revoke or change his/her election with respect to the accident and health plan once during that plan year; and (2) if the employee failed to make a salary reduction election, make a prospective salary reduction election for accident and health coverage on or after the first day of the 2013 plan year.

The Notice clarifies that this transition relief is available to all employers and is not limited to applicable large employers. The Notice also clarifies that employers may adopt amendments that are more restrictive than the two options in the transition relief, but the amendment may not be less restrictive. For example, the employer may limit the period that the employee can make the salary reduction election change to a certain time period, such as the first month in 2014, instead of during the entire 2013 – 2014 plan year.

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