IRS MODIFIES “USE IT OR LOSE IT” RULE FOR HEALTH FLEXIBLE SPENDING ARRANGEMENTS

The Internal Revenue Service (IRS) recently issued guidance modifying the longstanding “use it or lose it” rule for health flexible spending arrangements (health FSAs). Under the notice, employers that sponsor health FSA plans may elect to permit employees to carry over a maximum of $500 of unused amounts into the following year, instead of forfeiting such amounts with no opportunity to cash out or convert such funds for use under another employee benefit program.

The guidance should be welcome news to both employers and employees. The new carryover option, if adopted, should minimize the tendency of employees to spend down health FSA account balances on unnecessary expenses before forfeitures occur, possibly increase participation in the employer health FSA by lower-paid and moderately paid employees who would otherwise be reluctant to participate in a health FSA because of aversion to even modest forfeitures of their salary, and provide an opportunity to ease and simplify the administration of health FSAs.

Background

Health FSAs allow employees to set aside wages from their paychecks to pay for qualified medical expenses that are not otherwise covered by insurance. Employees can contribute up to $2,500¹ without having income and payroll taxes apply to a health FSA account, but if such amounts are not used, they are forfeited. This rule, known as the “use it or lose it rule,” was modified in 2005 by the “grace period rule.” The grace period rule permits employers to allow employees to use amounts remaining in a health FSA for up to 2 ½ months following the end of the plan year (generally, March 15) and forfeit any remaining amounts not used to pay for qualifying medical expenses after the grace period.

New IRS Guidance

The notice provides that health FSAs can (1) allow participants to carry over up to $500 of unused funds following a plan year, (2) use the grace period rule, or (3) use neither the carryover option nor the grace period rule. Accordingly, a health FSA cannot provide for both the grace period rule and the $500 carryover of unused funds.

The notice is effective immediately, so employers could amend their plans for the 2013 plan year to take advantage of the $500 carryover option; however, given the late timing in the plan year, it may not be administratively practical to amend for 2013. If the $500 carryover option is used, then the following rules also apply:

1. Carryover amounts do not count against (or otherwise reduce) the amount that an employee can contribute to a health FSA in the next year.
2. Medical expenses that were incurred during the plan year, but were submitted for reimbursement after the end of the plan year, will not be counted towards the $500 maximum carryover amount.
3. No more than $500 can be carried forward from one year to the next, which means that carryover amounts cannot accumulate.
4. Although not mentioned in the notice, an employer’s adoption of the carryover option likely does not constitute a “change in status” event that would otherwise permit an employee to change his or her health FSA election.

Action Items

1. If an employer wants to use the $500 carryover option and the health FSA does not use the grace period rule, the $500 carryover option may be applied retroactively to the first day of a plan year pursuant to a plan amendment. The employer should give employees notice of the carryover terms and the amendment must be adopted before the end of the plan year.
2. Employers adopting the $500 carryover option will want to follow up with their health FSA vendor to determine how and when the vendor can accommodate implementing the carryover option.
3. To the extent necessary, employers adopting the $500 carryover option may need to adjust their payroll and/or human resources administration to ensure proper implementation of the carryover.

¹IRS Notice 2013-71 (the notice).
²In 2013 and 2014, the maximum amount that can be set aside in a health FSA is $2,500, indexed for IRS cost-of-living adjustments in future years. Please keep in mind that employers can voluntarily elect to set the annual contribution and carryover caps lower than the IRS maximums of $2,500 and $500, respectively.
Not address how the new carryover rule carryover funds available. The notice also did not mention in the notice, we anticipate that participants who have a limited-purpose health FSA with a carryover option would be eligible to make HSA contributions.

For More Information

For practical and cost-effective assistance navigating through the notice and other laws, regulations, and IRS guidance that govern health FSAs and HSAs, please contact any member of the employee benefits and compensation practice of Wilson Sonsini Goodrich & Rosati.

Coordination with Health Savings Accounts

The notice does not modify the rules for coordination of general-purpose health FSAs with health savings accounts (HSAs). Individuals who are covered by general-purpose health FSAs are not eligible for HSA contributions. Under existing IRS guidance, a participant with a balance in a health FSA with a grace period is not eligible for HSA contributions until the first calendar month after the grace period ends. We anticipate that the IRS rules will similarly apply to the new carryover option, which would mean that if a participant is covered under a general-purpose health FSA with a carryover feature, then the participant will be ineligible to make HSA contributions until the first calendar month after he or she no longer has any carryover funds available. The notice also did not address how the new carryover rule applies to limited-purpose health FSAs (e.g., a health FSA limited to reimbursement for dental, vision, and post-deductible expenses). Participants covered by a limited-purpose health FSA are eligible to make HSA contributions under existing IRS guidance. Although not mentioned in the notice, we anticipate that participants who have a limited-purpose health FSA with a carryover option would be eligible to make HSA contributions.

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