EMPLOYEE BENEFITS

IRS ANNOUNCES MODIFICATION TO "USE-IT-OR-LOSE-IT" RULE FOR HEALTH CARE FLEXIBLE SPENDING ACCOUNTS
by Eric W. Gregory

On October 31, 2013, the Internal Revenue Service ("IRS") announced a modification to the "use-it-or-lose-it" rule that applies to health care Flexible Spending Arrangements ("FSAs") under a cafeteria plan. Under the use-it-or-lose-it rule, unused amounts in a participant's health care FSA for a plan year not used to pay eligible medical expenses incurred during the plan year were required to be forfeited to the employer, unless the employer adopted the 2 1/2 month grace period. The grace period rules permit participants to use amounts remaining from the prior year to pay eligible medical expenses incurred during the first two months and 15 days immediately following the end of the plan year (March 15 for a calendar year plan).

The New Carryover Provision

Under the new rule, an employer, at its option, may permit a participant to carryover to the immediately following plan year up to $500 in unused amounts from a health care FSA. This carryover may be used to pay or reimburse medical expenses under a health care FSA incurred during the entire plan year to which it is carried over. The rule also provides that:

- The carryover does not count against or otherwise affect the maximum payroll reduction limit for the plan year ($2,500 for 2014).
- Although the maximum unused amount allowed to be carried over to any plan year is $500, the plan may specify a lower amount.
- If a plan permits a carryover, the same dollar limit must apply to all plan participants.
- A plan that adopts the carryover provision is not permitted to provide the FSA grace period.
- The use of the carryover option does not affect the plan's ability to provide for the payment of expenses incurred in one plan year during a permitted "run-out" period at the beginning of the following year.
- A plan is not permitted to allow unused amounts related to an FSA to be cashed out to the participant or used for any other taxable or non-taxable benefit.
- A plan is permitted to treat reimbursements of all claims that are incurred in the current plan year as reimbursed first from unused amounts credited for the current plan year and, only after exhausting these amounts, as then reimbursed from unused amounts carried over from the previous year.
- Any carryover amount used to pay for eligible medical expenses in the current plan year will reduce the amounts available to pay claims during the run-out period from the prior plan year.

For example, Jane Smith participates in her employer's FSA with a calendar plan year, a run-out period from January 1 to March 31, an open enrollment in November for making salary reductions for the following year and the $500 carryover.

In November 2014, Jane elects a salary reduction of $2,500 for 2015. By December 31, 2014, she has $800 remaining from 2014. The plan may treat $500 of the unused $800 as available to pay 2015 expenses. Jane now has a total of $3,000 to spend in 2015. She is reimbursed for a $2,700 claim incurred in July 2015. The plan treats the first $2,500 as reimbursed with 2015 contributions, and the remaining $200 of the claim as reimbursed with unused 2014 contributions (leaving $300 for any further 2015 expenses). If she submits no further claims in 2015, the remaining $300 is carried over to 2016.

Assume these same facts, except that Jane's $2,700 expense is incurred and submitted in January 2015 (during the 2014 run-out period). Jane is reimbursed for the claim first from 2015 contributions ($2,500) and then from 2014 contributions ($200). Since this claim was incurred during the run-out period, the 2014 run-out amount is reduced to $600 ($800 – $200). If on February 1, 2015 Jane receives a medical bill from 2014 for $700 and submits the expense, the plan may only reimburse her for $600 of the total $700 claim. Jane continues to have $300 available for any 2015 expense, which may be carried over to 2016.

Next Steps

An employer that wants to implement the new carryover option must amend its cafeteria plan on or before the last day of the plan year from which amounts may be carried over and the amendment can be made effective retroactively to the first day of that plan year. For example, an employer can amend a calendar year plan on or before December 31, 2013 and have the carryover rule apply for 2013. The employer must notify participants of the new rule.

This increased flexibility will reduce a key barrier for many potential FSA users and may increase enrollment in FSA programs. Participants will no longer have to perfectly predict normally unpredictable health expenses a year in advance. Even though the carryover is limited to $500, the majority of forfeitures under the use-it-or-lose-it rule were less than $500.

Employers should carefully consider whether their employees would benefit from adopting the carryover rule instead of the grace period rule. The carryover rule is limited to $500 but permits the $500 to be used to pay for eligible expenses during the entire year into which it was carried over. In contrast, the grace period rule permits the entire amount of unused dollars in a health care FSA to be used but only to pay expenses incurred during the first 2 1/2 months of the next year.

Employers seeking to modify a 2013 plan that currently has a grace period should also carefully consider the ERISA implications of eliminating the availability of the grace period for 2013 contributions.

For your convenience, included is a link to IRS Notice 2013-71 and a Treasury Department fact sheet which explain the new modification.

If you have any questions about the FSA carryover rule, or any other employee benefits matter, please contact the author of this Alert, any member of the employee benefits practice team or your regular Dickinson Wright attorney for guidance and assistance.

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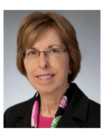

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