Management Alert

IRS Modifies Use-or-Lose Rule for Health Flexible Spending Arrangements

By Joy Sellstrom and Ajay Athavale

The Internal Revenue Service (IRS) recently issued Notice 2013-71 modifying the existing "use or lose rule" for health flexible spending arrangements (FSAs) available as part of a cafeteria plan maintained under Section 125 of the Internal Revenue Code (Code). Cafeteria plans may now be amended to allow up to $500 of unused FSA account balances to be carried over to the next plan year in order to pay for qualified expenses incurred in that subsequent plan year. The carryover option will apply at the discretion of the employer and is permitted only if the plan does not include the previously established grace period rule.

Background

An employee participating in a health FSA can elect a salary reduction of up to $2,500 per each plan year in order to pay for qualified medical expenses incurred in that plan year. (The $2,500 amount is adjusted for inflation, but the IRS recently issued Revenue Procedure 2013-35, which keeps the $2,500 limit for 2014.) Balances remaining in a health FSA at year end must be used by the end of the plan year (or grace period, if applicable) or forfeited. The IRS guidance refers to this as the "use-or-lose rule". Under the grace period rule, a plan may permit an employee to use account balances remaining at the end of the prior year to pay expenses incurred *during the 2 1/2 month period following the end of the plan year* (i.e. through March 15th for calendar year plans).

Notice 2013-71

The Notice provides an alternative to the grace period rule. An employer is now permitted to amend its plan to provide for a carryover of up to $500 a year of an unused account balance. The carryover amount may be used to pay or reimburse qualified medical expenses incurred *during the entire plan year* to which it is carried over. A plan adopting this carryover option may not, however, also provide a grace period. If an employer adopts a carryover, the same carryover limit must apply to all plan participants. In addition, carryover amounts may not be cashed-out or converted to any other benefit. Finally, any unused amount remaining as of termination of employment is forfeited, unless the employee elects COBRA continuation coverage.

Individuals who have a general purpose health FSA may not contribute to a health savings account (HSA) if they have a balance in their FSA at year end. Employers who also offer high deductible health plans with HSA contributions should make sure they consider the full impact on that plan design before adopting this new FSA carryover approach.

Required Plan Amendment

Employers should assess whether or not they want to implement the carryover rule going forward. Allowing for a carryover rule may help participants who often scramble to spend their account balances at the end of the year, but in order to implement a carryover option, the underlying cafeteria plan document must be properly amended. In addition participants must be notified of the change.

The Notice provides that a plan must be amended by the last day of the plan year from which amounts may be carried over. There is some relief, however, for plan years beginning in 2013. A plan may be amended to adopt the carryover provision for the 2013 plan year any time before the last day of the plan year that begins in 2014.

Joy Sellstrom and Ajay Athavale are members of the Employee Benefits and Executive Compensation Department. If you would like further information, please do not hesitate to contact your Seyfarth Shaw LLP attorney or any member of the Employee Benefits and Executive Compensation Department.