

## Publications

### *Labor and Employment Alert: Health FSA \$500 Carryover*

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**Summary:** The IRS has added a second exception to the use-or-lose rule for health flexible spending accounts (FSAs). Employers now have three alternatives for end-of-year health FSA credit balances:

1. allow carryovers of up to \$500 that can be used indefinitely
2. allow unlimited carryovers that can be used only during a 2½ month grace period
3. forfeit balances not used to pay medical expenses incurred during the year

### Health FSAs and the Use-or-Lose Rule

Health FSAs permit employees to pay medical expenses on a pre-tax basis. During open enrollment before the start of a year, an employee makes an election to reduce his or her pay by a specified amount (up to \$208.33 per month or \$2,500 for the year). The pre-tax salary reduction amount is then credited to the employee's health FSA. The employee can then submit claims for out-of-pocket medical expenses to be paid out of the credits.

One factor dampening employee participation in health FSAs has been the IRS' use-or-lose rule. The use-or-lose rule requires that, if an employee does not submit claims for out-of-pocket medical expenses incurred during the year equal to the FSA credit balance, the employee loses the unused credit balance.

### New Exception to the Use-or-Lose Rule

The IRS provided the first exception to the use-or-lose rule in 2005 when it permitted employers to offer a grace period of up to 2 ½ months (i.e., through March 15 for a calendar year health FSA) following the end of the year. Unused health FSA credits from the prior year could be used to pay medical claims incurred during the grace period. However, this optional design feature was not universally embraced. The grace period just postponed the day of reckoning. Health FSA credit balances not used for claims incurred during the year plus the

grace period were still forfeited.

In IRS [Notice 2013-71](#) (Oct. 31, 2013), the IRS created a second exception to the use-or-lose rule. Instead of the grace period, employers can offer a carryover of up to \$500 of unused health FSA dollars. The carryover is limited to \$500 per employee. The carryover does not reduce the maximum election for the following year. An employee with a \$500 carryover from year 1 could still elect a \$2,500 health FSA for year 2, making a \$3,000 health FSA credit balance available in Year 2. The carryover option is not available for dependent care FSAs.

How would this work? For example, let's say an employee makes a health FSA election of \$2,500 for a calendar year and only uses \$1,900 for medical expenses incurred during the year.

- **Grace period:** The employee could use the remaining \$600 for medical expenses incurred between January 1 and March 15. Any portion not applied to pay claims incurred between January 1 and March 15 would be forfeited.
- **Carryover:** The employee can carry over \$500. The remaining \$100 would still have to be forfeited. The \$500 could be used to pay medical claims incurred at any time during the following year – and could even be carried over into succeeding years.

The carryover cannot be coupled with the grace period. You can pick one (or neither) but you cannot have both a carryover and a grace period. Whichever option you choose, it must be applied uniformly to all participating employees.

## Timing

You are permitted to offer the carryover for current (2013) health FSA credit balances. That would however present administrative challenges. First and foremost, you will want to check with your health FSA third-party administrator to see when it will be prepared to administer carryovers. Second, you will have to communicate this significant change to employees. Third, your cafeteria plan document will need to be amended to allow for the carryover.

- **Special rule for employers allowing 2013 carryovers:** If you want to allow carryovers from the 2013 calendar year, you have until December 31, 2014 to amend your cafeteria plan document.
- **Employers first allowing carryovers in 2014 or later:** If you want to start allowing carryovers in a subsequent year (after 2013), your cafeteria plan document will need to be amended by the last day of the year from which you are allowing carryovers. For example, if you first allow carryovers from the 2014 year (i.e., a 2014 credit balance can be carried over to 2015), your cafeteria plan document would also have to be amended by December 31, 2014.

Note: If your health FSA program currently offers a grace period, please check with us on timing. To avoid reducing the rights of employees who might have planned on using their 2013 health FSA credit balances during the grace period, you may need to postpone the change until next year.

## Bottom Line

The carryover feature may provide assurance to employees who have up to now been hesitant to participate in your health FSA. With the addition of a carryover feature, a \$500 health FSA is practically a no-lose election for an employee. Of course, the flip side of the reduction of employee forfeiture of health FSA balances is that, if you have been relying on employee forfeitures to offset the cost of FSA administration, your expenses for FSA administration will increase.

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This alert is a summary and cannot include all details that may be relevant to your situation. As always, please contact us if you want more information on these developments or other employee benefits matters.