



SPECIAL Alert

In This Issue

In this sixth Special Alert for 2013, we review the recent IRS guidance permitting limited rollovers for health flexible spending accounts (FSAs). Employers have the option to add up to a \$500 rollover amount to health FSAs.

Employers should consider carefully whether the rollover makes sense for their organization. It will add administrative complexity. It may only add a limited value depending on current forfeiture activity. Employers need to consider if they may increase participation in a health FSA by limiting the impact of the “use it or lose it” rule.

We welcome your comments and suggestions regarding this issue of our Special Alert. For more information on this article, please contact your Account Manager or visit the McGrawWentworth web site at www.mcgrawwentworth.com.

“IRS Permits Health FSA Carryovers”

The IRS recently released Notice 2013-71, which allows employers to add a limited rollover (or “carryover”) provision to a health flexible spending account (FSA). A health FSA is an employer-sponsored account in which employees contribute pre-tax dollars to reimburse qualifying health-related expenses incurred during the plan year (or the plan year’s grace period, as applicable). Health FSAs are subject to a number of rules under Section 125 of the Internal Revenue Code (IRC), including the “use-or-lose” rule. This rule requires that any unused funds at the end of the plan year (and any grace period) be forfeited.

The new guidance relaxes the “use it or lose it” rule. Employers now have the **option** to amend their plans to allow participants to carry over up to \$500 in unused funds into the next plan year. **If a plan allows this carryover, however, it cannot also have a grace period.**

Key information on the new carryover provision includes:

- Employers have the **option** of amending their Section 125 plans to allow for a carryover of up to \$500. The employer can also

select a lower carryover maximum. Any monies carried over can be used to reimburse eligible health expenses incurred during the entire subsequent plan year.

- Amounts carried over do not offset the \$2,500 annual contribution limit.
- The same level of carryover must be applied to all plan participants. If an employer allows \$500 to be carried over into the following year, that \$500 limit must apply to all plan participants. For example, an



employer could not segregate a group of participants (e.g. hourly employees) and limit their carryover amount to \$300.

- The plan cannot allow an individual to cash out or convert any unused amounts in the health FSA. Please note that this is a current restriction for Section 125 plans, and not a change.
- Funds in the health FSA are forfeited at employment termination unless COBRA is elected.

The effective date for the carryover provision is not specified, but can be added for the 2014 plan year. An

employer may adopt the carryover at any time before the end of the 2013 plan year.

Plan Amendment Required

Section 125 requires all plans to have a plan document describing the plan and its rules. If an employer chooses to add the carryover, then the plan must be amended. In general, Section 125 requires all plan amendments to be prospective. An exception is made for this particular change.

The amendment must be made on or before the last day of the plan year from which amounts may be carried over. The amendment will retroactively apply the provision to the first day of that plan year. For example, assume an employer wants to add the carryover provision to the plan for 2014. The plan operates on a calendar-year basis. Therefore, the plan amendment must be made by December 31, 2014. The effective date can be retroactive. In this case, the change will be effective January 1, 2014. Although this is the timing for the formal plan amendment, the plan must advise participants of the carryover provision as soon as reasonably possible.

Plans with grace periods must be amended to eliminate the grace period. The same timing applies. The guidance notes that the retroactive elimination of the grace period is not an issue with Section 125, but there may be other legal constraints.

Carryover Provision Examples

The examples provided in the Notice give some indication of the potential administrative complexity created by the carryover provision. For example, how is the carryover amount determined when plans typi-

cally have time-sensitive claim filing requirements? (In the Notice, the IRS refers to this as the “run-out period.”)

FSA plans generally limit the time in which claims can be filed. For example, a calendar-year plan may allow reimbursements for eligible expenses incurred during a plan year to be submitted until the end of the following February. Assume an employee has \$1,000 remaining in the health FSA at the end of the calendar year, and the plan permits a \$500 carryover. Would the plan carry over \$500 and have the employee forfeit the remaining \$500? The employer needs to continue allowing claims to be submitted until the end of the plan’s run-out period. This employee submits \$600 in claims from the preceding plan year on January 15. The claims are then reimbursed from the health FSA. The employee now carries over the remaining \$400 and has not forfeited any money.

The timing in these situations can be problematic. You may have claims submitted for the current plan year before claims from the prior year are submitted during the run-out period. Employees should understand that any unused amounts from the previous plan year are permitted to be carried over and used against an expense incurred in the current year.

A Section 125 plan is permitted, however, to reimburse all claims for expenses incurred during the current plan year first from the current year’s health FSA, and then from any permitted carryover amounts.

Several examples in the guidance demonstrate how the carryover will work:

- **Example 1:** Employer A sponsors a health FSA that operates on a calendar-year basis. The plan requires claims from one plan year to be submitted by March 31 of the following year. The plan is amended to allow the \$500 carryover of unused health FSA funds. The plan allows up to \$500 remaining at the end of



the run-out period to be used for expenses incurred at any time during that plan year. The plan does not provide a grace period. Participant A, who elected a

health FSA for 2014, makes an annual election of \$2,500 for the health FSA in 2015. At the end of 2014, A has \$800 in unused health FSA funds. On February 1, 2015, A submits claims for \$350 of eligible expenses with 2014 dates of service. The plan reimburses those claims because they were submitted during the run-out period for 2014. The remaining \$450 is not forfeited, but instead carried over to the 2015 plan year. Therefore, A has \$2,950 in FSA funds available for claims incurred in the 2015 plan year. A incurs claims totaling \$2,700 in July 2015, and the FSA reimburses the entire amount. The remaining \$250 can be used on additional claims submitted during the plan year. If no additional claims are incurred, then the

\$250 can be carried over to the 2016 plan year. This arrangement satisfies the requirements of IRS Notice 2013-71.

- Example 2:** The same facts from Example 1, but with a different claims situation. A's \$2,700 claim is incurred and submitted in January 2015. In this situation, the first \$2,500 of the claim is reimbursable from the current year election. The additional \$200 can be reimbursed from the carryover amount. A submits \$350 in eligible claims with 2014 dates of service in February 2015. The \$350 can be reimbursed from the remaining \$600 available from the 2014 plan year (\$800 less the \$200 used for the January 2015 claim). A will still carry over \$250, which will be available for the remainder of the 2015 plan year.
- Example 3:** The same facts from Example 2, but with a different claims situation. A submits \$700 of expenses in February 2015 for claims with 2014 dates of service. However, the January 2015 claim for \$2,700 is still incurred and paid in January. In this case, the plan can reimburse no more than \$600 for the 2014 claims submitted in February. There was \$800 available at the end of 2014. However, \$200 was used for the January claim and only \$600 remains available. In this case, A has no additional health FSA dollars available for claims incurred in the 2015 plan year.



- Example 4:** The same facts from Example 1, except A only sets aside \$600 in the 2014 health FSA and does not use any of the funds for eligible claims incurred in 2014. A decides not to elect a health FSA for 2015. A does not submit any claims in 2015 during the run-out period for the 2014 plan year. At the end of the run-out period (March 31), A forfeits \$100 of the 2014 election because of the "use it or lose it" rule. The remaining \$500 can be carried over into the 2015 plan year. The plan reimburses A \$200 in claims in July 2015. At the end of 2015, A has a \$300 health FSA balance. A makes no health FSA election for 2016. A can have up to \$300 of eligible

medical expenses reimbursed under the FSA in 2016. This is permitted because the \$300 remaining in the account at the end

of 2015 is carried over into the 2016 plan year.

These examples give employers a sense of some of the complexity involved in offering the year-end carryover for a health FSA.

Employer Considerations for Adopting the Carryover

For many years, the IRS considered allowing a carryover for health flexible spending accounts. After the first statutory limit on health FSAs was applied in 2013, the IRS asked for feedback on modifying the "use it or lose it" rule. They then de-

ecided to change that rule for a number of reasons, including:

- Participants' difficulty in predicting their future needs for health-related expenditures;
- Minimizing unnecessary spending at the end of a plan year or the plan year's grace period;
- The possibility that some employees are reluctant to elect an FSA because they fear they may lose their contributions if they don't incur eligible expenses by the end of the plan year; and
- The opportunity to ease and potentially simplify the administration of health FSAs.

The IRS reasoning is sound. However, the availability of the carryover does not necessarily mean that employers will want to amend their plans. Employers should carefully consider the following:

- Does your plan anticipate significant forfeitures that may warrant the adoption of the carryover?
- Do you think some employees are not taking advantage of the health FSA because they are very concerned about the "use it or lose it" rule? Will these employees elect a medical FSA if the carryover provision is added?
- When will your vendor have the system capabilities to administer the carryover? Will the vendor charge an additional administrative fee if you decide to add the carryover to your plan?
- Is it necessary to add the carryover, or is your grace period providing enough extra time during the following plan year to minimize or eliminate forfeitures?

Adding a carryover provision could have significant consequences if an employer is considering launching a high-deductible health plan (HDHP) paired with a health savings account (HSA). The carryover provision could prohibit individuals from contributing to the HSA. This situation is not addressed in the guidance. However, **if** the IRS applies the same logic used with the grace period, here is how the issue would play out:

1. General purpose health FSAs are treated as comprehensive medical plans for HSA purposes. An individual with an HDHP and a general purpose health FSA is not eligible to contribute to an HSA because the FSA is deemed to be non-HDHP coverage.
2. If the plan includes the grace period, an individual could contribute to the HSA as of the first day of the next plan year if the funds in a health FSA were exhausted at the end of the prior plan year (and thus did not carry into the grace period).
3. If an individual has health FSA funds available to use in the grace period, then no contributions can be made to an HSA until the end of the grace

period. For a calendar-year plan with the maximum 2 ½ month grace period, the employee could not make an HSA contribution until April 1.

4. Carryover amounts in a general purpose health FSA may be treated the same way. If they are, they would block an individual from contributing to an HSA for the entire subsequent plan year. At a minimum, HSA contributions could not be made until the FSA carryover funds are exhausted. This guidance does not require an individual to enroll in the health FSA for the year in which funds are carried over, but the funds will carry over automatically and thus be available for use.



Employers contemplating offering HDHPs with HSAs should probably not adopt the carryover because of the problems it will likely cause with HSA contributions. At this point, the IRS has not clarified if they will modify their rules for these carryover situations.

Employers should take a thoughtful approach when considering the health FSA carryover provision. Just because the IRS will permit these carryovers does not mean that adding the provision will be the right fit for your plan. It will add administrative complexity. If you do not think it will increase participa-

tion, perhaps the grace period will provide enough of an extension to alleviate concern over the “use it or lose it” rule.

Please contact your McGraw Wentworth Account Manager with any questions. **MW**

Copyright McGraw Wentworth, a Marsh & McLennan Agency LLC company. Our publications are written and produced by McGraw Wentworth staff and are intended to inform our clients and friends on general information relating to employee benefit plans and related topics. They are based on general information at the time they are prepared. They should not be relied upon to provide either legal or tax advice. Before making a decision on whether or not to implement or participate in implementing any welfare, pension benefit, or other program, employers and others must consult with their benefits, tax and/or legal advisor for advice that is appropriate to their specific circumstances. This information cannot be used by any taxpayer to avoid tax penalties.

McGraw Wentworth

3331 West Big Beaver Road, Suite 200
Troy, MI 48084
Telephone: 248-822-8000 Fax: 248-822-4131
www.mcgrawwentworth.com

250 Monroe Ave. NW, Suite 400
Grand Rapids, MI 49503
Telephone: 616-717-5647 Fax: 248-822-1278
www.mcgrawwentworth.com

