Bernie Lowe & Associates, Inc.
"Beyond the Product"

Health Care Reform Update

IMPORTANT NOTICE REGARDING HEALTHCARE REFORM
Update 26 **November, 2013**

IRS Modifies the "Use it or Lose It" Rules for Flexible Spending Accounts

The IRS has announced new, long-requested relief from the "use it or lose it" rule that will allow health flexible spending account (FSA) participants to carry over up to $500 of unused contributions to the next plan year if this feature is adopted by the plan sponsor. Note that an FSA cannot have both a carryover and a grace period, which means many plan sponsors will need to make a difficult decision as to which feature is best suited for their plan. The timing of the rule also poses problems if a plan sponsor wants to implement changes for the current 2013 plan year to allow carryovers to the 2014 plan year.

Current rule and grace period exception
The current rule requires that unspent contributions in an FSA at the end of a plan year be forfeited. In 2005, the IRS created the "grace period" exception that allows any unused amounts to be spent down during the 2-1/2 months following the plan year. Under the Health Care Reform law, health FSAs are limited to $2,500 per year. In light of the new limit, the IRS announced in 2012 that it would consider modifying the use it or lose it rule.

New carryover benefit
In Notice 2013-71, the IRS modified the existing rules to allow a health FSA (but not a dependent care account) to adopt a carryover provision. The health FSA carryover allows up to $500 in unspent contributions (after claims submitted in the run-out period) to be carried over after the end of a plan year and used any time in the next plan year. The plan may adopt a carryover limit of less than $500 if it chooses, however the same limit must apply to all FSA participants. The carryover does not affect the amount a participant can elect for the next plan year, so up to $3,000 can be available, but the carryover is available even if no contributions are made the next year.

Notice 2013-71 states that a health FSA cannot have both a carryover and a grace period applicable for the unspent amounts in a given year. A plan with a grace period must eliminate it in order to adopt the carryover. This can pose a difficult choice for an employer. The grace period allows more than $500 to be carried over, but only for a limited time. The carryover is capped at $500 but can be used up over an entire year. If the FSA does not have a grace period, the sponsor only needs to weigh the administrative cost and loss of forfeitures from adding the carryover.

An example in the Notice shows that the carryover can be indefinite, continuing from year-to-year until it is used up or forfeited when the participant terminates. For example, a participant could carry over $500 from 2014 to 2015 and stop contributing to the FSA. If he/she only submits $200 in 2015, $300 would carry over to 2016, and so on.

Replacing a grace period with a carryover provision may create another unintended consequence. The grace period can make an FSA participant who moves to an HSA-based plan ineligible to contribute the HSA for three months. A rule that allows a new HSA participant to contribute the full year's amount in the first year of eligibility, even if eligible for only part of the year, alleviates the effect of the grace period. But since the carryover is available the entire following year, it presumably would prevent HSA contributions for the entire year. Thus, such a participant in a plan with a carryover would have to be sure to use up the entire account by the end of the year before moving to an HSA plan, unless the IRS gives us additional guidance.

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Implementation hurdles

Adding the carryover requires an amendment by the end of the year from which amounts may be carried over, however there is an extension for 2013, under which the amendment deadline is the last day of the plan year beginning in 2014. If the plan has a grace period, it must be eliminated by the end of the plan year from which amounts may be carried over. So, a plan with a grace period that wants to change to the carryover for 2013 account balances will have to act by the end of this year. Keep in mind removing the grace could affect participants who had been expecting the grace period at the end of 2013.

Action items

- Review the operation of your cafeteria plan and consider whether a carryover provision is suited to the plan and your general health plan.
- Even if you will wait until 2014 to adopt the carryover, consider whether participant communications for 2014 open enrollment (underway now in some plans) should explain that the grace period may be replaced by a carryover at the end of 2014.