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Health FSAs Carryovers

Under Internal Revenue Code (Code) section 125, a health flexible spending account (FSA) is an employer-sponsored account that employees can use to pay for or reimburse their qualifying medical expenses on a tax-free basis, up to the amount contributed for the plan year. Health FSAs are subject to a "use-or-lose" rule that generally requires any unused funds at the end of the plan year (plus any applicable grace period) to be forfeited.

On Oct. 31, 2013, the Internal Revenue Service (IRS) released Notice 2013-71 (Notice), which relaxes the "use-or-lose" rule for health FSAs. Under the relaxed rule, employers may allow participants to **carry over up to $500 in unused funds** into the next year. A health FSA may permit carryovers only if it does not also incorporate the grace period rule.

Also, on March 28, 2014, the IRS released an Office of Chief Counsel Memorandum to provide information on how health FSA carryovers affect eligibility for health savings accounts (HSAs). Although the IRS memorandum is not official guidance, it helps clarify the IRS' position on health FSA carryovers and HSA eligibility.

BACKGROUND ON HEALTH FSA RULES

The "use-or-lose" rule generally prohibits any contribution or benefit under a health FSA from being used in a later plan year or period of coverage. Employees are generally required to use their health FSA funds by the end of the plan year or the funds will be lost. The IRS allows employers to offer an extended deadline, or **grace period**, of two and a half months after the end of a plan year to use remaining health FSA funds.

In addition, the Affordable Care Act (ACA) imposes a $2,500 limit on employees' annual pre-tax salary reduction contributions to a health FSA offered under a cafeteria plan. This limit first became effective for plan years beginning on or after Jan. 1, 2013. The dollar limit is indexed for cost-of-living adjustments. The health FSA limit stayed at $2,500 for 2014.

On Oct. 30, 2014, the Internal Revenue Service (IRS) announced that the health FSA limit will increase to **$2,550**, **effective for plan years beginning on or after Jan. 1, 2015**. The health FSA limit will potentially be further increased for cost-of-living adjustments for later years. An employer may impose its own dollar limit on employees' salary reduction contributions to a health FSA, as long as the employer's limit does not exceed the ACA's maximum limit in effect for the plan year.

REASONS FOR ALLOWING CARRYOVERS

Although the $2,500 limit does not address the "use-or-lose" rule, the IRS stated in a previous notice that it reduces the potential for using health FSAs to defer compensation and limits the extent to which salary reduction amounts may accumulate over time.

The IRS had requested comments in that notice on whether the "use-or-lose" rule should be modified in light of the $2,500 limit for health FSA contributions. Numerous comments were submitted in response to this request and the overwhelming majority favored modification of the "use-or-lose" rule.

The IRS decided to change the “use-or-lose” rule for a number of reasons, including:

- Difficulty for employees in predicting their future needs for medical expenditures;
- Minimizing unnecessary spending at the end of a year or grace period;
- The possibility that lower-paid and moderately paid employees are reluctant to participate in an FSA because of the risk of losing salary reduction contributions; and
- The opportunity to ease and potentially simplify the administration of health FSAs.

OVERVIEW OF THE MODIFIED “USE-OR-LOSE” RULE

Under the modified rule, an employer, at its option, is permitted to amend its section 125 cafeteria plan document to allow **up to $500 of unused funds** remaining at the end of a plan year in a health FSA to be paid or reimbursed to plan participants for qualified medical expenses incurred during the following plan year.

The plan may specify a lower amount as the maximum (and has the option of not permitting any carryover at all). As noted above, this modification applies only if the plan does not also incorporate the grace period rule.

The carryover of up to $500 may be used to pay or reimburse medical expenses under the health FSA incurred during the entire plan year to which it is carried over. For this purpose, the amount remaining unused as of the end of the plan year is the amount unused after medical expenses have been reimbursed at the end of the plan’s run-out period for the plan year.

If an employer amends its plan to adopt a carryover, the same carryover limit must apply to all plan participants. A cafeteria plan is not permitted to allow unused amounts relating to a health FSA to be cashed out or converted to any other taxable or nontaxable benefit.

Carryover Amount

With respect to a participant, the amount that may be carried over to the following plan year is equal to the lesser of:

- Any unused amounts from the immediately preceding plan year; or
- $500 (or a lower amount specified in the plan).

Any unused amount in excess of $500 (or a lower amount specified in the plan) remaining at the end of the run-out period for the plan year will be forfeited. Any unused amount remaining in an employee’s health FSA as of termination of employment will also be forfeited (unless the employee elects COBRA coverage with respect to the health FSA).

Effect on the $2,500 Limit and Grace Period

This carryover rule does not affect the $2,500 limit on salary reduction contributions. This means the plan may permit the individual to elect up to $2,500 in salary reductions in addition to the $500 that may be carried over.

According to the IRS, this carryover option provides an alternative to the current grace period rule and administrative relief similar to that rule. A plan adopting this carryover provision may not also provide a grace period with respect to health FSAs. Also, for any plan year, the plan may not:

- Allow an individual to reduce his or her salary for qualified health FSA benefits more than the indexed $2,500 salary reduction limit; or
- Reimburse claims incurred during the plan year that exceed the $2,500 salary reduction limit (and any non-elective employer flex credits) plus the carryover amount of up to $500.

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Health FSA Carryovers

The Uniform Coverage Rule

The uniform coverage rule continues to apply for plans adopting the $500 carryover. This rule requires the maximum amount of reimbursement from the health FSA to be available for claims incurred at all times during the period of coverage.

Administration

For ease of administration, a cafeteria plan is permitted to treat reimbursements of all claims for expenses that are incurred in the current plan year as reimbursed first from unused amounts for the current plan year and, only after exhausting these current plan year amounts, as then reimbursed from unused carryover amounts from the preceding plan year. Any carryover amounts that are used to reimburse a current year expense:

- Reduce amounts available to pay prior plan year expenses during the run-out period;
- Must be counted against the permitted carryover of up to $500; and
- Cannot exceed the permitted carryover.

WRITTEN CAFETERIA PLAN AMENDMENT REQUIRED

To implement the new $500 carryover option, a cafeteria plan offering a health FSA must be amended to include the carryover provision.

The amendment must be adopted on or before the **last day of the plan year from which amounts may be carried over**, and may be effective retroactively to the first day of that plan year, provided that:

- The cafeteria plan operates in accordance with the rules in the Notice and informs participants of the carryover provision; and
- A plan may be amended to adopt the carryover provision for a plan year that begins in 2013 at any time on or before the last day of the plan year beginning in 2014.

If a plan has provided for a grace period and is being amended to add a carryover provision, the plan must also be amended to eliminate the grace period provision by no later than the end of the plan year from which amounts may be carried over. The ability to eliminate a grace period provision previously adopted for the plan year in which the amendment is adopted may be subject to non-Code legal constraints.

CARRYOVERS AND HSA ELIGIBILITY

Carryovers to General Purpose Health FSAs

The IRS' Office of Chief Counsel Memorandum provides that an individual who has coverage under a general purpose health FSA solely as a result of a carryover of unused amounts from the prior year is **not eligible for HSA contributions**. This rule applies regardless of the amount available from the health FSA for any month during the plan year. Thus, the individual's ineligibility for HSA contributions continues for the entire health FSA plan year, even for months in the plan year after the health FSA no longer has any amounts available to pay or reimburse medical expenses.

A cafeteria plan may provide that if an individual participates in a general purpose health FSA that provides for a carryover of unused amounts, the individual may elect prior to the beginning of the following year to **decline or waive the carryover for the following year**. In that case, the individual who declines or waives the carryover under the terms of the cafeteria plan may contribute to an HSA during the following year (assuming he or she meets the other tax rules for HSA eligibility).

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Carryovers to HSA-compatible Health FSAs

An individual who participates in a general purpose health FSA and elects for the following year to participate in an HSA-compatible health FSA may elect to have any unused amounts from the general purpose health FSA carried over to the HSA-compatible health FSA (that is, a limited purpose health FSA or a post-deductible health FSA). This individual is eligible for HSA contributions during the following year (assuming he or she meets the other tax rules for HSA eligibility).

There is no requirement that the unused amounts in the general purpose health FSA only be carried over to a general purpose health FSA. However, the carryover amounts may not be carried over to a non-health FSA or another type of cafeteria plan benefit.

A cafeteria plan that offers both a general purpose health FSA and an HSA-compatible health FSA may automatically treat an individual who elects coverage in an HDHP for the following year as enrolled in the HSA-compatible health FSA and carry over any unused amounts from a general purpose health FSA to the HSA-compatible health FSA for the following year.

Administration during Run-out Period

If an individual elects to carry over unused amounts from a general purpose health FSA to an HSA-compatible health FSA, the uniform coverage rules may be applied during the run-out period of the general purpose health FSA, as follows:

- The unused health FSA amounts may be used to reimburse any allowed medical expenses incurred prior to the end of the general purpose health FSA plan year.
- Any claims covered by the HSA-compatible health FSA must be timely reimbursed up to the amount elected for the HSA-compatible health FSA plan year.
- Any claims in excess of the elected amount may be reimbursed after the run-out period when the amount of any carryover is determined.

Example: Employer offers a calendar year general purpose health FSA and a calendar year HSA-compatible health FSA. Both FSAs provide for a carryover of up to $500 of unused amounts and do not have a grace period. Employee has an unused amount of $600 in the general purpose health FSA on Dec. 31 of Year 1. Prior to Dec. 31 of Year 1, Employee elects $2,500 in the HSA-compatible health FSA for Year 2 and elects to have any carryover go to the HSA-compatible health FSA. Employee also elects coverage by an HDHP for Year 2.

In January of Year 2, Employee incurs and submits a claim for $2700 in dental care covered by the HSA-compatible health FSA. The plan timely reimburses $2,500, the amount elected. In February of Year 2, Employee submits and is reimbursed from the general purpose health FSA for $300 in medical expenses incurred prior to Dec. 31 of Year 1. At the end of the run-out period, $300 in the general purpose health FSA is unused and carried over to the HSA-compatible health FSA. Employee is then reimbursed $200 for the excess of the January claim over the amount elected for the HSA-compatible health FSA. Employee has $100 remaining in the HSA-compatible health FSA to be used for expense incurred in the year or carried over to the next year. Employee is allowed to contribute to an HSA as of Jan. 1 of Year 2.

APPLICATION TO EXCEPTED BENEFITS

Excepted benefits provided under a group health plan or health insurance coverage generally are exempt from HIPAA and the ACA's market reform requirements. Health FSAs generally constitute excepted benefits if:

- The employer also **makes available group health plan coverage that is not limited to excepted benefits** for the year to the class of participants by reason of their employment; and

- The arrangement is structured so that the **maximum benefit payable** to any employee participant in the class cannot exceed:
  - Two times the employee's salary reduction election for the arrangement for the year; or
  - If greater, $500 plus the amount of the participant's salary reduction election.

An FAQ issued on May 2, 2014, clarifies that unused carryover amounts remaining at the end of a plan year in a health FSA that satisfy the modified "use-or-lose" rule **should not be taken into account** when determining if the health FSA satisfies the “maximum benefit payable limit” prong under the excepted benefits regulations.

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