



FSA Use-or-Lose Rule Modified

November 4, 2013

Under Internal 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 stating that any unused funds at the end of the plan year (plus any applicable grace period) will 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 will now be able to allow participants to carry over up to \$500 in unused funds into the next year. **This modification applies only if the plan does not also incorporate a grace period.**

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 required to use their health FSA funds by the end of the plan year (or grace period) or the funds would 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 health care reform law imposes a \$2,500 limit on salary reduction contributions to a health FSA offered under a cafeteria plan. This limit is expected to be indexed for cost-of-living adjustments for later years.

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 permissible 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 new carryover *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.

THE UNIFORM COVERAGE RULE

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

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 change 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

- The plan must 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.

This Legislative Brief is not intended to be exhaustive nor should any discussion or opinions be construed as legal advice. Readers should contact legal counsel for legal advice.