

IRS MODIFIES HEALTH FSA “USE-IT-OR-LOSE-IT” RULE

IRS rules governing health flexible spending arrangements ("FSAs") require cafeteria plans to forfeit unused amounts left in a participant's health FSA at the end of a plan year. This so-called "use-it-or-lose-it" rule was perceived as a significant barrier to health FSA participation by many employees, especially lower and moderate income employees. They are more reluctant than higher paid participants to risk forfeiting their pay.

The IRS has modified the use-it-or-lose-it rule for many but not all health FSAs. Under the new "carry forward" rule, cafeteria plans may be amended to allow health FSAs to carry forward up to \$500.00 of unused benefits remaining at the end of a year to be paid or reimbursed to plan participants for qualified medical expenses incurred in the following plan year.

The new rule is not available to all plans, however. Health FSAs that take advantage of the "grace period" rule may not use the carry forward rule unless the plan is first amended to delete the grace period rule. The grace period rule allows a cafeteria plan's health FSA to permit an employee to use amounts remaining from the previous year to pay expenses incurred during the first 2 months and 15 days immediately following the end of the plan year. That is, plan participants can continue to incur expenses after the end of a plan year for up to 2 months and 15 days and still receive reimbursement for those expenses using funds available at the end of the prior plan year. The grace period rule was the first IRS attempt back in 2005 to relax the stringent use-it-or-lose-it rule.

If a plan adopts the new rule, the \$500.00 carry forward may be used throughout the plan year to which it is carried. It does not impact the \$2,500.00 FSA deferral limit first added to the law for 2013 plan year by the Affordable Care Act ("ACA"). Before the ACA, there was no statutory limit. The employer may adopt a carry forward amount of less than \$500.00.

If an employer wants to take advantage of the carry forward, the employer must amend its cafeteria plan document. Normally, plan documents must be amended by the end of the year from which the money is carried forward. However, there is a special delayed amendment rule for 2013 because the carry forward rule was announced so late in the year. Plan documents may be amended as late as the end of the 2014 plan year to provide for the carry forward rule. This is the same date by which cafeteria plans must be amended for the new \$2,500.00 maximum deferral limit.

Of course, there are other considerations in implementing the carry forward for employers other than plan amendments. For example, employers will have to develop communication materials as well as procedures and processes during 2013 for any carry forward into 2014.

If you have questions about the carry forward rule, contact Bill Roberts at ebplans@hallrender.com or your regular Hall Render attorney.