Patterson Belknap Webb & Tyler LLP

Employee Benefits & Executive Compensation Alert December 2013

New Carryover Option for Health Flexible Spending Arrangements

Recent guidance from the IRS modifies the long-standing "use or lose it" rule under a health flexible spending arrangement ("Health FSA") to permit such arrangements to offer participants the opportunity to carryover up to $500 in unused Health FSA benefits for a plan year to the following plan year for reimbursement of medical care expenses incurred in such subsequent year. This new Health FSA carryover option is intended to provide participants with greater flexibility in using their Health FSA balance remaining at the end of a plan year and thereby avoid possibly unnecessary year-end Health FSA spending to prevent unused amounts from being forfeited to their employer.

Health FSAs - "Use It or Lose It" Rule

A "cafeteria plan" is an employer-provided benefit plan that allows employees to choose between receiving taxable cash compensation or one or more tax-free "qualified benefits." Qualified benefits include the opportunity to receive reimbursement of medical care expenses incurred by an employee or the employee's spouse or dependents on a tax-free basis through a Health FSA. Contributions to a Health FSA may be made by employees through pre-tax salary reduction contributions, employer non-elective contributions (often referred to as employer "flex credits"), or both.

Pursuant to long-standing IRS rules, benefits under a Health FSA for a plan year that are not used to reimburse eligible medical expenses incurred during such year are forfeited to the employer. In addition, any unused amount remaining in an employee's Health FSA as of the employee's termination of employment will be forfeited unless the employee elects COBRA continuation coverage under the Health FSA. Thus, under the use it or lose it rule, amounts in an employee's Health FSA account, even if attributable to the employee's own salary reduction contributions, will be forfeited to the employer if the employee does not obtain reimbursement for medical expenses incurred during the plan year (including, as applicable, during a related grace period (described below)) in an amount at least equal to the contributions made to the Health FSA for such year.

Grace Period Rule

Under the "grace period rule," an employee who has unused Health FSA benefits at the end of a plan year may obtain tax-free reimbursement from the unused amount for medical expenses incurred during the cafeteria plan's prescribed grace period. The grace period can extend until the 15th day of the third month following the end of the plan year. Thus, for a cafeteria plan with a calendar plan year, the grace period may extend through March 15 of the immediately following plan year. Any unused balance left at the end of the grace period (including any applicable "run-out period") will be forfeited.[1] Thus, a grace period provides a participant with up to an additional 2½ months in which to incur medical expenses that can be reimbursed from unused Health FSA amounts remaining at the end of the prior plan year.

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[1] A "run-out period" is a period immediately following the end of a plan year (or, as applicable, the end of a grace period) during which a participant can submit reimbursement claims for medical expenses incurred during the plan year (or grace period).

$500 Carryover Permitted

Under the new IRS guidance, an employer is permitted to amend its cafeteria plan to provide for the carryover to the following plan year of up to $500 (or any lower amount so long as the applicable limit is uniformly applied to all participants) of any amount remaining unused in a Health FSA as of the end of the plan year. The amount carried over, like regular current year contributions to a Health FSA, must be available to reimburse medical expenses during the entire plan year to which it is carried over. The carryover amount does not count against the otherwise applicable $2,500 (as adjusted for inflation after 2013) annual limit on employee salary reduction contributions to a Health FSA.[2]

Carryover or Grace Period - But Not Both

A cafeteria plan that adopts the $500 carryover option for its Health FSA is **not** permitted to also provide for a grace period with respect to the Health FSA for the same plan year. Thus, for example, if a grace period is in effect in the 2014 calendar plan year (i.e., permitting expenses incurred during the first 2½ months of 2014 to be reimbursed from the Health FSA balance as of December 31, 2013), the plan could not offer a $500 carryover option from 2013 to 2014, but it could be amended in 2014 to eliminate the grace period occurring in 2015 and instead add a $500 carryover option for plan year 2014 (i.e., allowing participants to carryover up to $500 in unused benefits from 2014 to 2015).[3]

Cafeteria Plan Amendment Requirement

In order to offer the $500 carryover option, a cafeteria plan must be amended to reflect the carryover provision in the terms of its Health FSA feature. Such amendment must generally be adopted by the last day of the plan year from which amounts may be carried over and given retroactive effect to the first day of such plan year. In addition, cafeteria plan participants must be informed of the availability of the carryover option. Under the IRS guidance, a special transition rule allows the carryover feature to be added for the plan year beginning in 2013 so long as the plan is amended to reflect the carryover option by the last day of the plan year beginning in 2014.

Carryovers and Health Savings Account Eligibility

Contributions to a Health Savings Account ("HSA") maintained by an "eligible individual" for any month are deductible subject to certain limits. An eligible individual is a person who is covered under a high deductible health plan ("HDHP") on the first day of the month and who is not, while so covered, also covered under any other health

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2 As we discussed in our prior Alert **[click here]** concerning guidance describing the impact of certain health care law market-based reforms on Health FSAs and health reimbursement arrangements, a Health FSA will be exempt from the market-based reforms (i.e., annual benefit limit prohibition; no cost-sharing for preventive care services) if the maximum annual benefit under the Health FSA for any participant does not exceed two times the employee's salary reduction contribution election amount (or, if greater, the employee's salary reduction contribution amount plus $500). However, it is not entirely clear under the recent IRS guidance whether, if a cafeteria plan provides Health FSA benefits in excess of a participant's salary reduction contribution amounts, the carryover amount will count as an employer contribution for the year to which the carryover is made in determining whether the maximum benefit limit is exceeded for that year and, in turn, potentially cause the Health FSA to violate the market reforms. It is hoped that the IRS will issue additional guidance to answer that question.

3 Amending a cafeteria plan during the plan year to eliminate a grace period feature and add a $500 carryover option may raise potential non-tax issues (e.g., contractual and estoppel arguments due to changing plan terms after employee cafeteria plan contribution elections are made for the plan year). Accordingly, we would suggest that, if possible, a change from a grace period to a carryover option be made effective at the beginning of a following plan year with adequate advance notice to participants.

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plan that is not a HDHP and that provides coverage for benefits that are covered under the HDHP. A Health FSA that reimburses all qualified medical expenses without restriction will be a health plan that provides other health plan coverage. A participant covered by such a Health FSA will not be an eligible individual for purposes of making contributions to an HSA. However, an individual's coverage under a "limited-purpose Health FSA" or "post-deductible Health FSA," or both, will not preclude contributions to the individual's HSA.[4]

Thus, if a Health FSA provides for a grace period and reimbursement of all qualified medical expenses incurred during the grace period (even if the participant has no unused Health FSA benefits at the end of the plan year preceding the grace period), the individual will not be eligible to make HSA contributions until the first day of the month following the end of the grace period (e.g., for a plan with a calendar plan year and a 2½ month grace period ending on March 15 of the following year, an individual will be HSA eligible on the following April 1). In addition, it would appear that a carryover of unused Health FSA amounts from the prior year would make the participant ineligible for HSA contributions in the following year to which the carryover is made.

Accordingly, employers who wish to add a carryover option to their Health FSAs (as well as those who alternatively offer a grace period feature) may want to consider providing a limited-purpose or post-deductible Health FSA with respect to the plan year to which the carryover is made (or period covered by the applicable grace period) in order to allow those individuals who wish to make HSA contributions in such plan year (or applicable grace period) to be able to do so. As the impact of the new $500 carryover option on HSA eligibility was not expressly addressed in the IRS guidance, it may be expected that the IRS will directly address this impact in future guidance.

Employer Considerations

- Would a $500 Health FSA carryover option be beneficial to employees? Have there regularly been unused Health FSA benefits that were forfeited? If so, were the forfeiture amounts per participant generally $500 or less and are the forfeitures in the aggregate significant in amount to the employer?

- Does the Health FSA already offer a grace period feature? If so, do employees use it and find it beneficial?

- If the Health FSA currently has a grace period feature, but instead wishes to provide a carryover option, how and when should the grace period provision be eliminated and a new carryover option be implemented?

- When adding a carryover option, consider the need for:

  - timely advance employee communication describing the carryover option;

  - timely adoption of a plan amendment to reflect the carryover option; and

  - sufficient lead time and coordination with outside cafeteria plan vendors to implement the carryover option (and, as applicable, eliminate the grace period feature).

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[4] A limited-purpose Health FSA is an arrangement that pays or reimburses only for preventive care or permitted limited health coverage, such as dental and vision care. A post-deductible Health FSA is an arrangement that pays or reimburses for preventive care and other qualified medical expenses only if such amounts are incurred after the minimum annual deductible for the HDHP is met.

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The new IRS guidance provides employers additional flexibility in the design of the Health FSAs they offer their employees. If you would like assistance with respect to the implementation of the new $500 carryover option or have any questions concerning the new IRS guidance, please contact any of the attorneys listed below.

This alert is for general informational purposes only and should not be construed as specific legal advice. If you would like more information about this alert, please contact one of the following attorneys or call your regular Patterson contact.

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