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Implementing the Health FSA Carryover: Tips and Traps

The IRS recently issued guidance modifying the "use it or lose it" rule, which has long been the most unpopular feature of health flexible spending accounts (health FSAs) commonly offered under a Section 125 cafeteria plan.

As a result of the change, set forth in Notice 2013-71, individuals who participate in health FSAs, and who have not used their full budget of deferrals by the end of a given plan year may carry over up to $500 in unused funds to the next plan year. (This discussion assumes a Sec. 125 cafeteria plan with the same plan year as the health FSA.)

Even if an employee carries over the full $500 amount, he or she may elect to defer the maximum amount currently permitted, $2,500, such that a health FSA may reimburse up to $3,000 in qualifying medical expenses in a given plan year (that, by necessity, follows a plan year in which no more than $2,000 in expenses were reimbursed).

Employers are eager to make use of this new feature, as the possibility of forfeiting even a small amount of hard-earned wages has kept significant number of employees away from health FSAs for years. However there are some tips and traps that employers should consider before implementing the new plan feature.

- **Make a Choice**. First, an employer whose health FSA currently includes a grace period cannot implement the carryover feature alongside a grace period. It is an "either or" choice.
  - A grace period is a period of up to 2 ½ months following the end of a plan year, during which prior year amounts may be used to reimburse expenses incurred during the grace period portion of the new plan year.
  - The main advantage of the grace period is that the full health FSA budget may be used within the grace period, whereas the carryover is limited to $500 (and employers may set a lower level if desired). On the other hand, the grace period does not eliminate the hurried spend-down that occurs at the end of a cafeteria plan year, it just postpones it slightly.
  - By contrast, the carryover amount (up to $500) can be used at any time in the following cafeteria plan year and even in subsequent plan years, if no medical expenses require it be used in the interim. Example 4 in Notice 2013-71 describes an instance in which $600 in unused funds from the 2014 calendar plan year, after reduction by $100 to meet the maximum carryover rule, is used to reimburse medical expenses in 2016. Thus the carryover eliminates the spend-down scramble, but only for amounts up to $500.

    - Note that you do *not* need to eliminate a claim run-out period, if your plan includes one. A claim run-out period is period following the end of a plan year, during which expenses *incurred* in the preceding plan year may be reimbursed using prior year amounts. Teaming the claim run-out period with a carryover (or a grace period) requires some reimbursement ordering rules, which are discussed below under "Sequence Your Reimbursement Buckets."

- **Timing is Everything**. For calendar year cafeteria plans, it is probably too late in the year to replace a grace period with a carryover, because employees may have scheduled procedures for after the first of the year that exceed $500 in out-of-pocket costs for the participant.
    - Because employees may have acted (or failed to act) in reliance on the grace period remaining in place, legal principles of "equity" and contract law would prevent employers from removing the feature at such a late date. (The IRS Notice specifically references "non-Code legal constraints" that would apply; a similar concept is the "anti-cutback" rule applicable in the retirement plan sphere.)
    - Employer flexibility in this area may exist, including under non-calendar year plans, and even for calendar year plans depending on the number of participants in the health FSA and on participants' forfeiture history. If forfeitures consistently have been below $500 (which typically is the case), then dropping the grace period in favor of the carryover would allow employees additional time to spend the funds on medical expenses.
    - Employers must also be mindful of deadlines set forth in Notice 2013-71 for amending their cafeteria plans in relation to the carryover rule. Amendments simply to add a carryover feature generally must be made before the last day of the plan year *from which* amounts are carried over. However, only for amendments to add a carryover feature effective for the 2013 plan year (without eliminating a grace period), the amendment may be made by the last day of the 2014 plan year. Amendments to remove a 2013 grace period (occurring early in 2014) must also be made by the last day of the plan year *from which* amounts may be carried over, retroactive to the first day of the plan year, but no transition relief is offered. Therefore, an amendment to remove a grace period from the 2013 plan year, separately or in exchange for a new carryover feature, must be made by the end of the 2013 plan year, subject to the timing concerns raised above.

- **Communicate and Document.** A health FSA is an employee welfare benefit plan subject to ERISA documentation and disclosure duties. The Notice requires plan sponsors that wish to add the carryover feature, either on its own, or in place of a grace period, to amend their cafeteria plan documents accordingly. Plan amendments that make a material change to the contents of a cafeteria plan document must in turn be communicated to participants in the form of a written summary. (Note: generally this rule applies in the context of Summary Plan Descriptions (SPDs), and Summaries of Material Modifications (SMMs) to same. However it is not uncommon for cafeteria plan documents, including health FSA components to be set forth in a single plan document without any abbreviated SPD.)

- For a plan amendment simply adding a carryover feature, the written summary of the change must be furnished within 210 days after the end of the plan year in which the change was adopted.
- For a plan amendment replacing a grace period with a carryover, a much shorter deadline applies: the change must be communicated to participants in writing within 60 days after the date the employer adopts the change.

In either event, however, employers should try to provide the written summary of the change to employees as promptly as is possible, because the change likely will impact their health FSA spending before the mandatory notice periods have expired.

- **Sequence Your Reimbursement Buckets.** For your cafeteria plan to run smoothly you need to adopt "ordering rules" for reimbursing medical expenses. It may be helpful to think of unused health FSA deferrals from the prior year as one "bucket" from which medical expenses may be reimbursed, and the new/current plan deferral amount as another "bucket." Important Note: if your plan includes a claim run-out period, you will not know how much is in your "carryover" bucket until the claim run-out period has expired. The carryover bucket can never hold more than $500.

- **One Possible Ordering Sequence**:
    1. Apply prior year's unused health FSA balance first to reimburse prior year expenses submitted during the claim-run out period.
    2. At the end of the claim run-out period, funds remaining in the prior year's unused health FSA "bucket" are treated as follows:
        - Up to $500 remains in the bucket, which is now a carryover bucket.
        - Amounts exceeding $500 are forfeited.
- **Alternative Sequence.** The Notice also permits use of this alternative sequence:
    1. Apply current year unused health FSA balance first to claims incurred in the current plan year. (Remember that under the uniform coverage rule, the maximum health FSA reimbursement budget elected by an employee is available to reimburse expenses as of the first day of a plan year, without regard to actual employee salary deferrals under the health FSA.)
    2. Apply prior year's unused health FSA balance only after exhaustion of current year amounts. Prior year unused amounts used to reimburse a current year expense (a) reduce the amounts available to pay prior plan year expenses during a claim run-out period, while applicable; (b) must be counted against the permitted carryover of up to $500, and (c) cannot exceed that maximum amount.

In either instance, current year health FSA funds may only be used to reimburse claims incurred in the current plan year, (except to the extent they remain unused at the end of a claim run-out period and are carried over to a subsequent plan year).

- **Beware of HSA Complications.** Tax-advantaged contributions to a Health Savings Account (HSA) may not be made by or on behalf of an individual who has coverage (as a participant or dependent) under a group health plan other than a high-deductible health plan (HDHP) ("disqualifying coverage"). Eligibility under a health FSA that permits reimbursement of all expenses for medical care as defined in Code Section 213(d) is disqualifying coverage. Coverage under a health FSA whose reimbursements are limited to dental and vision expenses, and or to other medical expenses incurred after the HDHP deductible amount is met, is not disqualifying coverage. Notice 2013-71 does not address how the carryover feature impacts HSA eligibility. Two possible approaches that representatives of the Groom Law Group informally have discussed with the IRS include restricting carryovers to a limited purpose health FSA, or permitting participants in general purpose health FSAs to opt out of participation in the health FSAs for years in which they want to preserve eligibility under an HSA arrangement. Until further guidance is issued employers should assume that a participant who has a carryover balance under a general purpose health FSA, and his/her eligible spouse and dependents, will not be able to contribute to a health FSA while the carryover balance is available.

http://www.irs.gov/pub/irs-drop/n-13-71.pdf

http://www.groom.com/media/publication/1312_Unused_Health_FSA_Balances.pdf