

Modifying the “Use-It-Or-Lose-It” Rule for Health FSAs

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Health FSAs are subject to a “use-it-or-lose-it” rule, meaning that unused contributions remaining as of the end of the plan year must be forfeited. There is one exception to the rule that allows cafeteria plans to permit an employee to use amounts remaining from the previous year to pay expenses incurred for certain qualified benefits during a grace period of up to 2 months and 15 days immediately following the end of the plan year.

The Treasury and IRS released guidance modifying the use-it-or-lose-it rule. Effective with the 2013 plan year, plan sponsors, at their option, may now allow employees to carryover up to \$500 of unused FSA funds to the next plan year, provided the plan does not allow for a grace period. Thus, if a carryover provision allows amounts that were unused in a plan year to be carried over to the following plan year, the plan is not permitted to provide for a grace period that occurs in the following plan year. For example, a calendar year plan permitting a carryover to 2015 of unused 2014 health FSA amounts (as determined at the end of the run-out period in early 2015) would not be permitted to have

a grace period in 2015, but would be permitted to have had a grace period during the first 2 ½ months of 2014. A plan may specify a lower amount as the permissible maximum, and may even choose not to permit any carryover at all. The same carryover limit must apply to all plan participants. Any unused amount in excess of \$500 (or a lower amount as specified in the plan) that remains unused as of the end of the plan year (that is, at the end of the run-out period for the plan year) is forfeited under the “use-it-or-lose-it” rule. Any unused amount remaining in an employee’s health FSA as of termination of employment also is forfeited (unless, if applicable, the employee elects COBRA continuation coverage with respect to the health FSA).

A health FSA must be amended to set forth 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 employer informs participants of the carryover provision. However, for a plan that begins in 2013, the plan document may be amended to

adopt the carryover provision at any time on or before the last day of the plan year that begins in 2014. The summary plan description should also be amended to reflect the new rollover provision. 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.

Under the Affordable Care Act, beginning with the first plan year beginning on or after January 1, 2013, a health FSA must limit each employee's salary reduction contributions to the health FSA to no more than \$2,500 (as indexed) per plan year. The carryover of up to \$500 does not count against the indexed \$2,500 salary reduction limit applicable to each plan year under the Affordable Care Act.

It should be noted that employees wishing to make HSA contributions in the following year may encounter problems. To make contributions to an HSA, a person must be an "eligible individual." In part, an eligible individual cannot be covered under any other health plan that is not a high deductible health plan which includes being covered under a general purpose health FSA. Under the new carryover rule, an employee with a health FSA who has remaining funds at the end of the plan year will have up to \$500 automatically carried over into the new plan year, even if the individual does not elect to participate in the health FSA the next year. Any carryover would presumably cause an individual to be ineligible to make HSA contributions for the entire following plan year. One potential solution is to specify in the cafeteria plan document that the rollover feature is only available if the individual actually elects a health FSA benefit for the new plan year. Any individual who does not elect a health FSA benefit for the new plan year will not receive a carryover of unused health FSA amounts and will have those funds forfeited. Absent further guidance, employers should consult with counsel on this issue.

