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Health FSA Carryover Amendments - Proceed with Caution

Recently the Internal Revenue Service published guidance that permits an employer to amend its health care flexible spending account program (HFSA) to allow a limited carryover of funds. In IRS Notice 2013-71, the IRS provides for a new exception to the "use it or lose it" requirements by allowing an employer to permit up to $500 in unused HFSA amounts from one year to be used for claims incurred in the next year. However, as with many tax-favored benefits, employers should carefully consider the requirements and potential consequences before implementing the change in their HFSA.

Background
HFSAs generally permit employees to elect to reduce their pay before tax and have the money available during the plan year to pay for qualifying medical expenses. In the past, the IRS has been concerned about these elections being used to defer income from one year to the next. As such, the HFSA rules initially provided that amounts set aside and not used during the year by the participant would be lost, a rule commonly referred to as "use it or lose it." This rule appeared to have a chilling effect on many workers who were concerned about the possible loss of money, and therefore did not participate in the HFSA. Even among those who chose to participate in the HFSA, there was often a year-end run for possibly unnecessary medical items to avoid loss of funds. We have even heard stories about eyeglasses being bought at the end of December and returned for cash in January.

The IRS tried to address these concerns in 2005 by allowing employers to adopt a grace period under both their HFSA and their dependent care flexible spending account programs. Under this 2-1/2-month long grace period, employers could amend their plans to allow employees to use prior year dollars for claims incurred during the grace period. There was no dollar limit on the amount from the prior year that could be spent on qualifying items during the grace period.

Notice 2013-71

In Notice 2013-71, the IRS has provided a different alternative to "use it or lose it." An employer can decide to amend its HFSA (starting as early as the 2013 plan year) to permit the carryover of up to $500 from one year to the next. In allowing this carryover, the IRS has stated that it is less concerned about the potential to defer income from one year to the next given the Affordable Care Act's $2,500 (as indexed) dollar limit on HFSAs. It further provided that the carryover amount will not count against the next year's $2,500 (as indexed) maximum HFSA amount.

The Notice sets forth other requirements and information around implementation of the HFSA carryover. It provides that an employer cannot offer both an HFSA grace period and an HFSA carryover for the same year. As such, if an HFSA currently provides for a grace period, it must be amended out for any year in which the HFSA is amended to permit a carryover. If an employer elects to allow the carryover for 2013, there is a special rule that permits the amendment reflecting the carryover to be adopted by the end of the 2014 plan year. Otherwise, the amendment adding the carryover needs to be adopted by the last day of the plan year in which the carryover is permitted. However, a grace period provision in an HFSA must be removed from the HFSA by the end of the year from which the amounts may be carried over. Accordingly, for a calendar year plan, any grace period provision must be amended out by **December 31, 2013** if the employer wants to allow a carryover of 2013 amounts.

The Notice also addresses the coordination of run-out claims (which usually occurs during the beginning of the following plan year), and carryover amounts. It provides that, to make administration easier, the HFSA can treat reimbursement of current year claims as being taken from new plan year money first, and then carryover money. This allows for carryover eligible amounts to be determined after any applicable prior year claims have been factored into the determination.

Employer Implementation Considerations

While the idea of allowing a carryover of unused amounts up to $500 seems to be a good one, employers need to consider the benefits, concerns and unknowns before making a decision for 2013 and beyond.

On the positive side, implementing a carryover may encourage better participation by employees. However, that positive impact will not be felt for 2013, since those elections are long past. After 2013, however, greater participation may mean FICA savings for employers (as contributions generally are exempt from FICA taxation). Employers may also feel that having the carryover ability is a positive from an employee relations perspective.

On the negative side, if an employer currently has a plan with a grace period, and an employee has counted on that for a big ticket item in 2014, taking away that grace period and implementing a carryover for 2013 will deny that employee access to the full 2013 account during the 2-1/2-month grace period.

The guidance also does not specify how COBRA continuation coverage will work in terms of a carryover for the HFSA. Questions include how to determine premium amounts and whether this will affect the special shorter COBRA period currently enjoyed by HFSAs.

The guidance is also silent on coordinating the carryovers with health savings account (HSA) eligibility. Can a small balance of $1.50 that gets rolled over affect eligibility in the HSA? Or will there be an exception similar to that applied to employees who have funds available during a grace period if all amounts are rolled to a limited purpose HSA?

The guidance addresses only HFSAs, not dependent care spending accounts. Is it possible for there to be a dependent care grace period and an HFSA carryover? It will likely mean even more confusing enrollment materials!

Employers should also consider potential costs and administrative issues related to implementing a carryover. If a participant has a small balance remaining and chooses not to participate for the 2014 plan year, the employer may be subject to an administrative charge that is greater than the small carryover amount. As well, before rolling out the program, the employer may wish to be certain the administrator has the tools to be able to coordinate run-out with new and old money.

Finally, it should be noted that many employers use the “lose it” amounts to help defray the administrative costs for the plan. Such employers should take into account that with the new carryover provisions there may be less available from “lost” funds.

In sum, the carryover is a welcome tool, but employers may be well served to consider the issues and wait for additional guidance before implementing it in the HFSA.

If you have questions regarding any aspect of this development, or other employee benefits issues, feel free to contact your Thompson Coburn attorney or any member of our Employee Benefits Group.

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