JONES WALKER

Employee Benefits, ERISA & Executive Compensation Client Alert

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IRS Loosens the FSA "Use-It-or-Lose-It" Rule

For nearly three decades, individuals participating in health flexible spending account plans ("FSAs") have been subject to a "Use-It-or-Lose-It" rule. This rule generally states that individuals with unused FSA balances at the end of the plan year (or applicable 2.5-month grace period) must forfeit those amounts. On October 31, 2013, the Internal Revenue Service ("IRS") issued Notice 2013-71, which permits, but does not require, employers to amend their cafeteria plans to allow participants to "carry over" up to $500 of unused funds to the following plan year. Below is a summary of the main features of the new carryover rules:

- Carryover only applies to health FSAs.
- Employers adopting the new rule have the option to allow up to $500 of unused FSA amounts to be carried forward to the following year (an employer may elect a lower maximum, e.g., $250). Carried over amounts may be used to pay claims incurred during the entire year to which they are carried forward.
- The carryover limit must apply uniformly to all plan participants.
- The carryover amounts do not count against the $2,500 yearly cap (adjusted for inflation) on FSA salary deferrals, enabling a participant with a $500 carryover to have up to $3,000 available for reimbursement for a given plan year.
- The carryover is equal to the remaining account balance after the end of the cafeteria plan's run-out period.
- Plans may have a carryover or a grace period feature, but cannot have both.
- Carryover amounts must be used to reimburse allowable expenses and cannot be cashed out or converted to any other taxable or non-taxable benefit.
- For ease of administration, plans can use a "Last In, First Out" approach, which allows year two expenses to be reimbursed first from year two salary reductions and second from any carryover amounts from year one.

Employers interested in adopting the carryover feature are generally required to amend their plans on or before the end of the plan year from which amounts may be carried over. For example, employers that wish to allow amounts for the 2014 plan year to carry over to 2015 must amend their cafeteria plan no later than December 31, 2014. A special transition rule allows employers who want to add the carryover feature for 2013 to wait until December 31, 2014, to amend their plan. However, if such employer's plan currently provides for a grace period, the plan must be amended no later than December 31, 2013, to remove the grace period and add the carry forward provision. As noted in the guidance, employers whose plans currently provide for a grace period may face legal challenges if they wish to implement the carryover rule for 2013 deferrals, particularly if employees are anticipating being able to use these amounts during the applicable grace period. Of course, participants should be notified regarding any amendment to the plan, in accordance with ERISA's disclosure requirements.

Employers should consider several other issues before implementing the carryover feature that are not addressed in the guidance. For instance, the guidance does not address how the new carryover rules interact with the health savings account ("HSA") eligibility rules, which generally preclude individuals (and dependents) covered under a general purpose FSA with a grace period from contributing to an HSA. However, this issue may be addressed by adding an "opt-out" feature along with the carryover feature that would allow the participant to terminate FSA coverage during open enrollment and forfeit any carryover amounts. The rules also do not address how the carryover feature will affect an FSA for purposes of HIPAA excepted benefits and COBRA's special FSA rules.

Employers who do not currently apply a grace period and who rely on forfeitures to offset plan administrative costs and/or losses caused by participants who terminate with overspent accounts may be reluctant to make changes that would increase the cost of their plan. On the other hand, employers whose plans already include a grace period will want to weigh the pros and cons of keeping the status quo or switching to the new carryover feature.

If you have questions regarding the carryover guidance or would like assistance amending your plan, please contact your Jones Walker relationship attorney.

— Ricardo X. Carlo

Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, please contact your Jones Walker relationship attorney or:

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