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HEALTH CARE REFORM

Eye on Washington

TREASURY AND IRS MODIFY HEALTH FSA "USE-OR-LOSE" RULE

On October 31, 2013, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) issued Notice 2013-71 (Notice) modifying the longstanding "use-or-lose" rule for health flexible spending arrangements (FSAs).

The Notice permits employers to now allow employees to carry over up to $500 of the unused amounts left in their health FSAs for expenses in the next year. In addition, the existing option for plan sponsors to allow employees a grace period after the end of the plan year remains in place. ***However, a health FSA cannot have both a carryover and a grace period: it can have either one or the other – or neither.***

The Notice, in part, states as follows:

"This modification permits § 125 cafeteria plans to be amended to allow up to $500 of unused amounts remaining at the end of a plan year in a health FSA to be paid or reimbursed to plan participants for qualified medical expenses incurred during the following plan year, **provided that the plan does not also incorporate the grace period rule**. This carryover of up to $500 does not affect the maximum amount of salary reduction contributions that the participant is permitted to make under §125(i) of the Code ($2,500 adjusted for inflation after 2012)."

A brief summary of Notice 2013-71 is as follows:

- Health FSAs may be amended to permit participants to carry over up to $500 of unused amounts to the following cafeteria plan year. An "unused amount" is the amount remaining at the end of the run-out period for the plan year. Any unused amount in excess of $500 must be forfeited.
- The carryover feature can't be used for any cafeteria plan year for which a grace period is in effect, so the two rules are mutually exclusive. If a plan sponsor wants to implement the carryover feature so that unused amounts from 2014 will carry over to 2015, then it can't make a grace period available for the two-and-a-half-month period following the end of 2014.
- The maximum carryover amount must be uniform for all participants; a plan sponsor can set the carryover amount at $500 or at a number less than $500. The carryover amount does not affect the $2,500 cap that applies to salary reduction contributions to health FSAs (in separate guidance the IRS confirmed that the $2,500 cap will remain the same for 2014).
- The carryover feature means what it says – up to $500 can be carried over. A carryover amount can't be cashed out and can't be converted to any other taxable or nontaxable benefit.

- The amendment adopting a carryover feature must be adopted on or before the last day of the plan year for which amounts may be carried over. For example, if a cafeteria plan operates on a calendar year, and 2014 will be the first plan year to which the carryover feature is applied, then the amendment must be adopted no later than December 31, 2014. If 2013 will be the first plan year to which the carryover feature is applied (and assuming the health FSA either doesn't have a grace period, or the plan sponsor does not eliminate the grace period), then the amendment must be adopted no later than December 31, 2013.
- A cafeteria plan may also adopt an "ordering" rule so that expenses can be paid first from current year unused amounts and then – after current unused amounts are exhausted – from carryover amounts from prior years.

For a copy of Notice 2013-71 please click on the link provided below.

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

ADP is a trusted service provider of Spending Account Services. You can count on ADP to keep you informed of important updates and to work closely with you to help ensure a successful change of your plan design. We understand that the change announced in this Notice represents significant change. We will provide additional information concerning this Notice, as it becomes available.

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