

IRS Modifies "Use It Or Lose It" Rule for Health Flexible Spending Accounts

Nov 21 2013

Posted By: Kenneth A. Hoogstra

Practice Area: Compensation and Benefits/ERISA

Many employers sponsor health flexible spending accounts ("FSAs") under which their employees may choose to have up to \$2,500 of their annual pre-tax pay set aside for the purpose of paying qualified medical expenses. However, as employees who contribute to health FSAs know, the IRS has had a long-standing "use it or lose it" rule, which requires employees to either spend all of the money in their health FSAs by the end of the plan year or forfeit the unused amounts.

In 2005, the IRS relaxed the use it or lose it rule slightly by allowing employers to include a grace period in their health FSAs. Under the grace period rule, an employee may use amounts remaining from the previous plan year to pay qualified medical expenses the employee incurs during the first two months and 15 days following the end of the plan year.

On October 31, the IRS made a significant change to the use it or lose it rule for health FSAs. In Notice 2013-71, the IRS ruled that an employer may amend its health FSA to allow up to \$500 of unused amounts remaining at the end of a plan year to be used for qualified medical expenses incurred during the following plan year. Amounts that are carried over under this new rule do not count against or otherwise affect the \$2,500 salary reduction limit for the year into which amounts are carried over – in other words, an employee may carry over the full \$500 into a plan year and still choose to contribute up to \$2,500 to his or her health FSA for that plan year.

Employers that wish to implement the \$500 health FSA carryover must amend their plans to do so. However, there is a tradeoff – an employer that chooses to allow a carryover may not also use the grace period in its health FSA. If a health FSA 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 the end of the plan year from which amounts may be carried over.

An amendment to add a carryover provision to a health FSA must generally 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. However, an employer that wants to adopt the carryover provisions for a plan year that begins in 2013 has until the last day of the plan year that begins in 2014 to amend its health FSA.

von Briesen & Roper Legal Update is a periodic publication of von Briesen & Roper, s.c. It is intended for general information purposes for the community and highlights recent changes and developments in the legal area. This publication does not constitute legal advice, and the reader should consult legal counsel to determine how this information applies to any specific situation.