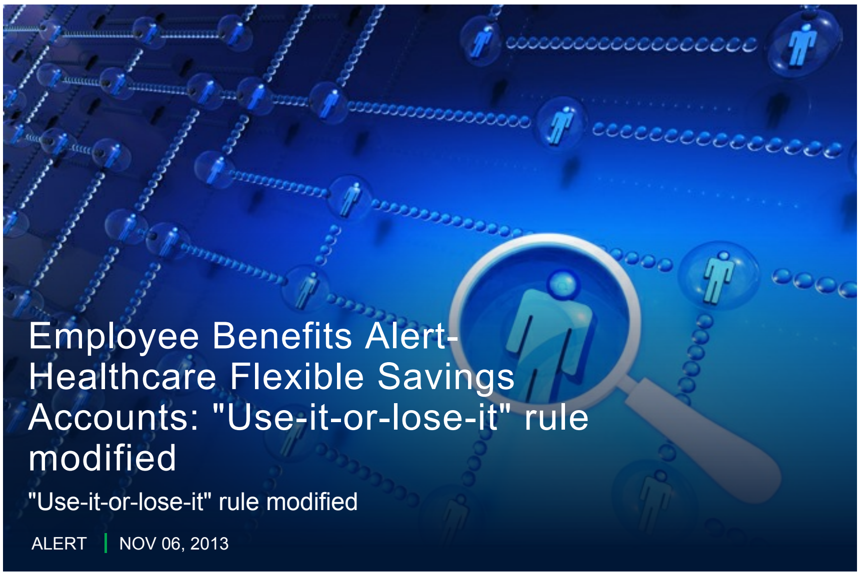
McDonald Hopkins Attorney **Insight.** Business **Foresight.**®



Employee Benefits Alert-Healthcare Flexible Savings Accounts: "Use-it-or-lose-it" rule modified

"Use-it-or-lose-it" rule modified

ALERT | NOV 06, 2013

On October 31, the U.S. Treasury Department and the IRS issued Notice 2013-71, which modifies the “use-it-or-lose-it” rule for Healthcare Flexible Savings Accounts (Healthcare FSA).

BACKGROUND

A Healthcare FSA is a form of cafeteria plan benefit offered by employers to allow their employees to pay for eligible out-of-pocket healthcare expenses with pre-tax dollars. Healthcare FSAs are typically funded by salary reduction contributions. Effective for plan years beginning after December 31, 2012, an employee’s contributions to a Healthcare FSA are statutorily limited to $2,500 per year, indexed for inflation beginning in 2014 in multiples of $50. Historically, such contributions were also subject to an annual “use-it-or-lose-it” rule which provided that contributions to the plan that are not used before the end of the plan’s fiscal year would be forfeited. This rule was modified several years ago to permit a plan to add a “grace period” of 2 ½ months following the end of the plan’s fiscal year in which unused contributions could be used to pay eligible expenses incurred during such period.

A NEW OPTION

The new rules issued by the IRS permit another option that employers may want to consider utilizing. According to the Notice, an employer may amend its plan document to permit a carryover to the immediately following plan year of up to $500 of any amount remaining unused in a Healthcare FSA as of the end of the plan year. The carryover, if permitted in the plan, may be used to pay medical expenses incurred during the entire plan year to which it is carried over, and would be in addition to the $2,500 employee contribution limit.

GRACE PERIOD OR CARRYOVER

Under the modified “use-it-or-lose-it” rule, a plan adopting the new carryover option is not permitted to also provide a grace period. The grace period provides the ability to effectively carry over more than the $500 permitted under the new carryover option. However, unlike the carryover option, which can be used by the participant anytime during the next plan fiscal year, the grace period requires such amounts be used by the participant within the first 2 ½ months of the subsequent fiscal year. Employers may either provide a grace period or the new carryover option, but not both. Of course, an employer may choose to provide for a carryover limit of less than $500, or not to permit either, as providing employees with a grace period or the new carryover option is entirely optional.

When deciding whether or not to eliminate a grace period in favor of the new carryover option, the employer may want to compare the potential administrative impact of each option. The employer should consider the impact of a potential reduction in the amount of unused contributions previously being forfeited back to the company as a result of the “use-it-or-lose-it” rule, and weigh the benefits of each option on its employees. Similarly, if the employer does not currently allow a grace period, but is thinking about providing its employees with the new carryover option, the employer should consider the potential administrative and loss of forfeiture costs, as well as the potential benefit to its employees, of providing this new option.

AMENDING YOUR PLAN

As mentioned above, the new carryover rule is not available during a plan year in which the plan permits a grace period. Therefore, plans containing a grace period must first be amended to remove it if the employer wants to add a carryover provision. The amendment to remove a grace period must be adopted before the end of the year in which it becomes effective. For plans that do not contain a grace period or that have been timely amended to remove such grace period, an employer may amend its plan to provide the new carryover option for such year by adopting an amendment to the plan on or before the last day of the plan year from which the carryover will be made. Thus, as an example, if an employer wants to permit participants to carryover up to $500 from the 2014 plan year to the 2015 plan year, the employer must amend the plan and provide participants with notice of the amendment before the end of the 2014 plan year.

The Notice also permits plans to retroactively adopt the carryover provision for a plan year beginning in 2013 (presuming the plan does not have a grace period applicable for such year) by amending the plan to include the carryover provision prior any time to the end of the 2014 plan year. Technically, you can remove a grace period by amending the plan and providing notice to the participants any time prior to the end of the plan fiscal year. However, eliminating the grace period retroactively may be problematic since some participants may be counting on utilizing the grace period.

For more information, please contact:

John M. Wirtshafter
216.348.5833
jwirtshafter@mcdonaldhopkins.com

Dale R. Vlasek
216.348.5452
dvlasek@mcdonaldhopkins.com

Antoinette M. Pilzner
248-220-1341
apilzner@mcdonaldhopkins.com

Meredith R. Fergus
216-348-5442
mfergus@mcdonaldhopkins.com

EMPLOYEE BENEFITS

Benefit programs should be a win-win for employers and employees. We strive to accomplish that goal in the design, implementation and operation of sophisticated benefit and executive compensation programs – qualified and non-qualified retirement programs and health and welfare plans. Our employee benefits team has a long track record of working to maximize the efficiency and economic feasibility of each program.