

## IRS Provides Additional Flexibility for Flexible Spending Arrangement Use-or-Lose Rules

On October 31, the Internal Revenue Service (IRS) released [Notice 2013-71](#), which modifies the long-standing “use-it-or-lose-it” rule for health flexible spending account plans (“FSAs”). Under the rule, any unused contributions remaining at the end of the plan year or grace period, if offered, are forfeited. The modification gives employers the option of amending their FSA plans to allow employees to carry over up to \$500 each plan year to their FSA for the following plan year. While this guidance provides welcome additional flexibility for employers, there are considerations employers should weigh before deciding whether to amend their plans to adopt the carryover.

### Description of Rule Change

Notice 2013-71 makes the following modifications to the “use-it-or-lose-it” rule:

- Employers can adopt any annual carryover amount up to a maximum of \$500. Employees would then be permitted to carry over the allowed amount at the end of each plan year.
- Employers that have adopted the 2-1/2 month grace period established under IRS Notice 2005-42 will have to choose between adopting the carryover and continuing to offer the grace period.
- Although employers cannot allow carryovers and the grace period in the same year, a plan may allow a grace period for a current year and a carryover for the following year. For example, a plan that is amended in 2013 to allow carryovers into 2014 will not violate the rules by having allowed a grace period at the beginning of 2013 (with respect to 2012 FSA contributions), but would violate the rules by allowing a grace period that runs into 2014 (with respect to 2013 FSA contributions).
- Any carryover allowed does not count toward the following year’s \$2,500 FSA contribution limit. In other words, an employee who elects to contribute \$2,500 to an FSA for 2014 and who carries over \$500 from 2013 to 2014 will have \$3,000 available for reimbursement of expenses incurred in 2014.
- For ease of administration, employers may treat reimbursements for current year spending as coming first from the current FSA contribution for the year, and only after that is exhausted, out of carried-over funds.
- This change does not affect the “run-out period,” the period following the end of the plan year and grace period, if applicable, during which employees can submit reimbursements for expenses incurred during that year.

### Other Considerations

Employers may wish to consider the following additional points before deciding whether to amend their plans to provide for carryovers:

1. While carryovers are limited to \$500, a plan with a grace period allows any balance remaining in an employee’s FSA at the end of the plan year to be used during the 2-1/2 month grace period. Employers whose FSA plans provide for a grace period will need to weigh the added flexibility in timing provided by the carryover against the lower cap.
2. An employer that offers employees a high deductible health plan with a Health Savings Account (HSA) should consider the operational and communications challenges posed by the adoption of the FSA carryover. Because an individual’s eligibility to contribute to an HSA will be affected if he or she

participates in a general purpose FSA, it may be the case that an employee who carries over FSA funds into a year in which he or she decides to enroll in a high deductible health plan with an HSA will lose access to the money carried over. This problem is more easily managed by plans with an FSA grace period. Current IRS guidance provides that an employee or the employee's spouse is not eligible to participate in an HSA until the month after the employee or spouse's grace period ends. Therefore, absent further guidance, the IRS rules that define when an individual can contribute to an HSA would presumably preclude an individual with carried-over FSA funds from participating in an HSA for the entire plan year in which carryover funds are available unless the FSA plan required that such funds be forfeited as of the effective date of the individual's enrollment in a high deductible health plan.

3. Employers with plans that offer a grace period should consider whether employees are relying on the grace period in planning when to incur reimbursable expenses. For example, if an employer with a grace period amended its FSA plan in 2013 to eliminate the grace period for 2013 and to allow for a \$500 carryover, an employee who has been planning to use the grace period to spend down his or her FSA would end up losing any balances in excess of \$500 that remain on December 31, 2013.

### Options Available to Employers

An employer that chooses to adopt a carryover must amend its FSA plan document to designate a permitted carryover amount of \$500 or less, to designate the first year for which the change will apply, and to eliminate any grace period currently provided under the plan.

In general, employers have until the last day of the plan year from which amounts may be carried over to amend their plans retroactive to the first day of that plan year. For example, an employer with a calendar year plan that wishes to amend its plan effective January 1, 2014, must amend the plan by December 31, 2014. There is a special exception for plans with plan years beginning in 2013 that wish to adopt the carryover provision for the 2013 plan year. Those plans may be amended at any time on or before the last day of the plan year that begins in 2014. Employers that currently provide a grace period, however, will lose the flexibility this exception provides. They must amend their plans to eliminate the grace period by no later than the end of the plan year from which amounts may be carried over. Therefore, employers whose plans provide for a grace period but that wish to adopt the carryover for the 2013 plan year must amend their plans by the last day of 2013 plan year.

If you have questions about Notice 2013-71 or about the options available to you as a result of this guidance, please contact your usual Ropes & Gray advisor or a member of the [executive compensation & employee benefits](#) practice.