Cooley

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Until now, employees contributing to a health care flexible spending account (FSA) were subject to a "use it or lose it" rule on the full amount they contributed to the FSA for that year (or in some cases, that year plus a "grace period" that runs through the following March 15).

The "use it or lose it" rule is often the hardest thing for employees to grapple with when they are making their annual FSA contribution decisions. No one likes to leave money on the table, and employees often under-contribute to FSAs for this reason.

Under new guidance from the IRS, FSAs can now include a feature allowing employees to carry over up to $500 from one year to the next, beginning with the 2013 plan year. The carryover does not reduce the annual salary reduction contribution limit of $2500 so an employee could have up to $3000 to use toward eligible medical expenses in any one calendar or plan year.

While this is welcome news, there are some restrictions and trade-offs that employers will need to consider before deciding whether to amend their FSAs to add this feature.

The key decision point has to do with the fact that, under the new rules, an FSA can only offer the $500 carryover if it does *not* also offer a grace period (which is the 2½ month period after the end of the plan year when employees can incur expenses and be reimbursed from prior-year contributions). As a result, employers who would like to add the $500 carryover feature to their plans will need to eliminate (or not add) a grace period.

While a carryover feature might seem like it will always work to an employee's advantage, this is not necessarily the case. For example, assume an employee knows now that her twins will both need braces in early 2015 and that she intends to contribute $2500 to an FSA for both 2014 and 2015.

- Under an FSA with no grace period feature or carryover feature, she can only use her 2015 FSA contributions to make a $2,500 payment to the orthodontist.
- Under an FSA with a grace period feature, she can use all of her 2014 and 2015 FSA contributions to make a $5000 payment to the orthodontist in February of 2015.
- Under an FSA with a carryover feature, the most she will have available in FSA funds in February 2015 is $3000.

The table below shows a timeline comparison of the three different FSA options.

<table>
<tr><th>TYPE OF FSA</th><th>2014 CALENDAR YEAR</th><th>JAN. 1–MAR. 15, 2015</th><th>MAR. 16–DEC. 31, 2015</th><th>JAN. 1–MAR. 15, 2016</th></tr>
<tr><td>FSA with no grace period and no carryover</td><td>$2500 available to reimburse expenses incurred in 2014</td><td colspan="2">$2500 available to reimburse expenses incurred in 2015</td><td></td></tr>
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<table>
<tr><td rowspan="2">FSA with grace period</td><td colspan="2">$2500 available to reimburse expenses incurred through March 15, 2015</td><td></td><td></td></tr>
<tr><td></td><td colspan="3">$2500 available to reimburse expenses incurred through March 15, 2016</td></tr>
<tr><td>FSA with $500 carryover</td><td>$2500 available to reimburse expenses incurred in 2014</td><td colspan="2">If $500 not used in 2014, up to $3000 available to reimburse expenses incurred in 2015</td><td>If $500 not used in 2015, up to $3000 available to reimburse expenses incurred in 2016</td></tr>
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To summarize, the advantage of the grace period is that the full year's contribution is available for reimbursement *at any time* during that 14½ month period which includes the 12-month plan year and the 2½ month grace period. In contrast, the carryover feature only results in the availability of up to an additional $500 in any one year.

For an employer whose FSA does not currently provide for a grace period, amending the FSA to add a carryover feature involves fewer considerations and trade-offs so it may be desirable, *if the FSA administrator is able to accommodate this change.*

For an employer whose FSA does contain a grace period feature, we suggest considering whether employees may have made their 2013 election decisions in reliance on that feature. If so, an employer may want to wait to make any changes (such as eliminating the grace period feature to add the carryover feature) until at least the 2014 plan year.

The new rules are effective immediately, so employers could allow up to $500 of unused FSA contributions made for 2013 to carry over into 2014, provided that the FSA is timely amended. The deadlines for adopting an FSA plan amendment to reflect the carryover feature vary as follows:

- **For an FSA that does not include a grace period**, the carryover can be implemented this year, but the FSA does not have to be amended to provide for the carryover until December 31, 2014 (for calendar-year plans). If the carryover feature is not implemented until 2014 or a later year, the deadline for amending the FSA is the last day of the plan year for which the feature is implemented (December 31 for calendar-year plans).
- **For an FSA that DOES include a grace period**, the carryover can be implemented this year only if an amendment to eliminate the grace period is adopted by December 31, 2013 (for calendar-year plans).

Note that it is not clear what effect allowing a carryover will have for COBRA purposes if an employee elects to continue FSA coverage after a COBRA qualifying event.

Here are some considerations for employers in light of this development:

- Talk to the FSA administrator to see when it can be ready to administer carryover FSAs.
- If the FSA administrator is ready to administer the carry over of 2013 contributions, then:
    - If no grace period feature, the company could notify employees now of this new feature, and wait until next year to adopt the plan amendment.

- If a grace period feature exists, the company should decide if it's worth eliminating this feature now to add the carryover for 2013. If so, and an employer wants to allow a carryover of 2013 funds, the company should contact us or the FSA administrator as soon as possible in order to have a plan amendment drafted and approved by year-end.

If you have any questions about this *Cooley Alert,* please contact one of your Cooley team members or one of the attorneys identified above.

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