

## EMPLOYEE BENEFITS &amp; COMPENSATION PLANNING

# ALERT

## IRS ALLOWS SPONSORS TO LOOSEN THE USE-IT-OR-LOSE-IT RULES FOR HEALTH FSAs

By Michelle M. McCarthy

On October 31, 2013, the IRS issued Notice 2013-71, which modifies the “use it or lose it” rules for Section 125 cafeteria plans.

The modification permits Section 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 Flexible Spending Account (FSA) to be paid or reimbursed to plan participants for qualified medical expenses incurred during the following plan year, provided 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 an employee is permitted to make for the year (\$2,500 adjusted for inflation after 2012).

Notice 2013-71 was issued in response to public comment on the “use it or lose it” guidance, arguing the difficulty for employees in predicting their future needs for medical expenditures, the desirability of minimizing incentives for unnecessary spending at the end of the year or grace period, the possibility that lower-and moderate-paid employees are more reluctant than others to participate because of aversion to even modest forfeitures of their salary reduction contributions and the opportunity to ease and potentially simplify the administration of Health FSAs.

Accordingly, an employer, at its option, is permitted to amend its Section 125 cafeteria plan document to provide for the carryover immediately following the end of the plan year, of up to \$500 of any amount remaining unused in a health FSA. The carryover does not count against, or

otherwise affect, the indexed \$2,500 salary reduction limit applicable to each plan year; although a plan adopting this carryover provision is not permitted to also provide a grace period of 2 ½ months during which unused benefits or contributions remaining at the end of the plan year may be reimbursed to employees for qualified benefit expenses incurred during the grace period.

To utilize the new carryover option within a Section 125 plan offering, a health FSA must adopt a carryover provision amendment on or before the last day of the plan year from which amounts may be carried over. The amendment may be effective retroactively to the first day of that plan year provided that the plan operates in accordance with the notice and informs participants of the carryover provision. Also, if the plan 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 no later than the end of the plan year from which amounts may be carried over. Since the Notice goes into effect immediately, employers can elect to amend their plans as early as for the 2013 plan year; however, if the plan has a grace period in effect, employers must either wait to amend their plan until the 2014 plan year or amend out of the grace period for 2013.

For additional information regarding Notice 2013-71 and how to amend your Health FSA to allow for the carryover option, please contact Michelle M. McCarthy at 310.598.4153 or [mmccarthy@foxrothschild.com](mailto:mmccarthy@foxrothschild.com), or any

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