By Janet Trewin, CMA, and Anthony P. Curatola

Flexible Spending Plan Rules Relaxed

The Treasury Department has provided some flexibility to the "use-it-or-lose-it" rule for health flexible spending accounts by permitting employers to adopt either a $500 carryover or grace period provision for their §125 cafeteria plan.

Many employers provide their employees with the opportunity to participate in a health flexible spending account (FSA) as part of a §125 cafeteria plan. Those employees electing to participate are able to pay for medical expenses (copays, glasses, dental, and so forth) with pre-tax dollars. Although the FSA is an attractive fringe benefit, its major failing has been that any unused amounts couldn't be carried over from the current tax year to the next tax year. Thus the benefit was either used or lost. In 2005, the U.S. Treasury Department adopted a grace period beyond year-end that allows taxpayers to use the benefits or contributions from the preceding plan year for up to 75 days into the new tax year. In October 2013, Treasury introduced a carryover option that allows employees to carry over up to $500 of any unused health FSA amounts into the following year as long as the plan doesn't incorporate the grace period.

Grace Period Rule

In 2005, Treasury and the IRS introduced the first modification to the "use-it-or-lose-it" rule with Treas. Reg. §1.125-1(e) and Notice 2005-42, 2005-1 C.B. 1204. Specifically, employers were permitted (not required) to modify their §125 cafeteria plan to allow employees to apply unused amounts of a health FSA from the previous year to pay expenses incurred for certain qualified benefits during the period of up to 75 days immediately following the end of the plan year. Thus employees who had money remaining in their FSA could use it for medical expenses incurred during the first 75 days of the new plan year.

Reduction of FSA Limit

The next change to the health FSA was introduced by the addition of §125(i) to the Internal Revenue Code (IRC) as part of the Affordable Care Act of 2010 (P.L. 111-148). This added section wasn't employee friendly, though. It lowered the maximum amount that an employee could reduce from his or her salary and contribute to a health FSA plan from $5,000 per taxable year to $2,500 (indexed for cost-of-living adjustments). Thus employees with significant medical expenses were limited in the pre-tax dollars they could use to cover those costs.

The cost-of-living adjustment is computed in $50 increments beginning for any taxable year after December 31, 2013 (IRC §125(i)(2)). Pursuant to Rev. Proc. 2013-35 §3.15, 2013-47 IRB 537, the maximum FSA contribution for 2014 is $2,500 (i.e., same as the 2013 amount).

Modified Use-It-or-Lose-It Rule

After the grace period rule was introduced, there continued to be clamoring for additional flexibility regarding the use-it-or-lose-it rule. As reported in Notice 2013-71, 2013-47 IRB 532, public comments addressed issues such as the difficulty for employees to predict their future needs for medical expenditures, the desirability of minimizing incentives for unnecessary spending at the end of a year or grace period, the possible reluctance of lower- and moderately paid employees to participate because of an aversion to even modest forfeitures of their salary reduction contributions, and the opportunity to ease—and potentially simplify—the administration of health FSAs. In light of these comments, Treasury and the IRS provided yet another modification to the use-it-or-lose-it rule with the issuance of Notice 2013-71 (October 31, 2013). This latest modification allows employers to amend their health FSA plans so that employees are able to carry over up to $500 of unused amounts in their FSA to the following plan year. (Again note that the rule allows employers to provide the option; it doesn't require them to do so.) This modification can be seen as an extension of the grace period rule but with an amount limitation.

But there is a catch to the modification. An employer that adopts the carryover provision may not also maintain the grace period provision. If an employer wants to adopt either of the provisions, it must choose between the grace period rule and the $500 carryover rule. It can't adopt both. Of course, the employer still has the option to adopt neither modification, which means the use-it-or-lose-it rule is still in play. As one would expect, the adoption of the carryover limit must be applied to all plan participants.

There also are procedural issues associated with the adoption of the carryover rule. The amount a participant may carry over to the following plan year is equal to the lesser of $500 (or a lower amount specified in the plan) or any unused amounts from the immediately preceding plan year. Any amount in excess of $500 (or a lower amount specified in the plan) that remains unused as of the end of the plan year, including the end of the run-out period for the plan year, is forfeited. A "run-out period" is the period immediately following the end of a plan year for which a participant may submit a claim for reimbursement of any unused FSA amounts attributable to the prior plan year (e.g., January through March).

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The use of the carryover option or grace period option doesn't prevent the participant from claiming expenses from the FSA during the run-out period. Consider, for example, that a participant has an unused balance at the end of the 2013 plan year. That amount may be used first for expenses incurred in 2013 and claimed during the plan's run-out period in early 2014. Then it may be used for expenses incurred at any time during the 2014 plan year up to the permitted carryover amount (i.e., up to $500 or the amount specified in the plan). The final 2013 unused amount is the year-end FSA amount reduced by any 2013 claims made by the participant during the run-out period. It's important to be mindful that any amounts credited to an FSA in the current plan year (e.g., 2014 contributions) may be used only for qualified medical expenses incurred in 2014—and not in 2013.

Example 1

An employer sponsors a §125 cafeteria plan with an FSA. The plan operates on the calendar year and has an annual run-out period for the FSA from January 1 through March 31. The employer adopts the $500 carryover provision for the FSA plan. In November 2013, Mandy elects a salary reduction amount of $2,500 for 2014. By December 31, 2013, her unused amount from the 2013 plan year is $800. On February 1, 2014, she submits claims and is reimbursed $350 for expenses incurred during the 2013 plan year. That leaves a carryover amount of $450 on March 31, 2014 (the end of the run-out period). Because the plan includes the carryover provision, the $450 amount isn't forfeited; instead, it's carried over to the 2014 plan year and is available to pay claims incurred in that year. Thus Mandy has a total FSA amount of $2,950 ($2,500 + $450) to pay claims incurred in 2014.

If Mandy incurs and submits claims for expenses of $2,700 during the year of 2014, she is reimbursed the total amount. That leaves $250 ($2,950 – $2,700) in the FSA at year-end. The $250 is available during the run-out period in 2015 and, if unused, is treated as a carryover to the 2015 plan year.

Example 2

In November 2012, José elects a salary reduction amount of $600 for 2013. On December 31, 2013, he still has $600 remaining in the health FSA plan. In November 2013, José elects no salary reduction for the health FSA for 2014, nor does he submit any claims during the run-out period for 2013. As a result, $500 is carried over from 2013 for medical expenses incurred in 2014, and he forfeits the remaining $100 ($600 – $500) because it exceeds the $500 carryover limit.

continued on page 61

Taxes

continued from page 14

If José incurs $300 in qualified medical expenses during 2014, he is able to claim the $300 against the $500 carryover amount. This leaves him with $200 for medical expenses incurred during the remainder of 2014 and claimable during 2014 or during the run-out period for 2014 in 2015. If José incurs no additional medical expenses in 2014, then the entire $200 would be carried over to 2015. As this example shows, a participant is technically able to carry forward small amounts of unused FSA amounts indefinitely.

Clearly, Treasury has provided some flexibility to the use-it-or-lose-it rule, yet it's important to remember that employers aren't required to adopt either the carryover or grace period option. Also, if an employer decides to take advantage of the available flexibility, it may adopt only the carryover or the grace period option for all participants, not both. And participants can't pick and choose which option they want for themselves. **SF**

Janet Trewin, CMA, Ph.D., is a professor of accounting at the University of Nebraska–Kearney and an IMA® Member at Large. You can reach her at trewinj1@ink.edu.

Anthony P. Curatola is the Joseph F. Ford Professor of Accounting at Drexel University in Philadelphia, Pa., and a member of IMA's Greater Philadelphia Chapter. You can reach Tony at (215) 895-1453 or curatola@drexel.edu.