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IRS Eases Health FSA 'Use-it-or-Lose-it' Rule

November, 2013

Thompson Publishing Group

Employers now have the option of allowing plan participants to roll over up to $500 in unused FSA funds at the end of each plan year, under a new regulatory interpretation on health flexible spending accounts, the U.S. Treasury Department and IRS announced Oct. 31. Employers are free to change their plan designs accordingly for any plan year beginning in 2013 or later, but they don't have to. The new carry-forward provision is optional, just as the current rules' grace period for spending is. IRS announced the change in Notice 2013-71.

A senior Treasury official said employers now have three options:

1. offer the $500 carry-forward to employees;
2. offer the grace period available under the current rules; or
3. offer neither.

The official said employers may not offer both the carry-forward option and the grace period option at the same time — they must choose one or the other. Employers have until the end of 2014 to decide whether they will adopt the change, which they can apply as early as Jan. 1, 2013. He said employers still have the option of making no change at all.

"This is designed to help consumers, to make it easier for people to consider participating in a flexible spending account without the same degree of concern that many people have today that if they guess wrong about their medical expenses for next year — the types of expenses that qualify under [their] FSA — that they might have ended up contributing too much and having money leftover that will get forfeited. The risk of that forfeiture would be dramatically reduced with this $500 carry-forward," the Treasury official said in a briefing to reporters. He said that based on informal conversations with employers, most forfeitures are less than $500, so the change would address most of the situations in which employees have to give up unused FSA funds.

Asked by a reporter for the dollar amount of a recent year's worth of forfeitures nationally, the official said that information is kept by employers and the federal government does not track it.

The carry-forward option retroactively applies to Jan. 1, 2013, in order to counter balance the effect of Congress' decision to halve the annual health FSA limit to $2,500, also effective Jan. 1, 2013, the official said. Providing an optional carry-forward was within the Treasury's and IRS' statutory interpretive authority. The Patient Protection and Affordable Care Act's reduction of the annual limit prompted their action, he said.

Under the "use-it-or-lose-it" rule, funds set aside in a health FSA for a plan year must be used by the end of that plan year; any that are not are forfeited and could not be carried over, at least until IRS issued Notice 2013-71. IRS allows employers to give health FSA participants a grace period of up to an additional 75 days after the end of a plan year in which to use FSA funds from the plan year that ended to cover eligible expenses incurred during that plan year but that may not have come due until after it ended, as well as eligible expenses incurred during the grace period. For example, an employer that allows a grace period and has a plan year that ends Dec. 31, 2013 will allow participants to continue to use 2013 health FSA funds to cover eligible expenses through March 15, 2014.

The annual limit works along with the longstanding "use it or lose it" rule to limit the availability of funds that employees set aside tax-free. If there were no downside risk to over-estimating one's medical expenses for the coming year, the rationale goes, employees would be likely to divert more money than necessary to cover potential future medical expenses, maximizing the amount of money that goes untaxed.

But the Treasury official, as well as employers and others in industry, said that strategy has had drawbacks. The "use it or lose it" rule triggers unnecessary purchases of eligible items as the end of the plan year approaches, as employees try to spend down their unused funds to avoid forfeiting them, the official said. "There is a fair amount of anecdotal [evidence] of people loading up on various items that they're permitted to purchase under these FSAs that they might not otherwise purchase. This change will reduce the amount of that potentially unnecessary spending," he said.

Orrin Hatch, R-Utah, the ranking minority member of the Senate Finance Committee, said the rule change was a good start but more needs to be done. "This was a good decision by the Treasury Department," Hatch said in a prepared statement Oct. 31. "Allowing Americans who have one of these accounts to roll $500 over to the following year just makes sense and will give people more help to pay for out-of-pocket health care costs," he said. "I'd like to see more done to expand these critical accounts that empower the individual to make informed health care decisions using money they saved."

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