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webinar

$500 Carryover Opportunity for Cafeteria Plan Health FSAs: Worth the Effort?

The long-standing “use-it-or-lose-it” rule for cafeteria plan health FSAs now has a second exception

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INTRODUCTION AND OVERVIEW

Introduction and Overview

- Allowing choice related to medical benefits has a long history that goes all the way back to 1974
- However, as the associated Internal Revenue Code (Code) rules sprung up, the rules have typically become more proscriptive over the years, not less
  - Section 125 was added to the Code in 1978 (along with the 401(k) rules)
    - *Section 125(d)(2)(A) prohibits the deferral of compensation in a Section 125 plan*
      - Exception added in 1980 for 401(k) plans

Introduction and Overview

  - Proposed regulations in 1984 introduced the “use-it-or-lose-it” rule for FSAs

- The result: must incur FSA claims by year-end in order to be reimbursed; amounts remaining after a claims submission run-out period (usually the end of March) are forfeited
  - Unpopular and introduces too much risk into the benefit for many potential participants
  - Creates a “rush to buy” at year-end, leading to familiar advertising campaigns by vendors of elective health FSA-eligible products and services

Introduction and Overview

- Further complications:
  - Uniform availability rule added to health FSAs in 1989
    - *Full annual goal amount must be available on the first day of the plan year, even though contributions are made on a pro rata basis over the full plan year*
      - Employers can “lose” if employees terminate after submitting expenses in excess of their current contributions
  - Final COBRA rules (from 2001) allow employers to refuse COBRA to individuals who have “overspent” their health FSA
    - *Also, COBRA need not be offered beyond the end of the year of termination*

Introduction and Overview

- In response to Congressional pressure, Treasury Notice 2005-42 added the first optional exception to the general deferred compensation prohibition
  - Allows claims incurred in the first 2½ months of year #2 to be paid from year #1 health or dependent care FSA balances
  - Must be adopted uniformly
  - Frustrates HSA contributions (if health FSA balance on December 31 of year #1) until April 1 of year #2
    - *Significantly frustrates voluntary transition to HDHP/HSA options*

Introduction and Overview

- Treasury Notice 2012-40 asked for comments on modifying the “use-it-or-lose-it” regulations
- After the Affordable Care Act added the $2,500 cap on annual salary deferrals starting in 2013, pressure mounted anew to modify or eliminate the “use-it-or-lose-it” rule

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Introduction and Overview

- However, the interplay of the historical thicket of cafeteria plan rules, practices, and prohibitions makes it very difficult to create and implement a carryover exception to the “use-it-or-lose-it” deferred compensation requirement
  - Experts hoped for a cash-out response to this new pressure

NOTICE 2013-71

Notice 2013-71

- On October 31, Treasury responded to the renewed pressure and added a second exception to the “use-it-or-lose-it” rule
- Notice 2013-71 allows an optional carryover of up to $500 from year #1, and the $500 can be used for expenses incurred at any time in year #2—and beyond
- Can still make a full $2,500 salary deferral contribution for year #2
  – Can result in up to $3,000 available for expenses incurred at any time in year #2

Notice 2013-71

- Cannot also have the 2½-month grace period
  - The grace period and the $500 carryover are mutually exclusive; both are optional for sponsors
- Must apply to all participants
- Uniform availability rule still applies
  - Unclear how this works during the early months of year #2 due to run-out period for year #1 claims
  - Can treat year #2 expenses as coming first from year #2 salary deferrals; last from any carryover dollars from year #1

Notice 2013-71

- Must still forfeit amounts in excess of $500
- Any unused amounts from year #1 that are used to reimburse a year #2 expense
  - reduce the amounts available to pay year #1 expenses during the run-out period,
  - must be counted against the permitted carryover of up to $500, and
  - cannot exceed the permitted carryover

Notice 2013-71

- Must amend plan (on retroactive basis) by the end of the year of adoption (by the end of 2014 if adopting for 2013), provided that the plan operates in accordance with the Notice and participants are told about the carryover
  - Must end any use of the grace period
    - *Unclear if this is practically possible once a year starts (such as 2013) with a promise of a grace period for early in year #2*
    - *Note that, for some participants, the grace period is far more valuable for large anticipated expenses early in year #2 (see the following examples)*

Notice 2013-71

- Early reactions:
  - – Complicated to figure out and correctly account for the carryover
    - *But note that vendors are thrilled to possibly increase the number of participants and the possibility of multiple years of recordkeeping fees due to continuing rollovers*
  - – Confusing participant experience given that the amount (if any) of the carryover cannot be determined at OE time—and, really, not until after the end of the year #1 claims submission run-out period
  - – Worst possible time (OE) to release this Notice

Notice 2013-71

- There are significant conceptual holes in the Notice that require additional guidance, such as how the carryover:
  - Interacts with HSA eligibility
  - Impacts the special health FSA COBRA rules

EXAMPLES

Examples

- Notice 2013-71 basics: Example #1
  - 2014 OE—elect $2,500 for 2015
  - 2014 unused amount is $800 as of 12.31.2014
    - *Submits 2014 $350 claim during run-out; $450 ($800-$350) left at end of run-out for 2014*
  - 2015 goal amount ($2,500 + $450) = $2,950
    - *Submits $2,700 on 7.1.2015*
    - *Can carry over $250 into 2016 depending upon any remaining claims submitted during 2015 run-out*

Examples

- Unclear whether it is permissible to indicate goal amount for 2015 is $2,500 at the start of the year and jumps to $2,950 as of the end of the run-out period
- Unrealistically simplistic example, as no 2015 claims were submitted until after the end of the run-out period

Examples

- Example #2:
  - Same as Example #1, but $2,700 in 2015 expenses are submitted during January of 2015
    - *Plan may treat $500 of currently unused 2014 contributions available as of 1.1.2015*
  - Reimburse full $2,700
    - *$2,500 first from 2015 contributions*
    - *$200 from 2014 carryover*
  - 2014 unused amount falls to $600 ($800-$200) for claims submitted during run-out period

Examples

- Submits $350 in 2014 expenses during run-out period
  - *$250 remaining ($600-$350)*
- Full $250 remaining treated as carryover ($250 carryover plus prior 2015 use of 2014 $200 is $450, which is less than the maximum permissible $500 carryover)
- If no other claims are submitted for 2015, the $250 carries over until year 2016
- Unclear whether goal amount must be described as $3,000 as of 1.1.2015
- Unclear how happy the employee will be about using 2014 $ for 2015 expenses before the end of the run-out period

Examples

- Example #3:
  - Same as Example #2, but on 2.1.2015 employee submits $700 of expenses from 2014
  - Remember, employee only had $600 left over to use for 2014 (because the $800 was reduced by $200 to pay 2015 expenses the prior month)
  - Can only reimburse $600
  - Nothing remains from 2014 to carryover
  - Unclear how happy this individual will be, as they may not have wanted the outcome of Example #2

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Examples

- Example #4:
  - Same as Example #1, but:
    - *$600 unused as of 12.31.2014*
    - *No 2015 contribution*
    - *No claims submitted during run-out period for 2014*
  - $500 carryover to 2015 ($600-$100 forfeiture)
  - $200 in 2015 claims
  - $300 as of 12.31.2015
  - No 2016 contribution

Examples

- $300 carryover into 2016 for use with 2016 expenses
- Illustrates:
  - *How individuals will still have accounts (and incur recordkeeping fees) for years when they have a carryover*
  - *How carryover of unused amounts can continue indefinitely*

Examples

- Carryover v. Grace Period
  - Carryover:
    - *Elect $2,500 for 2014*
    - *No expenses submitted during 2014 or run-out period*
    - *Elect $2,500 for 2015*
    - *Maximum amount available for 2015 is $3,000 ($2,000 forfeiture)*
  - Grace Period
    - *Elect $2,500 for 2014*
    - *Elect $2,500 for 2015*
    - *Eligible for $5,000 reimbursement through 3.15.2015*

Examples

- Most high contributors will prefer the grace period because $5,000 for expenses incurred during the first few months of year #2 is a far better deal than $3,000 available for all of year #2 ($500 maximum carryover + $2,500 contribution for year #2)

OPEN ISSUES

Open Issues

- As mentioned earlier, there are significant open issues in the Notice such as how the carryover:
  - Impacts the uniform availability rule for year #2, particularly in the early months of year #2
  - Interacts with HSA eligibility
    - *Beginning to hear unofficial whispers that there may be undocumented ways to allow HSA eligibility even when adopting the $500 carryover option*
      - Can unrestricted health FSAs carryover into limited scope FSAs?
      - Can employees reject the carryover?

Open Issues

  - Can employees spend down the health FSA by 12.31.20XX to frustrate the carryover and ensure HSA eligibility as of the start of the next year?
  - Might a health FSA with only carryover $ in any given year still permit HSA participation for that full year?

- *Very risky at this time (and absent future written guidance) to "bet the farm" by adopting the carryover into 2014 if there are also HSA options*
- *Equally risky at this time to adopt the carryover if long-term strategy includes a full replacement HDHP/HSA in future years*

Open Issues

– Impacts the special health FSA COBRA rules
  - *Must COBRA be permitted in year #2 and beyond if there is a $500 carryover possibility?*
  - *How to determine this possibility and, at the onset of COBRA, communicate the proper duration?*

– And why doesn't it apply to dependent care FSAs?

– What risks are there for an employer with a 2013 grace period that wants to adopt the carryover into the 2014 plan year?

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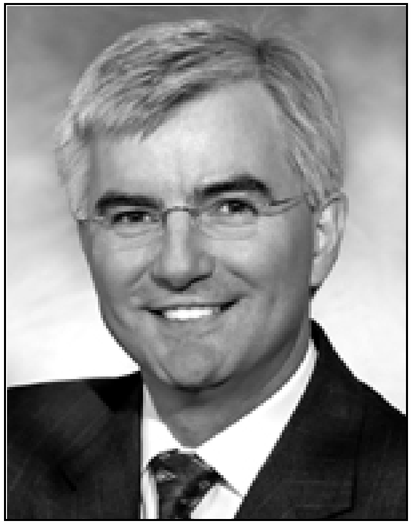
Open Issues

- If a significant number of health FSA participants currently contribute more than $500, they may be far better served with the grace period (assuming no HSA participation problems)
  - *Some (most?) employers will not choose to use the $500 carryover*
- While employers may enjoy increased FICA tax savings if more employees participate in a health FSA, keep in mind the additional administrative fees which will apply even when the employee does not make new contributions in future years and lower forfeitures to offset those fees
  - *Is this worth all of the trouble and cost for $500?*

QUESTIONS?

Contact Information



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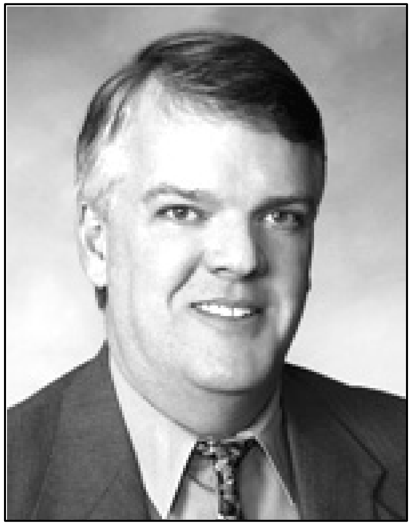

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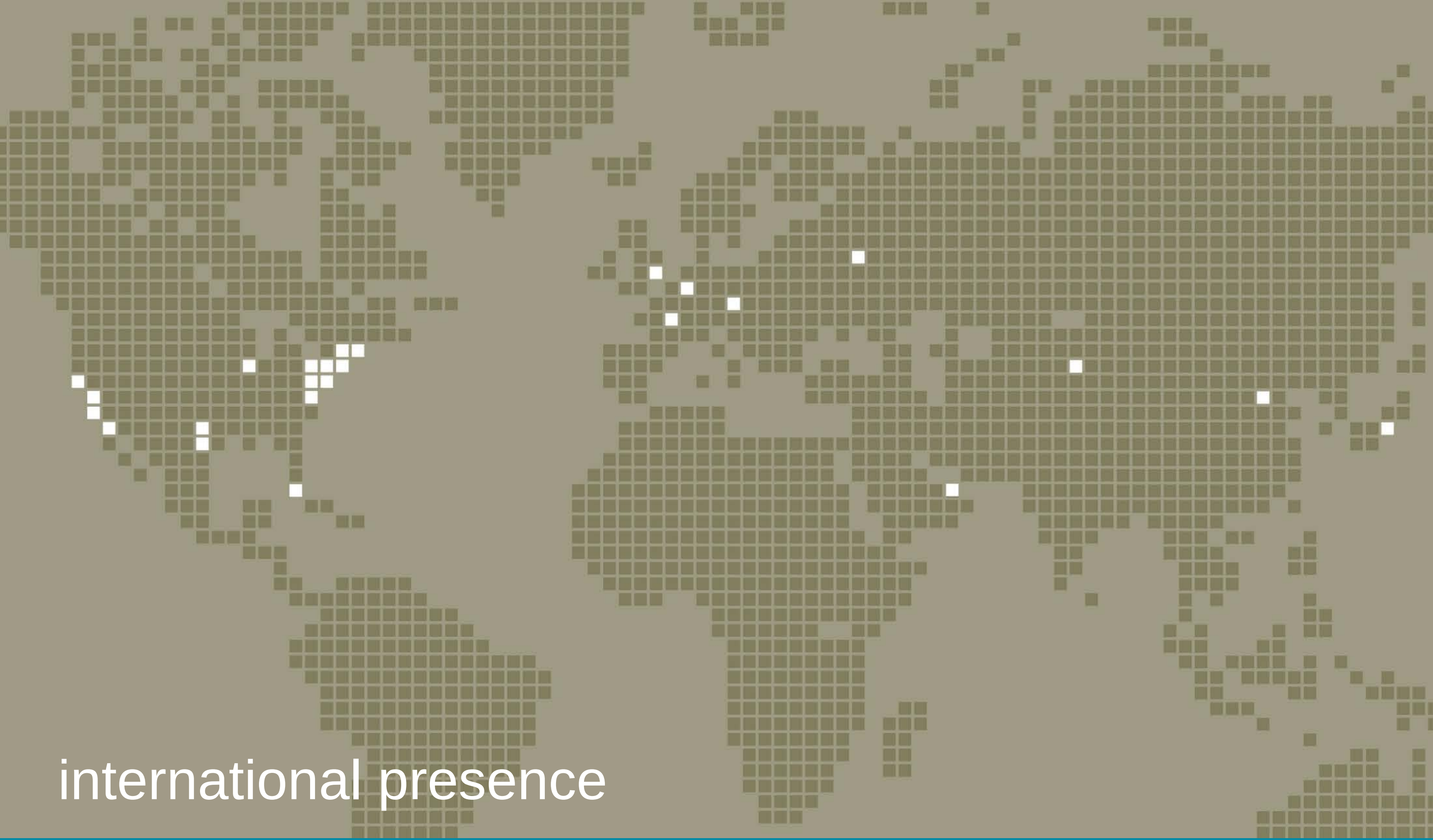

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