The Benefits Brief...

Landmark Notice Allows Carryover Of Unused Funds

JANET LeTOURNEAU
ACFCI, is the compliance manager at WageWorks. She draws upon more than 20 years of experience with flexible benefits plans and tax laws to perform consulting services and monitor quality control.

LeTourneau is a frequent speaker to employer groups and conferences and was formerly on the board of directors for the Employers Council on Flexible Compensation (ECFC) and is a current member of the ECFC Technical Advisory Committee (TAC). She is the lead instructor for the Section 125 administrators training workshop.

LeTourneau was one of the first people in the country to earn the Advanced Certification in Flexible Compensation Instruction designation sponsored by the Employers Council on Flexible Compensation. She is a certified trainer in the ACFCI program.

LeTourneau can be reached by telephone at 262-236-3021 or by email at ***jan.letourneau@wageworks.com****.*

The words "use-it-or-lose-it" may have kept many employees from participating in employers' flexible benefits plans because of their aversion to forfeiting even small amounts of their contributions. In response to numerous comments and overwhelming requests for carryover of unused funds for health flexible spending accounts (health FSAs), Notice 2013-71 was released on October 31, 2013.

The notice contained modifications to the rules for IRC Section 125 cafeteria plans that speak to several concerns the public expressed. First, the difficulty involved in predicting future medical expenses and the possibility of losing money at the end of the plan year. Second, minimizing incentives for unnecessary spending at the end of a plan year or "grace period" to avoid losing money.

Employers may now, at their option, adopt an amendment to their cafeteria plans to provide a carryover to the immediately following plan year of up to $500. Unused amounts remaining in a health FSA are determined at the end of the plan's run-out period. "Run-out" is the days allowed after the end of a previous plan year in which to turn in expenses incurred in the previous plan year.

Uniform Coverage

The uniform coverage rule requires that the maximum amount of reimbursement from the health FSA be available for claims incurred at all times during a participant's period of coverage. In other words, the employer is liable to pay eligible health care expenses up to and including a participant's annual election, regardless of the amount of contributions received by the plan. This rule continues to apply to cafeteria plans adopting the carryover provision. This means carryover amounts up to $500 from the previous plan year are generally available on the first day of the new plan year.

The Facts

- The participant must be an active participant in the plan as of the last day of the plan year.
- Once the new plan year starts, participants still have all their funds from the previous plan year to spend on qualified expenses incurred in the previous plan year.
- Previous plan year contributions may be used for current year expenses to the extent that the current year election is depleted.
- Any carryover may not allow unused amounts to be cashed out or converted to any other taxable or nontaxable benefit. This means a participant cannot use carryover funds from a health FSA to fund a dependent care benefit.
- Carryover is only applicable to health FSAs. However, plans may still allow "grace periods" for dependent care FSAs.
- Unused amounts in excess of $500 (or a lower amount specified in the plan) that remains as of the end of the plan year, after run-out, is forfeited. As is any remaining amounts in an employee's health FSA as of termination of employ-

ment if COBRA is not elected.

• Carryover is an alternative to the "grace period." If employers amend their cafeteria plans to allow health FSA carryover, they must remove the "grace period" language from the health FSA benefit.

More good news. The carryover does not count against or otherwise affect the indexed $2,500 salary reduction health FSA limit applicable to each plan year. For example, participants may elect $2,500 for the 2015 plan year and add their leftover funds, up to $500, from the 2014 plan year. Plus, any employer contributions to the plan, within certain limitations, may be made available in addition to the participant election and carryover amounts.

When details of health FSA carryovers exploded on October 31, 2013, the benefits world saw the end to the "use-it-or-lose-it" rule. It also saw a torrent of questions surrounding the characterization of the carryover funds and COBRA and nondiscrimination questions. Having dollars carry over from one plan year to the next is great. But how are these excess funds treated in the new year for health savings account (HSA) eligibility, COBRA eligibility and premiums, W-2 reporting requirements and discrimination testing?

Health FSA Carryover and HSA Eligibility

What's the difference between the "grace period" extension and this new carryover feature, and why should participants care?

The "grace period" allowed participants to use previous year contributions in a general-purpose health FSA for current year eligible expenses. However, at the end of the "grace period" any leftover funds were forfeited, and participants were eligible to set up and contribute to an HSA.

Carryover allows participants to move leftover contributions from one plan year to the next. Carried over general-purpose health FSA funds would be considered ineligible health care coverage for the entire current year and preclude participants from setting up or contributing to an HSA.

To avoid losing HSA eligibility for the full year, general-purpose health FSAs may carry over into the current year as a limited-purpose health FSA either because the participant is enrolled in a limited-purpose health FSA in the current year, or the participant elected to have the carryover funds become a limited-purpose health FSA election for the current year. The participant could also waive any leftover funds from a previous year general-purpose health FSA to prevent disqualification for HSA coverage.

As an example: Joe had 2014 excess contributions from a general-purpose health FSA in the amount of $600 and a new 2015 election of $2,500 in a limited-purpose health FSA. Joe submits an eligible dental/vision expense in the amount of $2,700 at the beginning of 2015. From the current year limited-purpose health FSA, $2,500 is paid. In February Joe submits and is reimbursed from the general-purpose health FSA $300 for eligible expenses incurred in 2014. At the end of the run-out period, $300 in general-purpose health FSA funds is unused and carried over to the HSA-compatible health FSA. Joe is paid $200 for the excess of the January claim over the amount elected, and $100 remains in the HSA-compatible health FSA for vision and dental expenses incurred in 2015.

In addition, Joe is allowed to contribute to his HSA as of January 1, 2015.

Health FSA Debit Card Credits

Debit card credits would apply to the plan year in which the original claim was paid. Credits received after the beginning of new plan years, for purchases made in previous plan years, must be credited and used for previous year expenses. If not used for previous year expenses, these credits could be included in carryover amounts.

COBRA Continuation

Employers should take into consideration the carryover funds for determining eligibility but not for establishing COBRA premiums. COBRA is generally not offered to health FSA participants if they have overspent their accounts. In determining if disbursements exceed contributions, the current year contributions and carryover funds are used. For example, Jane had $400 carried over from 2014 and elected $1,500 in the health FSA for 2015. On June 30 she terminates employment, having contributed $750 and been disbursed $900. Taking into consideration the carryover, her contributed-to-date is $1,150 ($750 + $400). Jane's available balance at termination ($1,000) is higher than her required COBRA premiums ($750), thus requiring COBRA to be offered.

In the example above, COBRA premiums are based on the $750 remaining balance of current year elections. Jane's premium would be $125 per month for the next six months, not including any service charges that might be applied. Keep in mind—if COBRA continuation is not elected for a plan year, the participant would not be eligible for carryover the following year. Carryover candidates must be active participants in the plan as of the last day of the plan year.

Coverage periods for COBRA are generally 18 months. If COBRA is elected and premiums paid through the end of the plan year, participants are considered active past the end of the health FSA plan year and therefore have access to the carryover amount into a subsequent plan year. The COBRA premium for a participant making no election in the subsequent plan year would be zero for the carryover amounts.

Miscellaneous Items

Employers also have options to:

• Impose limitations (e.g., three years) on carryover funds so that these funds would expire at a certain point and not be carried forward for an indefinite period of time.

• Impose a dollar amount limit (e.g., $1 to $10) on the minimum amount that may be carried over from one year to the next.

• Charge an administrative fee to employees with only rollover dollars in their health FSAs to reduce the carryover into the following plan years.

Employers would ignore carryover amounts for W-2 reporting purposes and for nondiscrimination purposes. The contributions, in both cases, were counted in the year they were contributed.

Further guidance, in the form of IRS Chief Counsel Memo No. 201413005, was published by the IRS on March 28, 2014, supporting the options and issues discussed in this article *(www.irs.gov/pub/irs-wd/1413005.pdf)*

The information contained in this article is not intended to be legal, accounting, or other professional advice. We assume no liability whatsoever in connection with its use, nor are these comments directed to specific situations.