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## *New Rollover Option Available to Health Flexible Spending Account Plans*

### Overview

The tax rules were recently changed, to allow up to \$500 of an unused health flexible spending account balance to be rolled over for use in the next plan year. This new rollover option provides an alternative to the current grace period rule, which otherwise would allow unused account balances to be used toward claims incurred up to 2 ½ months after the end of the plan year.

### Forfeiture of Unused Health Flexible Spending Account Balances

A health flexible spending account (“FSA”) is a method by which an employee can effectively use pre-tax dollars to pay certain health expenses. Under an FSA, an employee can generally elect to forego up to \$2,500 of pre-tax compensation per year, and can then receive up to that amount from the FSA to reimburse qualifying medical expenses incurred.

In the past, FSAs had to comply with “use-it-or-lose-it” requirements under the Internal Revenue Code. Unused health FSA balances had to be forfeited at the end of the plan year. Or, the health FSA could allow a grace period of up to 2 ½ months following the end of the plan year, after which any unused health FSA balances had to be forfeited. Some employees stockpiled medical supplies at year-end, to use up their FSA balance. For others, the use-it-or-lose-it rules cause them to contribute less to their health FSA, out of fear that they might forfeit unused amounts. The availability of a grace period tends to reduce these types of inefficient behaviors, but does not eliminate them.

### Rollover of Unused Health Flexible Spending Account Balances

Recently, the IRS issued guidance that modified the use-it-or-lose-it rules for health FSAs. The new guidance permits employers to amend their health FSAs (which are provided under a cafeteria plan, sometimes called a 125 plan) to allow up to \$500 of an unused health FSA account balance remaining at the end of a plan year to be rolled over for use in the next plan year. In order to provide this rollover option, the health FSA can no longer reimburse qualifying expenses incurred during any grace period. In other words, instead of forfeiting their entire unused health FSA account balance at year end or at the end of a grace period, a plan participant can use up to \$500 of their unused account balance for qualifying expenses incurred at any point in time during the following plan year. Just as with the use of a grace period, the use of this rollover option will help reduce inefficient behaviors, but will not eliminate them.

A rollover of up to \$500 does not affect the maximum annual amount of salary reduction contributions that the participant is permitted to make to a health FSA. The annual limit remains at \$2,500 for 2014, and will increase within inflation in future years.

**Example:** Jane elects a health FSA benefit amount of \$2,500 in 2015, but at the end of the year she has an unused benefit amount of \$600 remaining. The health FSA provides for a rollover of \$500 of the unused balance,

and the excess of \$100 (\$600 - \$500 = \$100) is forfeited. In 2016, Jane elects a health FSA amount of \$2,500, and because of the rollover from the prior year, she has available to her a total of \$3,000 for reimbursement in 2016. At the end of 2016, Jane has an unused benefit amount of \$400. The health FSA rolls over the unused \$400 balance into 2017. [Total forfeiture: \$100.]

If the health FSA had a grace period instead of the rollover provision, Jane would forfeit up to \$600 from the 2015 plan year (the portion of the unused \$600 balance from 2015 that was not used in the first 2 ½ months of 2016), and up to \$400 from the 2016 plan year (the portion of the unused \$400 balance from 2016 that was not used in the first 2 ½ months of 2017). [Total forfeitures: Up to \$1,000.]

The availability of rollovers will reduce forfeitures, and some employers rely on forfeitures to offset plan administrative costs. Providing rollovers may reduce employees' fear of a forfeiture taking place, however, and for that reason allowing rollovers may tend to increase annual health FSA election amounts. This will reduce the tax obligation for the employer as well as the employees.

### **Conclusion**

In order to take advantage of the new use-it-or-lose-it rule during your health FSA's next plan year, the plan document has to be amended in advance. The amendment must add the necessary rollover language, and eliminate the right to reimbursement for claims incurred during a grace period, if any. Employers wishing to take advantage of this new option should talk with the author of this e-mail news alert, a member of the Butzel Long Employee Benefits Practice Group, or your regular Butzel Long attorney.

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