

IRS Provides Additional Guidance on Health FSA Carryovers

The IRS recently issued Notice 2015-87 that addresses, among other things, issues affecting the administration of health FSA carryovers. The guidance clarifies how carryovers must be treated for purposes of COBRA and discusses the conditions that a plan sponsor may impose on the availability of carryovers. Employers that permit health FSA carryovers need to be aware of this guidance to ensure that they are in compliance with COBRA.

Background

A health flexible spending account (health FSA) is an account typically funded through salary reduction that may be used to pay for health care expenses incurred by an employee, the employee's spouse and other eligible dependents. The Affordable Care Act imposes an annual limit on the amount of salary reduction contributions that an employee may make to a health FSA for a plan year. For plan years beginning in 2016, that limit is \$2,550; this limit is indexed and may be increased for subsequent years.

Health FSAs are group health plans and, as such, are subject to various legal requirements, including the obligation to offer continuation coverage through COBRA. However, health FSAs that qualify as "excepted benefits" (see sidebar on page 2) have only the following limited COBRA obligations:

- While other group health plans must make COBRA coverage available for the 18 (or 36) month period following the qualifying event, health FSA COBRA coverage may be terminated on the last day of the plan year in which the qualifying event occurs.
- Although all qualified beneficiaries who lose health FSA coverage may be extended the opportunity to continue coverage through COBRA, an employer is required to offer COBRA coverage only to qualified beneficiaries who have "underspent" their health FSA at the time of the qualifying event.

A health FSA is considered "underspent" when the maximum benefit available from the account for the remainder of the plan year after claims submitted prior to the qualifying event are deducted from the amount of the election is greater than the amount of COBRA premium required for the remainder of such year.



Under the “use-it-or-lose-it” rule, FSA funds not applied to eligible expenses incurred by the end of the plan year, or by the end of a 2½ month “grace period” following the close of the plan year, must be forfeited. In 2013, the IRS relaxed this rule to permit a participant to carry over up to \$500 in unused health FSA funds for use in subsequent plan years. For a discussion of prior IRS carryover guidance, see our [April 24, 2014](#) and [November 1, 2013](#) *For Your Information* publications.

The IRS recently issued [Notice 2015-87](#) which, among other things, provides additional guidance on issues affecting health FSA carryovers.

Notice 2015-87

Notice 2015-87 sets out questions and answers on a variety of issues. Part V of the notice clarifies how COBRA continuation coverage rules apply to health FSA carryovers. It also discusses the conditions that the plan sponsor may impose on the availability of carryover amounts.

Health FSA Carryovers and COBRA

The notice addresses the interplay of COBRA and carryovers in health FSAs that qualify for the limited COBRA obligation:

Treatment of carryovers in determining the applicable COBRA premium. The guidance states that carryover amounts are not taken into account in determining the applicable COBRA premium; the amount of the premium must be based solely on the sum of the employee’s salary reduction election for the year and any nonelective employer contributions (if the employer contributes to the health FSA).

Effect on determination of whether health FSA is “underspent.” The notice states that in determining whether the qualified beneficiary’s account was underspent at the time of the qualifying event, carryover amounts are included in calculating the maximum benefit available for the remainder of the plan year.

The following example illustrates how these rules interact to affect the determination of whether an account has been underspent.

Example. Mudhut Corporation (“Mudhut”) sponsors health FSAs that are funded exclusively through salary reduction. Participants may carryover up to \$500 in used amounts to the next calendar year. Mike, who has a \$500 carryover from 2015, elects to contribute \$2,400 through salary reduction for the 2016 calendar year; resulting in a maximum benefit available for 2016 of \$2,900. If at the time of his termination of employment on May 31, 2016, Mike had submitted claims for \$1,000 in expenses, the maximum benefit available for the remainder of 2016 would be \$1,900.

When is a health FSA an excepted benefit?

A health FSA is an excepted benefit for COBRA purposes only if the:

- Maximum benefit payable under the FSA to any participant is no more than twice his or her salary reduction election or, if greater, the amount of that election plus \$500
- Participant is eligible for other health coverage through the employer that does not consist of excepted benefits (e.g., limited scope dental or vision coverage)
- Annual COBRA premium is not less than the annual maximum coverage amount (which will always be the case when a health FSA is funded exclusively through salary reduction)

The maximum amount that Mudhut may charge Mike to continue his health FSA under COBRA for the remainder of 2016 is \$1,428 (102 percent of 1/12 of the applicable premium of \$2,400 times the number of months remaining in the year after the qualifying event). The \$500 carried over from the prior year is disregarded in determining the premium. Because the \$1,900 maximum benefit potentially available for the remainder of the plan year is greater than \$1,428, Mike would be deemed to have underspent his account and therefore must be offered COBRA coverage.

Comment. Note that the carryover is also disregarded in determining the maximum applicable COBRA premium even when COBRA coverage is extended to all qualified beneficiaries regardless of whether they have underspent their accounts.

Availability of new carryovers to qualified beneficiaries. Qualified beneficiaries who continue their health FSA coverage through COBRA must be permitted to carry over unused amounts to the next year under the same terms and conditions as similarly situated health FSA participants who did not have a qualifying event during the year. However, the health FSA does not have to permit a qualified beneficiary to elect additional salary reduction amounts for the carryover period or to have access to any contributions that an employer might make to the health FSAs of non-COBRA participants during the carryover period. Because carryovers are not taken into account in determining the applicable premium, the guidance notes that the applicable COBRA premium for the carryover period is zero.

Subject to the terms and conditions applicable to similarly situated non-COBRA participants, a qualified beneficiary must be provided access to carryover amounts through the end of the maximum COBRA coverage period that applies to the particular qualifying event (e.g., in the case of termination of employment, 18 months from the date of the qualifying event). This is the case even when COBRA coverage does not have to be offered beyond the year of the qualifying event.

Example. Assume that in the above example, Mike, who at the time of his termination was also enrolled in Mudhut medical coverage, elected COBRA coverage and continued his health FSA coverage through the end of 2016. Prior to December 31, 2016, he submits additional eligible expenses in the amount of \$1,400, leaving a balance of \$500 of unused benefits at the end of the year (\$1,900 balance on May 31, 2015 reduced by \$1,400 in subsequent reimbursements). Although Mike cannot make new contributions to a health FSA in 2017, he must be permitted to carry over up to \$500 of unused benefits and use those funds to pay for expenses incurred in 2017 just as similarly situated non-COBRA participants are permitted to do.

The carryover must be made available to Mike only through November 30, 2017, 18 months from the date of the qualifying event. The health FSA is not required to reimburse any expense incurred after that date.

Permissible Conditions on the Availability of Carryovers

In addition to discussing carryovers and COBRA, the guidance also provides some clarification on the types of conditions that an employer may impose on the availability of carryovers to active employees. A health FSA may limit the availability of the carryover of unused amounts to individuals who have elected to participate in the health FSA in the next year, even if the ability to participate in that next year requires a minimum salary reduction election to the health FSA for that next year. A health FSA may also impose a maximum period on the availability of a carryover. For example, a health FSA can provide that a carryover will only be available for the subsequent plan year and provide that any balance remaining at the end of that period will be forfeited.

Comment. The notice does not specifically address what happens to COBRA participants when a health FSA limits the availability of the carryover to those participants who elect to participate in the health FSA in the next year. It appears that a COBRA participant who cannot elect to participate in the health FSA in the plan year following the year of the qualifying event would not have the right to a carryover since a similarly situated non-COBRA beneficiary who did not elect to participate would not. Additional clarification by the IRS would be welcome.

Important!

Employers should review their health FSA plan document to make certain it authorizes carryovers and that carryovers are administered in accordance with the terms of the plan.

In Closing

Employers that permit health FSA carryovers need to make certain that they do not run afoul of COBRA. They should also consider whether they want to impose any conditions or limitations on the availability of carryovers as discussed in the guidance. Most importantly, employers should review their health FSA plan document to make certain it authorizes carryovers and that carryovers are administered in accordance with the terms of the plan.

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