

## Health FSAs—Changes for 2014

Health flexible spending accounts (FSAs) are tax-advantaged accounts that reimburse employees for certain medical expenses, up to the amount contributed for the plan year. Health FSAs are commonly offered through a cafeteria plan to allow employees to make pre-tax salary reduction contributions to their FSAs. Employers may provide health FSA benefits in addition to employees' salary reduction contributions.

The Affordable Care Act (ACA) includes reforms that limit the availability of health FSAs beginning in 2014. Recently issued guidance from the Internal Revenue Service (IRS) and Department of Labor (DOL) indicates that health FSAs that do not qualify as excepted benefits will be prohibited beginning in 2014. Health FSAs that qualify as excepted benefits will be permitted, but must continue to comply with the ACA's reforms for health FSAs.

In addition, the IRS has relaxed the health FSA "use-or-lose" rule. Under the relaxed rule, employers will be able to allow participants to carry over up to \$500 in unused funds into the next year. However, the relaxed "use-or-lose" rule only applies if a plan does not also incorporate an extended deadline, or grace period, after the end of the plan year to use health FSA funds. The new carryover provision is available beginning with the 2013 plan year.

### ACA IMPACT

The following chart provides an overview of the ACA's impact on different types of health FSAs, effective for plan years beginning on or after Jan. 1, 2014.

Type of Health FSA	Status in 2014
Health FSA—Excepted Benefits, offered through cafeteria plan	Permitted, but subject to the \$2,500 annual limit on employee salary reduction contributions and the restriction on reimbursement of over-the-counter medicines and drugs. The health FSA may be amended for the relaxed "use-or-lose" rule.
Health FSA—Excepted Benefits, not offered through cafeteria plan	Not allowed under IRS Notice 2013-54. The health FSA would violate the ACA's prohibition on annual limits because it is not offered through a cafeteria plan.
Health FSA—Non-excepted Benefits, offered through cafeteria plan	Not allowed under IRS Notice 2013-54. Although the health FSA would satisfy the ACA's prohibition on annual limits, health FSAs that are not integrated with a group health plan will fail to meet the ACA's preventive services requirement.
Health FSA—Non-excepted Benefits, not offered through cafeteria plan	Not allowed under IRS Notice 2013-54. The health FSA would violate the ACA's prohibition on annual limits because it is not offered through a cafeteria plan and it would fail to meet the ACA's preventive service requirement because it is not integrated with a group health plan.

## EXCEPTED BENEFITS

Employee benefits that qualify as excepted benefits are not subject to the ACA's market reforms, including the ACA's prohibition on annual limits and preventive care coverage requirement. However, health FSAs that qualify as excepted benefits are subject to the ACA's reforms for health FSAs, such as the \$2,500 annual limit on employee salary reduction contributions and the restriction on the reimbursement of over-the-counter medicines and drugs.

Health FSAs qualify as excepted benefits if they satisfy the **availability** AND **maximum benefit** requirements

### Availability Requirement



Other non-excepted group health plan coverage (for example, coverage under a major medical group health plan) must be made available for the year to the class of participants by reason of their employment.

### Maximum Benefit Requirement



The maximum benefit payable under the health FSA to any participant for a year cannot exceed the greater of:

- Two times the participant's salary reduction election under the health FSA for the year; or
- The amount of the participant's salary reduction election for the health FSA for the year, plus \$500.

For example, a health FSA with a one-to-one employer match (\$700 employee, \$700 employer) would satisfy the maximum benefit requirement. Also, a health FSA with an employer contribution of \$500 or less would satisfy the maximum benefit requirement.

## ACA REFORMS

### *Preventive Care*

The ACA requires non-grandfathered group health plans to cover certain preventive care services without imposing any cost-sharing. On Sept. 13, 2013, the IRS and DOL issued technical guidance on how the ACA's reforms apply to health FSAs, health reimbursement arrangements (HRAs) and cafeteria plans. This guidance is contained in IRS Notice 2013-54. It applies for plan years beginning on or after **Jan. 1, 2014**, but can be applied for all prior periods.

According to the IRS and DOL, if an employer provides a health FSA that does not qualify as excepted benefits, the health FSA generally is subject to the market reforms, including the preventive care coverage requirement. **IRS Notice 2013-54 states that, because a health FSA that is not excepted benefits is not integrated with a group health plan, it will fail to meet the preventive care coverage requirement.**

IRS Notice 2013-54 does not address whether the grandfathered plan exception to the preventive care coverage requirement applies to health FSAs. The guidance also does not distinguish between health FSAs that satisfy the availability requirement for excepted benefits, but not the maximum benefit requirement.

### *Annual Limits*

For plan years beginning on or after Jan. 1, 2014, the ACA prohibits group health plans from placing annual dollar limits on the coverage of essential health benefits.

In addition, the ACA imposes a **\$2,500** limit on salary reduction contributions to a health FSA offered under a cafeteria plan, effective for plan years beginning after Dec. 31, 2012. The \$2,500 limit will be indexed for cost-of-living adjustments for 2014 and later years. Non-elective employer contributions to a health FSA (for example, matching contributions or flex credits) generally do not count toward the \$2,500 limit. However, if employees may elect to receive the employer contributions in cash or as a taxable benefit, then the contributions will be treated as salary reductions and will count toward the \$2,500 limit.

On June 28, 2010, the Departments of Health and Human Services, Labor and the Treasury (Departments) issued interim final regulations on the ACA's annual limit prohibition. These interim final regulations indicated that the ACA's annual limit prohibition did not apply to health FSAs. However, IRS Notice 2013-54 provides that the annual limit exemption for health FSAs **only applies when the FSA is offered under a cafeteria plan**. The Notice also indicates that the Departments will update their annual limit regulations to clarify this exemption, applicable Sept. 18, 2013.

### *Over-the-counter Drugs*

The ACA revised the definition of "qualified medical expenses" for purposes of reimbursement from health FSAs. Under the revised definition, qualified medical expenses include amounts paid for medicines or drugs only if the medicine or drug is a prescribed drug (determined without regard to whether the drug is available without a prescription) or is insulin. This means that health FSAs **may not reimburse the cost of over-the-counter medications that do not have a prescription**. This change became effective for medicines and drugs purchased after Dec. 31, 2010.

### **CHANGE TO THE USE-OR-LOSE RULE**

On Oct. 31, 2013, the IRS released Notice 2013-71, which relaxes the "use-or-lose" rule for health FSAs. Under the relaxed rule, employers will now be able to allow participants to **carry over up to \$500 in unused funds** into the next year. This modification applies only if the plan does not also incorporate the grace period rule.

The "use-or-lose" rule generally prohibits any contribution or benefit under a health FSA from being used in a later plan year or period of coverage. Employees are required to use their health FSA funds by the end of the plan year (or grace period) or the funds would be lost. The IRS allows employers to offer an extended deadline, or grace period, of two and a half months after the end of a plan year to use remaining health FSA funds.

Under the modified rule, an employer, at its option, is permitted to amend its section 125 cafeteria plan document to allow up to \$500 of unused funds remaining at the end of a plan year in a health FSA to be paid or reimbursed to plan participants for qualified medical expenses incurred during the following plan year. The plan may specify a lower amount as the permissible maximum (and has the option of not permitting any carryover at all). As noted above, this modification applies only if the plan does not also incorporate the grace period rule.

To implement the new \$500 carryover option, a cafeteria plan offering a health FSA must be amended to include the carryover provision. The amendment must be adopted on or before the last day of the plan year from which amounts may be carried over, and may be effective retroactively to the first day of that plan year, provided that the cafeteria plan operates in accordance with the rules in IRS Notice 2013-71 and informs participants of the carryover provision.

A plan may be amended to adopt the carryover provision for a plan year that begins in 2013 at any time on or before the last day of the plan year beginning in 2014.