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EASING THE IMPACT OF THE USE-IT-OR-LOSE-IT RULE: FSA CARRYOVER VS. GRACE PERIOD

OVERVIEW:

A general rule regarding Flexible Spending Account elections, is that funds not used during the plan year are forfeited by the participant. This use-it-or-lose-it rule can cause frustration for participants, and is often a barrier to participation in the plan altogether.

Currently, there are two ways to ease the impact of that general rule. They cannot both be applied to the same benefit, but either will typically result in higher employee satisfaction, and ultimately participation.

DEFINITIONS:

Grace period – Essentially extend access to plan funds by an extra 2 ½ months. This allows participants who don't use their full FSA balance in the plan year itself to continue incurring expenses that would otherwise not be eligible. Feature can apply to a Health FSA (including a limited-purpose FSA) or a Dependent Care Assistance Plan.

Carryover –This feature allows up to $640 in unspent funds to roll from one plan year into the next. Rolled funds are integrated into the new plan year election, without impact on the annual maximum. The IRS determines the maximum amount that can be carried over each year. For 2024 plan years, up to $640 can be carried over, if specified in the plan documents. While funds can be rolled each year, they cannot accumulate year over year, meaning that an individual cannot expect to roll $1000 in year 2, or $1500 in year 3, etc. This can only be applied to a Health FSA (including a limited-purpose FSA), and NOT to a Dependent Care Plan.

COMMON ADVANTAGES:

Both features ease the general use-it-or-lose-it rule that applies to FSAs. Fear of losing funds at the end of the year is a significant barrier to participation, so either of these two features may encourage higher entry into the plan, typically increasing tax savings for participants and employers.

With either feature, funds from each plan year are made simultaneously available to the participant. Whether accessing their funds through a debit card, manual claims submission, or an electronic data feed from an insurance carrier, BPC's system will automatically apply claims to plan years in the most advantageous manner to the participant. Re-enrollment for the next plan year is not necessary to utilize the funds available through the grace period or rollover.

HOW TO CHOOSE:

Employers weighing the two options should consider a number of questions before deciding which feature to utilize.

- **What's easiest to communicate to employees?** For most participants, the carryover will seem very straightforward, while the grace period may require some additional explanation. However, for some groups of employees, the grace period may be a longstanding feature with which there is significant comfort and familiarity. **ADVANTAGE: Draw (depends on history)**

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- **Do you offer a Health Savings Account (HSA) or HSA-compatible health plan?** The grace period can cause confusion and frustration for participants attempting to move from a traditional health plan/general-purpose Health FSA to a qualified high-deductible health plan/HSA. Any amount of funds left in the FSA at the end of the plan year will activate the grace period, and delay eligibility for the HSA by 3 months[1]. The IRS has clearly stated[2] that the rollover can be structured in a friendlier manner, by allowing rolled funds to convert from a general-purpose Health FSA to a limited-purpose Health FSA. **ADVANTAGE: Rollover**

  1: IRS Notice 2005-86; I.R.B. 2005-49 - http://www.irs.gov/irb/2005-49_IRB/ar08.html

  2: IRS Chief Counsel Advice 201413005 (Feb. 12, 2014) - http://www.irs.gov/pub/irs-wd/1413005.pdf

- **Which will keep the most dollars in employee pockets?** Generally speaking, the rollover will offer a greater financial advantage to employees, but an analysis of past spending for your population may be advisable. If you routinely have employees use up more than $640 during the grace period, then those employees could actually be harmed by the rollover. Keep in mind that their behavior may have been modified if the rules were different though. If you rarely see employees end the year with more than $640 anyway, then it makes sense to utilize the rollover, since it gives them an indefinite timeframe to spend, rather than limiting them to a 2 ½ month period. **ADVANTAGE: Draw (depends on history)**

OTHER CONSIDERATIONS:

Carryover – To avoid insignificant balances from rolling over indefinitely, BPC recommends a small minimum ($25 or less) be placed on the rollover. This prevents balances below the minimum from rolling, but would not reduce balances for participants above the minimum. Any such minimum should be stated in the plan document.[3]

3: Per informal, non-binding comments by IRS official Kevin Knopf in ECFC call on 2/12/2014

Grace Period – While many plans utilize a 3-month run out after the end of the plan year, the grace period can make this is a difficult window for some claims. If a calendar year plan has a 2 ½ month grace period, and only a 3-month run out, then an eligible service could occur on March 15, but the participant would have only 15 days to obtain and submit documentation. BPC generally recommends using a 4-month run out, giving participants 1 ½ months to submit claims incurred at the end of the grace period.

COMPARISON:

Carryover	Grace Period
• Maximum dollar amount is $640	• No dollar cap
• Funds rollover indefinitely	• Funds are available for just 2 ½ months
• Simpler concept for employee understanding	• Longstanding feature, with which many employees may be comfortable
• Only applies to Health FSA's (including limited-purpose FSA)	• Can apply to Health or Dependent Care FSA (It is permissible to offer rollover on Health FSA and grace period on Dependent Care FSA)
• Able to convert rollover funds from General-Purpose FSA to Limited-Purpose FSA, to allow easy transition to HSA for individuals.	• Entering grace period with General-Purpose Health FSA funds will disqualify individual from HSA contributions for 3 full months.