American Benefits Council
P4P Webinar
FSA “Use-or-Lose” Rule

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How Use-or-Lose Rule Evolved

- Section 125 requires that a cafeteria plan must not provide for the deferral of compensation.
- The “use-or-lose" rule is the IRS’s interpretation of the statute’s prohibition against deferral of compensation.
  - It was originally developed by the IRS in 1984 in proposed regulations (expanded in 1989 and re-proposed in 2007).
What Use-or-Lose Rule Requires

- To satisfy the use-or-lose rule, any FSA funds remaining after all reimbursable claims are paid for the plan year must be forfeited.

- The rule has never been popular, and many argue that it leads to wasteful spending of health care dollars at the end of the year (e.g., designer prescription sun glasses).
Is Use-or-Lose Rule Necessary?

- Many say “no” and point to examples where funds carry over from year to year without being viewed as impermissible deferred compensation.
- IRS 2007 proposed cafeteria plan regulations create some exceptions:
  - LTD policy paying benefits over more than one plan year
  - Reasonable premium rebates or policy dividends
  - Advance payments for orthodontia
Congressional Response

- Over the years, there have been several attempts to eliminate the use-or-lose rule through legislation.
- Numerous bills have been introduced in Congress to eliminate or modify the use-or-lose rule.
  - Legislative proposals have included carry forwards and cash outs (e.g., $500).
  - H.R. 436, the Health Care Cost Reduction Act of 2012, passed the House on 6/7/12.
Grace Period Rule

- In 2005, the IRS modified the use-or-lose requirement (Notice 2005-42).
- A cafeteria plan may provide a “grace period” of 2-1/2 months following the close of a plan year.
- During grace period, participants can incur claims and receive reimbursement from amounts unused at end of previous plan year.
Limit on Salary Reduction Contributions under PPACA

- $2,500 limit (per employee) added to Section 125 by the Patient Protection and Affordable Care Act, effective for taxable years beginning after 2012.
- Limit applies only to salary reduction contributions and not to employer contributions or “flex credits.”
- Adjustment for inflation will apply to taxable years beginning after 2013.
Limit Applies on Plan-Year Basis

- IRS Notice 2012-40 resolves uncertainty over use of “taxable year”
  - Limit applies on plan-year basis for cafeteria plan years beginning after December 31, 2012
  - Example: If Plan Year begins May 1st, first Plan Year of application is May 1, 2013 through April 30, 2014
  - Rule eliminates challenges non-calendar year plans would have faced in implementing and administering the limit.
Application to Plans With Grace Periods

- For plans with grace periods, limit applies in Plan Year when salary reductions are made, not following the Plan Year.
- Salary reductions only count toward the limit once, even though they may actually be used during grace period in the following Plan Year.
Possible Change to Use-or-Lose Rule?

● Notice 2012-40 states that the IRS and Treasury are considering whether to modify the use-or-lose rule
  ● Rationale: $2,500 limit reduces potential to defer compensation under a health FSA
  ● Changes might be instead of, or in addition to, current grace-period rule
Possible Changes to Use-or-Lose Rule?

- Notice 2012-40 requests comments on possible modifications to use-or-lose rule for health FSAs
  - Should use-or-lose be modified to provide more flexibility?
  - How might additional flexibility “be formulated and constrained”?
  - How would any changes interact with $2,500 limit?
Cash Out, Carryover or Something Else?

- Cash out would be easiest to administer.
- Carryover, depending upon structure, could result in administrative challenges.
  - Carryover that requires reduction of election in following year may be complex, particularly because of run out period.
- Limit to cashout or carryover?