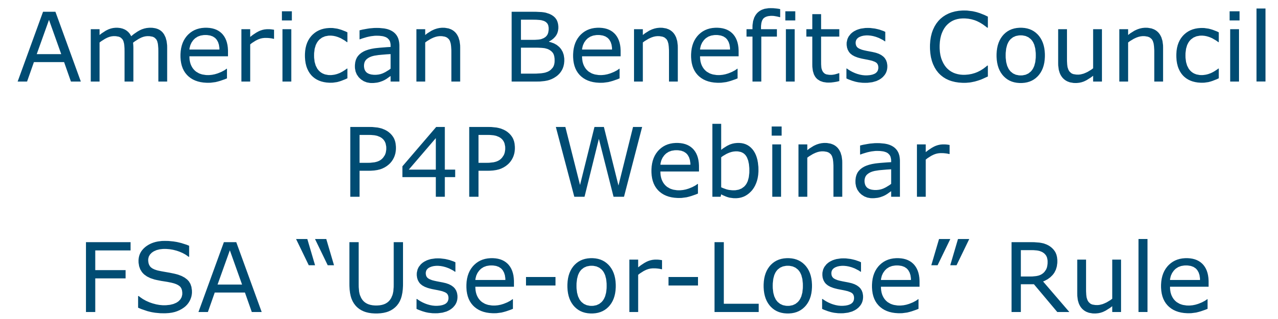


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# How Use-or-Lose Rule Evolved

- 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?