

Advocacy Recommends that the IRS Eliminate the Use it or Lose it Rule for Health FSAs

On July 24, 2012, the Office of Advocacy (Advocacy) filed a comment letter with the Internal Revenue Service (IRS) on Notice 2012-40. The IRS notice requested comments on the potential modification or elimination of the “use it or lose it rule” for health flexible spending accounts (health FSAs). Because the use it or lose it rule negatively impacts small business employers offering health FSAs, and because recent changes to tax law no longer make the rule necessary, Advocacy recommended that the IRS eliminate this rule.

- In 1984, the IRS issued proposed regulations to implement Internal Revenue Code section 125 which included the use it or lose it rule for health FSAs. The use it or lose it rule prohibits any contribution or benefit under an FSA from being used in a subsequent plan year or period of coverage. The purpose of this rule was to limit the potential to use health FSAs to defer compensation.
- The Patient Protection and Affordable Care Act of 2010 (Act), Pub. L. No. 111-148, added section 125(i) to the Code setting forth a \$2,500 limit on salary reduction contributions under a health FSA.
- On March 21, 2012, Advocacy hosted a roundtable meeting where small business stakeholders, and staff from the IRS and Department of Treasury met to discuss pension-related issues impacting small business. At the roundtable, small business representatives discussed the burdens associated with the use it or lose it rule.
- On May 30, 2012, the IRS issued Notice 2012-40. The IRS notice stated that the \$2,500 limit set forth in Code section 125(i) limits the potential for using health FSAs to defer compensation. The IRS explained that, due to the \$2,500 limit, it is considering whether the use it or lose it rule for health FSAs should be modified or eliminated.
- On July 24, 2012, Advocacy filed a comment letter in which Advocacy recommended that the IRS eliminate the use it or lose it rule for health FSAs. Instead of requiring the forfeit of unused amounts in a health FSA at the end of a plan year, the IRS should permit an employer to give plan participants the choice of receiving the unused taxable cash or making a tax-deferred contribution to the employer’s Code section 401(k), section 403(b), or section 457(b) plan. This recommendation would not violate the provisions of Code section 125. Moreover, as the IRS observed, the enactment of the new \$2,500 limit on health FSA contributions limits the potential to use health FSAs to defer compensation, and therefore, the need for the use it or lose it rule no longer exists. <http://www.sba.gov/advocacy/816>.

For more information, visit Advocacy's Web page at <http://www.sba.gov/advocacy/816> or contact Assistant Chief Counsel Dillon Taylor by email at dillon.taylor@sba.gov or by phone at (202) 401-9787.