Tax Reduction Letter

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Notice 2013-71, Part III

I. PURPOSE

This notice contains modifications to the rules for *§ 125* cafeteria plans. First, sections II through V of the notice modify the "use-or-lose" rule for health FSAs that is currently set forth in proposed regulations under *§ 125 of the Internal Revenue Code* (the Code). This modification permits *§ 125* cafeteria plans to be amended to allow up to $500 of unused amounts 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, provided that the plan does not also incorporate the grace period rule. This carryover of up to $500 does not affect the maximum amount of salary reduction contributions that the participant is permitted to make under *§125 (i) of the Code* ($2,500 adjusted for inflation after 2012). This carryover option provides an alternative to the current grace period rule and administrative relief similar to that rule.

Second, section VI of this notice clarifies the scope of the transition relief provided in the preamble to proposed regulations under *§ 4980H* that allows greater flexibility for individuals to make changes in salary reduction elections for accident [*2] and health plans provided through *§ 125* cafeteria plans for non-calendar cafeteria plan years beginning in 2013.

II. BACKGROUND

Section 125 (d) (1) defines a *§ 125* cafeteria plan as a written plan maintained by an employer under which all participants are employees, and all participants may choose among two or more benefits consisting of cash and qualified benefits. *Section 125 (f)* defines a qualified benefit as any benefit which, with the application of *§ 125 (a)*, is not includable in the gross income of the employee by reason of an express provision of the Code (with certain exceptions). Qualified benefits include employer-provided accident and health plans excludable from gross income under *§§ 106* and *105 (b)*, but exclude long term care insurance and certain qualified health plans offered through an Exchange (also referred to as a Marketplace) established under *§ 1311 of the Patient Protection and Affordable Care Act* (the Act).1

Pursuant to *§ 125 (d) (2) (A)*, a *§ 125* cafeteria plan generally does not include any plan that provides for deferred compensation. Proposed regulations under *§ 125* that predated the enactment of the Act generally have prohibited participants from using contributions [*3] made for one plan year to purchase a benefit that will be provided in a subsequent plan year. Commonly referred to as the "use-or-lose" rule, this requires that unused benefits or contributions remaining as of the end of the plan year (that is, amounts credited to a health FSA participant's account that remain unused, referred to below as "unused amounts") be forfeited. See *Prop. Treas. Reg. §§ 1.125-1 (c) (7) (C)*, *1.125-1 (o)*, and *1.125-5 (c)*.

In 2005, the Treasury Department and the IRS modified the use-or-lose rule by adopting the grace period rule. Under the grace period rule, a *§ 125* cafeteria plan may permit an employee to use amounts remaining from the previous year (including amounts remaining in a health FSA) to pay expenses incurred for certain qualified benefits during the period of up to two months and 15 days immediately following the end of the plan year. See *Notice 2005-42, 2005-1 C.B. 1204*, and

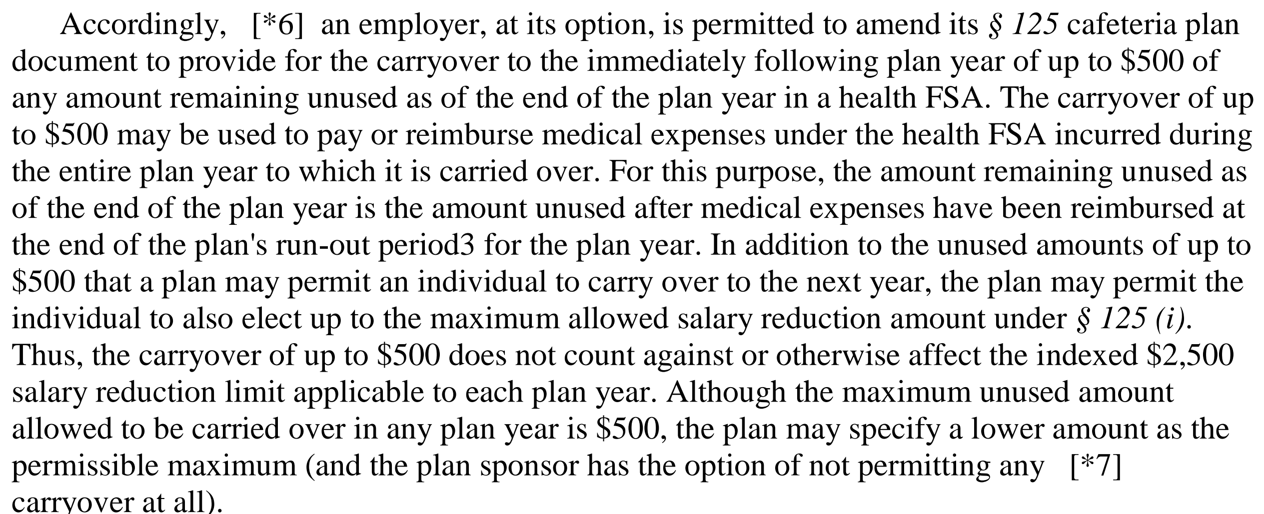
Prop. Treas. Reg. § 1.125-1 (e). This exception was based on other areas of tax law that do not treat certain arrangements as providing for deferred compensation if the compensation payment is made no later than the fifteenth day of the third month after the taxable year in which [*4] the services are performed. See, for example, *Treas. Reg. § 1.404 (b)-1T, Q&A-2*.

*Section 125 (i)*2 provides that, beginning in 2013, a health FSA is not treated as a qualified benefit unless the *§ 125* cafeteria plan limits each employee's salary reduction contributions to the health FSA to no more than $2,500 per taxable year (as indexed for cost-of-living adjustments). *Notice 2012-40, 2012-1 C.B. 1046*, provides that the term "taxable year" in *§ 125 (i)* refers to the plan year of the *§ 125* cafeteria plan, so that the limit is applicable only beginning with the first day of the first plan year beginning in 2013.

Notice 2012-40 stated that "[t]he $2,500 limit, while not addressing the 'use-or-lose' rule, limits the potential for using health FSAs to defer compensation and the extent to which salary reduction amounts may accumulate over time. Given the $2,500 limit, the Treasury Department and the IRS are considering whether the use-or-lose rule for health FSAs should be modified to provide a different form of administrative relief (instead of, or in addition to, the current 2 1/2 month grace period rule)." *Notice 2012-40* requested comments on whether the proposed regulations under *§ 125* [*5] should be modified to provide flexibility with respect to the operation of the use-or-lose rule for health FSAs in addition to the 2 1/2-month grace period rule. Numerous comments were submitted in response to this request, the overwhelming majority favoring modification of the use-or-lose rule.

III. FURTHER MODIFICATION OF USE-OR-LOSE RULE

The public comments argued for additional flexibility with respect to the operation of the use-or-lose rule for a number of reasons. These included the difficulty for employees of predicting their future needs for medical expenditures, the desirability of minimizing incentives for unnecessary spending at the end of a year or grace period, the possibility that lower- and moderate-paid employees are more reluctant than others to participate because of aversion to even modest forfeitures of their salary reduction contributions, and the opportunity to ease and potentially to simplify the administration of health FSAs. In light of these comments, the Treasury Department and the IRS have determined that it is appropriate to modify the use-or-lose rule to permit the use of up to $500 of unused amounts in a health FSA in the immediately following plan year.



Accordingly, [*6] an employer, at its option, is permitted to amend its *§ 125* cafeteria plan document to provide for the carryover to the immediately following plan year of up to $500 of any amount remaining unused as of the end of the plan year in a health FSA. The carryover of up to $500 may be used to pay or reimburse medical expenses under the health FSA incurred during the entire plan year to which it is carried over. For this purpose, the amount remaining unused as of the end of the plan year is the amount unused after medical expenses have been reimbursed at the end of the plan's run-out period3 for the plan year. In addition to the unused amounts of up to $500 that a plan may permit an individual to carry over to the next year, the plan may permit the individual to also elect up to the maximum allowed salary reduction amount under *§ 125 (i)*. Thus, the carryover of up to $500 does not count against or otherwise affect the indexed $2,500 salary reduction limit applicable to each plan year. Although the maximum unused amount allowed to be carried over in any plan year is $500, the plan may specify a lower amount as the permissible maximum (and the plan sponsor has the option of not permitting any [*7] carryover at all).

A plan adopting this carryover provision is not permitted to also provide a grace period with respect to health FSAs. Nor is the plan, for any plan year, permitted to allow an individual to salary reduce for qualified health FSA benefits more than the indexed $2,500 salary reduction limit or permitted to reimburse claims incurred during the plan year that exceed the applicable indexed $2,500 salary reduction limit (and any nonelective employer flex credits) plus the carryover amount of up to $500. If an employer amends its plan to adopt a carryover, the same carryover limit must apply to all plan participants. A *§ 125* cafeteria plan is not permitted to allow unused amounts relating to a health FSA to be cashed out or converted to any other taxable or nontaxable benefit. Unused amounts relating to a health FSA may be used only to pay or reimburse certain *§ 213 (d)* medical expenses (excluding health insurance, long-term care services or insurance, see *Prop. Treas. Reg. §1.125-1 (q)*). With respect to a participant, the amount that may be carried over to the following plan year is equal to the lesser of (1) any unused amounts from the immediately preceding plan year or [*8] (2) $500 (or a lower amount specified in the plan). Any unused amount in excess of $500 (or a lower amount specified in the plan) that remains unused as of the end of the plan year (that is, at the end of the run-out period for the plan year) is forfeited. Any unused amount remaining in an employee's health FSA as of termination of employment also is forfeited (unless, if applicable, the employee elects COBRA continuation coverage with respect to the health FSA).

The uniform coverage rule requires that the maximum amount of reimbursement from the health FSA (including both salary reduction amounts and any nonelective employer flex credits) be available for claims incurred at all times during the period of coverage (properly reduced as of any particular time for prior reimbursements for the same period of coverage). That rule continues to apply to *§ 125* cafeteria plans adopting the carryover of up to $500.

Use of the carryover option permitted under this notice does not affect the ability of a health FSA to provide for the payment of expenses incurred in one plan year during a permitted run-out period at the beginning of the following plan year (just as a run-out period can also be provided [*9] when using the grace period rule). Thus, for plans using the new carryover option, a participant's unused health FSA balance at the end of the prior plan year may be used (a) for expenses incurred in the prior plan year, but only if claimed during the plan's run-out period that begins at the end of the prior plan year (in effect retroactively reducing the unused amount as of the end of the prior plan year) or (b) to the extent of the permitted carryover amount of up to $500 from the final prior plan year unused amount, for expenses that are incurred at any time in the current plan year. In contrast, salary reduction or other amounts credited to a health FSA with respect to service in the current plan year may be used only for expenses incurred in the current plan year (unless and to the extent that these current plan year amounts may later be carried over to the following plan year).

For ease of administration, a *§ 125* cafeteria plan is permitted to treat reimbursements of all claims for expenses that are incurred in the current plan year as reimbursed first from unused amounts credited for the current plan year and, only after exhausting these current plan year amounts, as then reimbursed [*10] from unused amounts carried over from the preceding plan year. Any unused amounts from the prior plan year that are used to reimburse a current year expense (a) reduce the amounts available to pay prior plan year expenses during the run-out period, (b) must be counted against the permitted carryover of up to $500, and (c) cannot exceed the permitted carryover. For examples of how the carryover operates, see section V of this notice.

IV. WRITTEN § 125 CAFETERIA PLAN AMENDMENT

To utilize the new carryover option permitted under this notice, a *§ 125* cafeteria plan offering a health FSA must be amended to set forth 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 *§ 125* cafeteria plan operates in accordance with the guidance under this notice and informs participants of the carryover provision, and provided further that 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 that begins in 2014.

A *§ 125* cafeteria plan that incorporates [*11] a carryover provision may not also provide for a grace period in the plan year to which unused amounts may be carried over. Accordingly, if, pursuant to the carryover provision, a plan permits amounts that were unused in a plan year to be carried over to the following plan year, the plan is not permitted to provide for a grace period that occurs in that following plan year. For example, a calendar year plan permitting a carryover to 2015 of unused 2014 health FSA amounts (as determined at the end of the run-out period in early 2015) would not be permitted to have a grace period in 2015, but would be permitted to have had a grace period during the first 2 1/2 months of 2014.

If a plan has provided for a grace period and is being amended to add a carryover provision, the plan must also be amended to eliminate the grace period provision by no later than the end of the plan year from which amounts may be carried over. The ability to eliminate a grace period provision previously adopted for the plan year in which the amendment is adopted may be subject to non-Code legal constraints.

V. EXAMPLES

The preceding rules of this notice are illustrated by the following examples:

Example 1. Employer [*12] sponsors a *§ 125* cafeteria plan and health FSA with a calendar plan year, an annual run-out period from January 1 through March 31 in which participants can submit claims for expenses incurred during the preceding plan year, and an annual open enrollment season in November in which participants elect a salary reduction amount (not to exceed $2,500) for the following plan year. The plan is timely amended to provide for a carryover that allows all participants to apply up to $500 of unused health FSA amounts remaining at the end of the run-out period to the health FSA for expenses incurred at any time during that plan year. The plan does not provide for a grace period with respect to the health FSA. The plan also does not provide for nonelective employer flex credits.

In November 2014, Participant A elects a salary reduction amount of $2,500 for 2015. By December 31, 2014, A's unused amount from the 2014 plan year is $800. On February 1, 2015, A submits claims and is reimbursed with respect to $350 of expenses incurred during the 2014 plan year, leaving a carryover on March 31, 2015 (the end of the run-out period) of $450 of unused health FSA amounts from 2014. The $450 amount is not [*13] forfeited; instead, it is carried over to 2015 and available to pay claims incurred in that year so that $2,950 (that is, $2,500 + $450) is available to pay claims incurred in 2015. A incurs and submits claims for expenses of $2,700 during the month of July 2015, and does not submit any other claims during 2015. A is reimbursed with respect to the $2,700 claim, leaving $250 as a potential unused amount from 2015 (depending upon whether A submits claims during the 2015 run-out period in early 2016).

This *§ 125* cafeteria plan satisfies the preceding rules of this notice.

Example 2. The same facts as Example 1, except that A's expenses of $2,700 are incurred and submitted during the month of January 2015 (and not July 2015). The plan may treat $500 of the $800 unused amounts as of December 31, 2014, as available to pay current year expenses. Accordingly, A is reimbursed with respect to the $2,700 claim. The plan treats the first $2,500 of the claim as reimbursed with health FSA contributions for 2015, and the remaining $200 of the claim as reimbursed with the unused amounts as of December 31, 2014. The unused amount remaining from 2014 from which claims for expenses incurred during the [*14] 2014 plan year may be reimbursed during the 2014 run-out period in early 2015 is reduced to $600 ($800 - $200). On February 1, 2015, A submits and is reimbursed with respect to $350 of claims for expenses incurred during the 2014 plan year. After the $350 reimbursement, the unused amount remaining for 2014 from which claims for expenses incurred during the 2014 plan year may be reimbursed during the 2014 run-out period in early 2015 is reduced to $250 ($600 - $350). A submits no further claims for expenses incurred during the 2014 plan year, so that in addition to the $200 previously used to reimburse the January 2015 claim, $250 is carried over to the 2015 plan year. A submits no further claims for 2015. The amount carried over to 2016 is $250.

This *§ 125* cafeteria plan satisfies the preceding rules of this notice.

Example 3. The same facts as Example 2, except that on February 1, 2015, A submits claims with respect to $700 of expenses incurred during the 2014 plan year. Because the unused amount remaining from 2014 from which claims for expenses incurred during the 2014 plan year may be reimbursed has been reduced to $600 prior to February 1, 2015, the plan reimburses A for only $600 [*15] of the total $700 of claims. After the $600 reimbursement, the unused amount remaining from 2014 from which claims for expenses incurred during the 2014 plan year may be reimbursed is reduced to zero ($600 - $600). A submits no further claims for expenses incurred during the 2014 plan year, so that the amount carried over to the 2015 plan year is $0 (the entire $800 of unused amounts as of December 31, 2014, having been used to reimburse claims submitted in January 2015 ($200) and February 2015 ($600)).

This *§ 125* cafeteria plan satisfies the preceding rules of this notice.

Example 4. The same facts as Example 1, except that, for 2014, A elects a salary reduction amount of $600 and, on December 31, 2014, A still has $600 of unused health FSA amounts.

For 2015, A elects no salary reduction for the health FSA, submits no claims during the run-out period, and as of the end of the run-out period on March 31, 2015, $600 in unused health FSA amounts remains. Of that amount, $100 is forfeited because it exceeds the $500 carryover limit, and $500 is carried over to the 2015 plan year. A incurs $200 in expenses during the 2015 plan year, which are reimbursed during that plan year. As of December [*16] 31, 2015, A has $300 in unused health FSA amounts.

For 2016, A elects no salary reduction for the health FSA but has the $300 carryover from 2015, which is not forfeited. A incurs medical expenses of $300 in 2016, which are reimbursed using the $300 carryover from 2015.

This *§ 125* cafeteria plan satisfies the preceding rules of this notice.

VI. CLARIFICATION OF SCOPE OF TRANSITION RULE APPLICABLE TO NON-CALENDAR PLAN YEARS BEGINNING IN 2013 FOR PARTICIPANT CHANGES IN SALARY REDUCTION ELECTIONS UNDER HEALTH PLANS PROVIDED THROUGH § 125 CAFETERIA PLANS

A. BACKGROUND

Generally, *§ 125* cafeteria plan elections must be made before the start of the plan year, and are irrevocable during the plan year, with limited exceptions, including certain changes in status. See *Prop. Treas. Reg. § 1.125-2*, *Treas. Reg. §1.125-4*. Under existing regulations, the availability of health plan coverage through an Affordable Insurance Exchange (also referred to in other published guidance as a Marketplace) beginning with calendar year 2014 does not constitute such a change in status. As a result, employees would not be able to change their salary reduction elections for health coverage during a plan year in order [*17] to, for example, cease their salary reductions and *§ 125* cafeteria plan coverage and purchase coverage through an Exchange. However, the Treasury Department and the IRS previously concluded that transition relief is appropriate for individuals with respect to non-calendar *§ 125* cafeteria plan years beginning in 2013. For individuals eligible for such a plan, health plan coverage through an Exchange will first become available in the middle of the plan's 2013-2014 non-calendar plan year (that is, January 2014). Accordingly, the Treasury Department and the IRS have provided transition relief from the election rules in *Prop. Treas. Reg. § 1.125-2* with respect to salary reduction elections under a *§ 125* cafeteria plan for an employer-provided accident and health plan with a non-calendar plan year beginning in 2013. The transition relief was provided in Section IX.B of the preamble to proposed regulations (issued on December 28, 2012) under *§ 4980H* (referred to below as "Section IX.B"). See *78 Fed. Reg. 218, 237 (Jan. 2, 2013).*

Specifically, Section IX.B permits an employer, at its election, to amend one or more of its written *§ 125* cafeteria plans to allow employees to make either or both [*18] of the following changes in salary reduction elections, whether or not the employee experienced a change in status event described in *Treas. Reg. § 1.125-4*:

1. An employee who elected to salary reduce through the employer's *§ 125* cafeteria plan for accident and health plan coverage with a non-calendar plan year beginning in 2013 is allowed to prospectively revoke or change his or her election with respect to the accident and health plan once during that plan year; and

2. An employee who failed to make a salary reduction election through the employer's *§ 125* cafeteria plan for accident and health plan coverage with a non-calendar plan year beginning in 2013 before the deadline in *Prop. Treas. Reg. § 1.125-2* for making elections for the *§ 125* cafeteria plan year beginning in 2013 is allowed to make a prospective salary reduction election for accident and health coverage on or after the first day of the 2013 plan year of the *§ 125* cafeteria plan.

B. CLARIFICATION OF § 125 CAFETERIA PLAN TRANSITION RULE FOR PARTICIPANT SALARY REDUCTION ELECTIONS AS SET FORTH IN SECTION IX.B

Although the description of the *§ 125* cafeteria plan transition rule in Section IX.B refers to applicable large employer [*19] members (generally meaning a person that, together with one or more other persons, is treated as a single employer that is an applicable large employer), the relief is available, subject to the rules set forth in Section IX.B, to an employer with a *§ 125* cafeteria plan non-calendar plan year beginning in 2013 whether or not the employer is an applicable large employer or applicable large employer member under *§ 4980H*.

Stakeholders have asked whether employees may use the relief set forth in Section IX.B if their employer amends its *§ 125* cafeteria plan to allow changes in salary reduction elections but adopts an amendment that is more limited than the two options listed in Section IX.B, as described above. An amendment to a *§ 125* cafeteria plan adopted pursuant to Section IX.B may be more restrictive than the amendments described in Section IX.B but may not be less restrictive. For example, an employer may amend its *§ 125* cafeteria plan to allow an employee

who elected to salary reduce through the *§ 125* cafeteria plan to pay for accident and health plan coverage under the *§ 125* cafeteria plan with a non-calendar plan year beginning in 2013 to prospectively revoke or change his or her [*20] election with respect to the accident and health plan once, during a limited period (for example, the first month of 2014 only rather than the entire plan year) without regard to whether the employee experienced a change in status event described in *Treas. Reg. § 1.125-4*.

VII. EFFECTIVE DATES

An employer may adopt the carryover provision (of up to $500) authorized in this notice to health FSAs for the current *§ 125* cafeteria plan year (and/or subsequent *§ 125* cafeteria plan years) by amending the *§ 125* cafeteria plan document in the manner and within the time frames described in section IV of this notice.

The clarifications described in section VI of this notice of the relief provided in Section IX.B may be applied beginning on or after December 28, 2012 (the date on which the proposed regulations that included Section IX.B were issued).

VIII. EFFECT ON OTHER DOCUMENTS

The Treasury Department and the IRS intend to amend *Prop. Treas. Reg. §§ 1.125-1 (o)* and *1.125-5 (c)* to reflect the guidance in this notice; taxpayers may rely on the guidance in this notice pending the issuance and effectiveness of those amendments to the regulations.

IX. DRAFTING INFORMATION

The principal author of this notice [*21] is Janet A. Laufer of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding the modification of the use or lose rules contained in this notice, contact Ms. Laufer at (202) 927-9639 (not a toll-free call). For further information regarding the clarifications to Section IX.B, contact Ms. Katy Johnson at (202) 927-9639 (not a toll-free call).

FOOTNOTES:

1

Public Law 111-148 (124 Stat. 1029 (2010)), amended by *§ 10104* and *§ 10203* of the Act.

2

Section 125 (i) was added to the Code by § 9005 of the Act, amended by § 10902 of the Act, and further amended by § 1403 (b) of the Health Care and Education Reconciliation Act of 2010 (HCERA), Pub. L. No. 111-152.

3

A "run-out period" is a period immediately following the end of a plan year during which a participant can submit a claim for reimbursement of expenses incurred for qualified benefits during the plan year. See *Prop. Treas. Reg. § 1.125-1 (f)*. By contrast, a grace period is a period of up to two months and 15 days immediately following the end of a plan year during which a participant may use amounts remaining from the previous plan year (including amounts remaining in a health FSA) to pay expenses incurred for certain qualified benefits during that

two-month-and-15-day period. See *Notice 2005-42, 2005-1 C.B. 1204*, and *Prop. Treas. Reg. § 1.125-1 (e)*. (A run-out period may also be provided immediately following the end of a grace period instead of immediately following the end of a plan year, so that participants can submit claims for reimbursement of expenses incurred during the grace period or the previous plan year.)