Prop. Reg. Section 1.125-5

Flexible spending arrangements.

(a) *Definition of flexible spending arrangement* --(1) *In general.* An FSA generally is a benefit program that provides employees with coverage which reimburses specified, incurred expenses (subject to reimbursement maximums and any other reasonable conditions). An expense for qualified benefits must not be reimbursed from the FSA unless it is incurred during a period of coverage. See paragraph (e) of this section. After an expense for a qualified benefit has been incurred, the expense must first be substantiated before the expense is reimbursed. See paragraphs (a) through (f) in § 1.125-6.

(2) *Maximum amount of reimbursement.* The maximum amount of reimbursement that is reasonably available to an employee for a period of coverage must not be substantially in excess of the total salary reduction and employer flex-credit for such participant's coverage. A maximum amount of reimbursement is not substantially in excess of the total salary reduction and employer flex-credit if such maximum amount is less than 500 percent of the combined salary reduction and employer flex-credit. A single FSA may provide participants with different levels of coverage and maximum amounts of reimbursement. See paragraph (r) in § 1.125-1 and paragraphs (b) and (d) in this section for the definition of salary reduction, employer flex-credit, and uniform coverage rule.

(b) *Flex-credits allowed* --(1) *In general.* An FSA in a cafeteria plan must include an election between cash or taxable benefits (including salary reduction) and one or more qualified benefits, and may include, in addition, "employer flex-credits." For this purpose, flex-credits are non-elective employer contributions that the employer makes for every employee eligible to participate in the employer's cafeteria plan, to be used at the employee's election only for one or more qualified benefits (but not as cash or a taxable benefit). See § 1.125-1 for definitions of qualified benefits, cash and taxable benefits.

(2) *Example.* The following example illustrates the rules in this paragraph (b):

Example.

Flex-credit. Contribution to health FSA for employees electing employer-provided accident and health plan. Employer A maintains a cafeteria plan offering employees an election between cash or taxable benefits and premiums for employer-provided accident and health insurance or coverage through an HMO. The plan also provides an employer contribution of $ 200 to the health FSA of every employee who elects accident and health insurance or HMO coverage. In addition, these employees may elect to reduce their salary to make additional contributions to their health FSAs. The benefits offered in this cafeteria plan are consistent with the requirements of section 125 and this paragraph (b).

(c) *Use-or-lose rule* --(1) *In general.* An FSA may not defer compensation. No contribution or benefit from an FSA may be carried over to any subsequent plan year or period of coverage. See paragraph (k)(3) in this section for specific exceptions. Unused benefits or contributions remaining at the end of the plan year (or at the end of a grace period, if applicable) are forfeited.

(2) *Example.* The following example illustrates the rules in this paragraph (c):

Example.

Use-or-lose rule. (i) Employer B maintains a calendar year cafeteria plan, offering an election between cash and a health FSA. The cafeteria plan has no grace period.

(ii) Employee A plans to have eye surgery in 2009. For the 2009 plan year, Employee A timely elects salary reduction of $ 3,000 for a health FSA. During the 2009 plan year, Employee A learns that she cannot have eye surgery performed, but incurs other section 213(d) medical expenses totaling $ 1,200. As of December 31, 2009, she has $ 1,800 of unused benefits and contributions in the health FSA. Consistent with the rules in this paragraph (c), she forfeits $ 1,800.

(d) *Uniform coverage rules applicable to health FSAs* --(1) *Uniform coverage throughout coverage period--in general.* The maximum amount of reimbursement from a health FSA must be available at all times during the period of coverage (properly reduced as of any particular time for prior reimbursements for the same period of coverage). Thus, the maximum amount of reimbursement at any particular time during the period of coverage cannot relate to the amount that has been contributed to the FSA at any particular time prior to the end of the plan year. Similarly, the payment schedule for the required amount for coverage under a health FSA may not be based on the rate or amount of covered claims incurred during the coverage period. Employees' salary reduction payments must not be accelerated based on employees' incurred claims and reimbursements.

(2) *Reimbursement available at all times.* Reimbursement is deemed to be available at all times if it is paid at least monthly or when the total amount of the claims to be submitted is at least a specified, reasonable minimum amount (for example, $ 50).

(3) *Terminated participants.* When an employee ceases to be a participant, the cafeteria plan must pay the former participant any amount the former participant previously paid for coverage or benefits to the extent the previously paid amount relates to the period from the date the employee ceases to be a participant through the end of that plan year. See paragraph (e)(2) in this section for COBRA elections for health FSAs.

(4) *Example.* The following example illustrates the rules in this paragraph (d):

Example.

Uniform coverage. (i) Employer C maintains a calendar year cafeteria plan, offering an election between cash and a health FSA. The cafeteria plan prohibits accelerating employees' salary reduction payments based on employees' incurred claims and reimbursements.

(ii) For the 2009 plan year, Employee N timely elects salary reduction of $ 3,000 for a health FSA. Employee N pays the $ 3,000 salary reduction amount through salary reduction of $ 250 per month throughout the coverage period. Employee N is eligible to receive the maximum amount of reimbursement of $ 3,000 at all times throughout the coverage period (reduced by prior reimbursements).

(iii) N incurs $ 2,500 of section 213(d) medical expenses in January, 2009. The full $ 2,500 is reimbursed although Employee N has made only one salary reduction payment of $ 250. N incurs $ 500 in medical expenses in February, 2009. The remaining $ 500 of the $ 3,000 is reimbursed. After Employee N submits a claim for reimbursement and substantiates the medical expenses, the cafeteria plan reimburses N for the $ 2,500 and $ 500 medical expenses. Employer C's cafeteria plan satisfies the uniform coverage rule.

(5) *No uniform coverage rule for FSAs for dependent care assistance or adoption assistance.* The uniform coverage rule applies only to health FSAs and does not apply to FSAs for dependent care assistance or adoption assistance. See paragraphs (i) and (j) of this section for the rules for FSAs for dependent care assistance and adoption assistance.

(e) *Required period of coverage for a health FSA, dependent care FSA and adoption assistance FSA* --(1) *Twelve-month period of coverage--in general.* An FSA's period of coverage must be 12 months. However, in the case of a short plan year, the period of coverage is the entire short plan year. See paragraph (d) in § 1.125-1 for rules on plan years and changing plan years.

(2) *COBRA elections for health FSAs.* For the application of the health care continuation rules of section 4980B of the Code to health FSAs, see Q & A-2 in § 54.4980B-2 of this chapter.

(3) *Separate period of coverage permitted for each qualified benefit offered through FSA.* Dependent care assistance, adoption assistance, and a health FSA are each permitted to have a separate period of coverage, which may be different from the plan year of the cafeteria plan.

(f) *Coverage on a month-by-month or expense-by-expense basis prohibited.* In order for reimbursements from an accident and health plan to qualify for the section 105(b) exclusion, an employer-funded accident and health plan offered through a cafeteria plan may not operate in a manner that enables employees to purchase the accident and health plan coverage only for periods when employees expect to incur medical care expenses. Thus, for example, if a cafeteria plan permits employees to receive accident and health plan coverage on a month-by-month or an expense-by-expense basis, reimbursements from the accident and health plan fail to qualify for the section 105(b) exclusion. If, however, the period of coverage under an accident and health plan offered through a cafeteria plan is twelve months and the cafeteria plan does not permit an employee to elect specific amounts of coverage, reimbursement, or salary reduction for less than twelve months, the cafeteria plan does not operate to enable participants to purchase coverage only for periods during which medical care will be incurred. See § 1.125-4 and paragraph (a) in § 1.125-2 regarding the revocation of elections during a period of coverage on account of changes in family status.

(g) *FSA administrative practices*-- (1) *Limiting health FSA enrollment to employees who participate in the employer's accident and health plan.* At the employer's option, a cafeteria plan is permitted to provide that only those employees who participate in one or more specified employer-provided accident and health plans may participate in a health FSA. See § 1.125-7 for nondiscrimination rules.

(2) *Interval for employees' salary reduction contributions.* The cafeteria plan is permitted to specify any interval for employees' salary reduction contributions. The interval specified in the plan must be uniform for all participants.

(h) *Qualified benefits permitted to be offered through an FSA.* Dependent care assistance (section 129), adoption assistance (section 137) and a medical reimbursement arrangement (section 105(b)) are permitted to be offered through an FSA in a cafeteria plan.

(i) *Section 129 rules for dependent care assistance program offered through a cafeteria plan* --(1) *General rule.* In order for dependent care assistance to be a qualified benefit that is excludible from gross income if elected through a cafeteria plan, the cafeteria plan must satisfy section 125 and the dependent care assistance must satisfy section 129.

(2) *Dependent care assistance in general.* Section 129(a) provides an employee with an exclusion from gross income both for an employer-funded dependent care assistance program and for amounts paid or incurred by the employer for dependent care assistance provided to the

employee, if the amounts are paid or incurred through a dependent care assistance program. See paragraph (a)(4) in § 1.125-6 on when dependent care expenses are incurred.

(3) *Reimbursement exclusively for dependent care assistance.* A dependent care assistance program may not provide reimbursements other than for dependent care expenses; in particular, if an employee has dependent care expenses less than the amount specified by salary reduction, the plan may not provide other taxable or nontaxable benefits for any portion of the specified amount not used for the reimbursement of dependent care expenses. Thus, if an employee has elected coverage under the dependent care assistance program and the period of coverage has commenced, the employee must not have the right to receive amounts from the program other than as reimbursements for dependent care expenses. This is the case regardless of whether coverage under the program is purchased with contributions made at the employer's discretion, at the employee's discretion, or pursuant to a collective bargaining agreement. Arrangements formally outside of the cafeteria plan providing for the adjustment of an employee's compensation or an employee's receipt of any other benefits on the basis of the assistance or reimbursements received by the employee are considered in determining whether a dependent care benefit is a dependent care assistance program under section 129.

(j) *Section 137 rules for adoption assistance program offered through a cafeteria plan* --(1) *General rule.* In order for adoption assistance to be a qualified benefit that is excludible from gross income if elected through a cafeteria plan, the cafeteria plan must satisfy section 125 and the adoption assistance must satisfy section 137.

(2) *Adoption assistance in general.* Section 137(a) provides an employee with an exclusion from gross income for amounts paid or expenses incurred by the employer for qualified adoption expenses in connection with an employee's adoption of a child, if the amounts are paid or incurred through an adoption assistance program. Certain limits on amount of expenses and employee's income apply.

(3) *Reimbursement exclusively for adoption assistance.* Rules and requirements similar to the rules and requirements in paragraph (i)(3) of this section for dependent care assistance apply to adoption assistance.

(k) *FSAs and the rules governing the tax-favored treatment of employer-provided health benefits* --(1) *Medical expenses.* Health plans that are flexible spending arrangements, as defined in paragraph (a)(1) of this section, must conform to the generally applicable rules under sections 105 and 106 in order for the coverage and reimbursements under such plans to qualify for tax-favored treatment under such sections. Thus, health FSAs must qualify as accident and health plans. See paragraph (n) in § 1.125-1. A health FSA is only permitted to reimburse medical expenses as defined in section 213(d). Thus, for example, a health FSA is not permitted to reimburse dependent care expenses.

(2) *Limiting payment or reimbursement to certain section 213(d) medical expenses.* A health FSA is permitted to limit payment or reimbursement to only certain section 213(d) medical expenses (except health insurance, long-term care services or insurance). See paragraph (q) in § 1.125-1. For example, a health FSA in a cafeteria plan is permitted to provide in the written plan that the plan reimburses all section 213(d) medical expenses allowed to be paid or reimbursed under a cafeteria plan except over-the-counter drugs.

(3) *Application of prohibition against deferred compensation to medical expenses* --(i) *Certain advance payments for orthodontia permitted.* A cafeteria plan is permitted, but is not required to, reimburse employees for orthodontia services before the services are provided but only to the extent that the employee has actually made the payments in advance of the

orthodontia services in order to receive the services. These orthodontia services are deemed to be incurred when the employee makes the advance payment. Reimbursing advance payments does not violate the prohibition against deferring compensation.

(ii) *Example.* The following example illustrates the rules in paragraph (k)(3):

Example.

Advance payment to orthodontist. Employer D sponsors a calendar year cafeteria plan which offers a health FSA. Employee K elects to salary reduce $ 3,000 for a health FSA for the 2009 plan year. Employee K's dependent requires orthodontic treatment. K's accident and health insurance does not cover orthodontia. The orthodontist, following the normal practice, charges $ 3,000, all due in 2009, for treatment, to begin in 2009 and end in 2010. K pays the $ 3,000 in 2009. In 2009, Employer D's cafeteria plan may reimburse $ 3,000 to K, without violating the prohibition against deferring compensation in section 125(d)(2).

(iii) *Reimbursements for durable medical equipment.* A health FSA in a cafeteria plan that reimburses employees for equipment (described in section 213(d)) with a useful life extending beyond the period of coverage during which the expense is incurred does not provide deferred compensation. For example, a health FSA is permitted to reimburse the cost of a wheelchair for an employee.

(4) *No reimbursement of premiums for accident and health insurance or long-term care insurance or services.* A health FSA is not permitted to treat employees' premium payments for other health coverage as reimbursable expenses. Thus, for example, a health FSA is not permitted to reimburse employees for payments for other health plan coverage, including premiums for COBRA coverage, accidental death and dismemberment insurance, long-term disability or short-term disability insurance or for health coverage under a plan maintained by the employer of the employee or the employer of the employee's spouse or dependent. Also, a health FSA is not permitted to reimburse expenses for long-term care insurance premiums or for long-term care services for the employee or employee's spouse or dependent. See paragraph (q) in § 1.125-1 for nonqualified benefits

(l) *Section 105(h) requirements.* Section 105(h) applies to health FSAs. Section 105(h) provides that the exclusion provided by section 105(b) is not available with respect to certain amounts received by a highly compensated individual (as defined in section 105(h)(5)) from a discriminatory self-insured medical reimbursement plan, which includes health FSAs. See § 1.105-11. For purposes of section 105(h), coverage by a self-insured accident and health plan offered through a cafeteria plan is an optional benefit (even if only one level and type of coverage is offered) and, for purposes of the optional benefit rule in § 1.105-11(c)(3)(i), employer contributions are treated as employee contributions to the extent that taxable benefits are offered by the plan.

(m) *HSA-compatible FSAs-limited-purpose health FSAs and post-deductible health FSAs* -- (1) *In general. Limited-purpose health FSAs* and *post-deductible health FSAs* which satisfy all the requirements of section 125 are permitted to be offered through a cafeteria plan.

(2) *HSA-compatible FSAs.* Section 223(a) allows a deduction for certain contributions to a "Health Savings Account" (HSA) (as defined in section 223(d)). An *eligible individual* (as defined in section 223(c)(1)) may contribute to an HSA. An eligible individual must be covered under a "high deductible health plan" (HDHP) and not, while covered under an HDHP, under any health plan which is not an HDHP. A general purpose health FSA is not an HDHP and an individual covered by a general purpose health FSA is not eligible to contribute to an HSA. However, an individual covered by an HDHP (and who otherwise satisfies section 223(c)(1))

does not fail to be an eligible individual merely because the individual is also covered by a limited-purpose health FSA or post-deductible health FSA (as defined in this paragraph (m)) or a combination of a limited-purpose health FSA and a post-deductible health FSA.

(3) *Limited-purpose health FSA.* A limited-purpose health FSA is a health FSA described in the cafeteria plan that only pays or reimburses permitted coverage benefits (as defined in section 223(c)(2)(C)), such as vision care, dental care or preventive care (as defined for purposes of section 223(c)(2)(C)). See paragraph (k) in this section.

(4) *Post-deductible health FSA* --(i) *In general.* A post-deductible health FSA is a health FSA described in the cafeteria plan that only pays or reimburses medical expenses (as defined in section 213(d)) for preventive care or medical expenses incurred after the minimum annual HDHP deductible under section 223(c)(2)(A)(i) is satisfied. See paragraph (k) in this section. No medical expenses incurred before the annual HDHP deductible is satisfied may be reimbursed by a post-deductible FSA, regardless of whether the HDHP covers the expense or whether the deductible is later satisfied. For example, even if chiropractic care is not covered under the HDHP, expenses for chiropractic care incurred before the HDHP deductible is satisfied are not reimbursable at any time by a post-deductible health FSA.

(ii) *HDHP and health FSA deductibles.* The deductible for a post-deductible health FSA need not be the same amount as the deductible for the HDHP, but in no event may the post-deductible health FSA or other coverage provide benefits before the minimum annual HDHP deductible under section 223(c)(2)(A)(i) is satisfied (other than benefits permitted under a limited-purpose health FSA). In addition, although the deductibles of the HDHP and the other coverage may be satisfied independently by separate expenses, no benefits may be paid before the minimum annual deductible under section 223(c)(2)(A)(i) has been satisfied. An individual covered by a post-deductible health FSA (if otherwise an eligible individual) is an eligible individual for the purpose of contributing to the HSA.

(5) *Combination of limited-purpose health FSA and post-deductible health FSA.* An FSA is a combination of a limited-purpose health FSA and post-deductible health FSA if each of the benefits and reimbursements provided under the FSA are permitted under either a limited-purpose health FSA or post-deductible health FSA. For example, before the HDHP deductible is satisfied, a combination limited-purpose and post-deductible health FSA may reimburse only preventive, vision or dental expenses. A combination limited-purpose and post-deductible health FSA may also reimburse any medical expense that may otherwise be paid by an FSA (that is, no insurance premiums or long-term care benefits) that is incurred after the HDHP deductible is satisfied.

(6) *Substantiation.* The substantiation rules in this section apply to limited-purpose health FSAs and to post-deductible health FSAs. In addition to providing third-party substantiation of medical expenses, a participant in a post-deductible health FSA must provide information from an independent third party that the HDHP deductible has been satisfied. A participant in a limited-purpose health FSA must provide information from an independent third-party that the medical expenses are for vision care, dental care or preventive care.

(7) *Plan amendments.* See paragraph (c) in § 1.125-1 on the required effective date for amendments adopting or changing limited-purpose, post-deductible or combination limited-purpose and post-deductible health FSAs.

(n) *Qualified HSA distributions* --(1) *In general.* A health FSA in a cafeteria plan is permitted to offer employees the right to elect qualified HSA distributions described in section 106(e). No qualified HSA distribution may be made in a plan year unless the employer amends the health

FSA written plan with respect to all employees, effective by the last day of the plan year, to allow a qualified HSA distribution satisfying all the requirements in this paragraph (n). See also section 106(e)(5)(B). In addition, a distribution with respect to an employee is not a qualified HSA distribution unless all of the following requirements are satisfied--

(i) No qualified HSA distribution has been previously made on behalf of the employee from this health FSA;

(ii) The employee elects to have the employer make a qualified HSA distribution from the health FSA to the HSA of the employee;

(iii) The distribution does not exceed the lesser of the balance of the health FSA on--

(A) September 21, 2006; or

(B) The date of the distribution;

(iv) For purposes of this paragraph (n)(1), balances as of any date are determined on a cash basis, without taking into account expenses incurred but not reimbursed as of a date, and applying the uniform coverage rule in paragraph (d) in this section;

(v) The distribution is made no later than December 31, 2011; and

(vi) The employer makes the distribution directly to the trustee of the employee's HSA.

(2) *Taxation of qualified HSA distributions.* A qualified HSA distribution from the health FSA covering the participant to his or her HSA is a rollover to the HSA (as defined in section 223(f)(5)) and thus is generally not includible in gross income. However, if the participant is not an eligible individual (as defined in section 223(c)(1)) at any time during a testing period following the qualified HSA distribution, the amount of the distribution is includible in the participant's gross income and he or she is also subject to an additional 10 percent tax (with certain exceptions). Section 106(e)(3).

(3) *No effect on health FSA elections, coverage, use-or-lose rule.* A qualified HSA distribution does not alter an employee's irrevocable election under paragraph (a) of § 1.125-2, or constitute a change in status under § 1.125-4(a). If a qualified HSA distribution is made to an employee's HSA, even if the balance in a health FSA is reduced to zero, the employee's health FSA coverage continues to the end of the plan year. Unused benefits and contributions remaining at the end of a plan year (or at the end of a grace period, if applicable) must be forfeited.

(o) *FSA experience gains or forfeitures* --(1) *Experience gains in general.* An FSA experience gain (sometimes referred to as forfeitures in the use-or-lose rule in paragraph (c) in this section) with respect to a plan year (plus any grace period following the end of a plan year described in paragraph (e) in § 1.125-1), equals the amount of the employer contributions, including salary reduction contributions, and after-tax employee contributions to the FSA minus the FSA's total claims reimbursements for the year. Experience gains (or forfeitures) may be--

(i) Retained by the employer maintaining the cafeteria plan; or

(ii) If not retained by the employer, may be used only in one or more of the following ways--

(A) To reduce required salary reduction amounts for the immediately following plan year, on a reasonable and uniform basis, as described in paragraph (o)(2) of this section;

(B) Returned to the employees on a reasonable and uniform basis, as described in paragraph (o)(2) of this section; or

(C) To defray expenses to administer the cafeteria plan.

(2) *Allocating experience gains among employees on reasonable and uniform basis.* If not retained by the employer or used to defray expenses of administering the plan, the experience gains must be allocated among employees on a reasonable and uniform basis. It is permissible to allocate these amounts based on the different coverage levels of employees under the FSA. Experience gains allocated in compliance with this paragraph (o) are not a deferral of the receipt of compensation. However, in no case may the experience gains be allocated among employees based (directly or indirectly) on their individual claims experience. Experience gains may not be used as contributions directly or indirectly to any deferred compensation benefit plan.

(3) *Example.* The following example illustrates the rules in this paragraph (o):

Example.

Allocating experience gains. (i) Employer L maintains a cafeteria plan for its 1,200 employees, who may elect one of several different annual coverage levels under a health FSA in $ 100 increments from $ 500 to $ 2,000.

(ii) For the 2009 plan year, 1,000 employees elect levels of coverage under the health FSA. For the 2009 plan year, the health FSA has an experience gain of $ 5,000.

(iii) The $ 5,000 may be allocated to all participants for the plan year on a per capita basis weighted to reflect the participants' elected levels of coverage.

(iv) Alternatively, the $ 5,000 may be used to reduce the required salary reduction amount under the health FSA for all 2009 participants (for example, a $ 500 health FSA for the next year is priced at $ 480) or to reimburse claims incurred above the elective limit in 2010 as long as such reimbursements are made on a reasonable and uniform level.

(p) *Effective/applicability date.* It is proposed that these regulations apply on and after plan years beginning on or after January 1, 2009.