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ObamaCare Calls Flexible Spending Account Use-It-Or-Lose-It Rule Into Question

Prescription frappuccino (Photo credit: quinn.anya)

In light of the new $2,500 cap on healthcare flexible spending accounts under ObamaCare, the Internal Revenue Service is asking taxpayers: Do we need the use-it-or-lose-it rule? It might sound arcane, but it can mean hundreds of dollars extra in your pocket each year.

Some 33 million workers divert pre-tax salary into these accounts to cover out-of-pocket healthcare expenses like co-pays, deductibles, and orthodontia. But millions of folks don't take advantage of these plans because of the dreaded "use-it-or-lose it" rule: Dollars left in the account at the end of the plan year are forfeited. Others rush and make unnecessary expenditures at year end trying to run down their balances, and those who forfeit money because they miscalculated projected expenses are left seething.

"Many middle class Americans are foregoing this benefit because they aren't able to accurately predict their health care expenses," says Natasha Rankin, executive director of the Employers Council On Flexible Compensation, which has long supported efforts to eliminate the use-it-or-lose-it rule.

Now the Department of Treasury in Notice 2012-40 is soliciting comments on whether to modify the use-it-or-lose-it rule. Anyone can send in comments via email to notice.comments@irscounsel.treas.gov (subject line: IRS Notice 2012-40) through Aug. 17, 2012.

FSAs were invented by Congress in 1978, and the use-it-or-lose-it rule dates to proposed regulations issued in 1984 sparked by a concern about excessive compensation deferral. Why the new interest in modifying the rule? Under the Affordable Care Act, aka ObamaCare, starting Jan. 1, 2013, there will be a new $2,500 annual salary-deferral limit for healthcare FSAs. Currently, there is no legal limit, and 78% of large employers set it at $5,000 or higher, according to AON Hewitt. The $2,500 cap was a revenue raiser estimated at $14.6 billion over 10 years. The thinking is that with the cap, there is no need for the use-it-or-lose-it rule. But that comes with a cost.

”There’s been pressure to revisit the regulations, but there’s been push back about the financial cost,” says Kathryn Bakich, national health care compliance leader at benefits consultancy The Segal Company.

One recent legislative proposal to mitigate the risk of putting too much in the FSA each year would allow employees to cash out up to $500 of unused FSA funds within 7 months of the end of the plan year (the $500 would count as income). This passed the House as part of The Protect Medical Innovation Act of 2011, H.R. 436, but has stalled in the Senate. The cash-out provision was scored by the Joint Committee on Taxation as costing $4.1 billion over 10 years. (H.R. 436 would also revert back to pre ObamaCare rules and count over-the-counter drugs such as aspirin and antacids as FSA-eligible expenses.)

Another idea is to allow employees to roll over unused funds each year. But how much should be allowed to be rolled over each year? The full $2,500? And then can you keep deferring $2,500 a year to create a slush fund for healthcare expenses akin to a health savings account? What if you leave your employer? Now you typically you get a grace period to use up your FSA money. One easy way to use it up is for COBRA coverage, for example. Should these accounts be portable like HSAs? These issues should all be hashed out in the comments to the IRS, Rankin says.

Looming over this discussion is whether the Supreme Court will throw out the Affordable Care Act altogether. Another question is whether Treasury can make these changes through the regulatory process or whether Congress needs to act to change the rule, says Bakich. In 2005, the IRS through regulations said that employers could allow a grace period of 2 months and 15 days after the plan year for employees to use up their FSA dollars. Regulations have also permitted the use of FSA debit cards, which make it easier to tap these accounts.

In addition to asking question about the use-it-or-lose-it rule, the IRS notice clears up a few questions about the $2,500 cap. It’s applicable to the plan year, not the calendar year (if your next plan year starts July 1, 2013, that’s when the $2,500 cap kicks in). If your plan includes a grace period, unused contributions that are carried over into the grace period in a new plan year will not count against the $2,500 cap for that plan year.

Finally, there’s something to really watch out for that could come up again: An earlier version of the Affordable Care Act called for eliminating FSAs altogether.

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