

**DESCRIPTION OF H.R. 1004, THE  
“MEDICAL FSA IMPROVEMENT ACT OF 2011”**

Scheduled for Markup  
by the  
HOUSE COMMITTEE ON WAYS AND MEANS  
on May 31, 2012

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



May 29, 2012  
JCX-49-12

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## INTRODUCTION

The House Committee on Ways and Means has scheduled a markup on May 31, 2012, of H.R. 1004, the “Medical FSA Improvement Act of 2011,” which amends the Internal Revenue Code of 1986 to increase participation in medical flexible spending arrangements.<sup>1</sup> This document,<sup>2</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of these provisions.

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<sup>1</sup> Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended.

<sup>2</sup> This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. 1004, the “Medical FSA Improvement Act of 2011”* (JCX-49-12), May 29, 2012. This document can also be found on the internet at [www.jct.gov](http://www.jct.gov).

## **A. Taxable Distributions of Unused Balances Under Medical Flexible Spending Arrangements**

### **Present Law**

#### **Exclusion from income for employer-provided health coverage**

Employees are not taxed on (that is, may exclude from gross income) the value of employer-provided health coverage under an accident or health plan.<sup>3</sup> In addition, any reimbursements under an employer-provided accident or health plan for medical care expenses for employees, their spouses, their dependents, and adult children under age 27 generally are excluded from gross income.<sup>4</sup> The exclusion applies both to health coverage in the case in which an employer directly pays the cost of employees' medical expenses not covered by insurance (*i.e.*, a self-insured plan) as well as in the case in which the employer purchases health insurance coverage for its employees. There generally is no limit on the amount of employer-provided health coverage that is excludable. A similar rule excludes employer-provided health insurance coverage from the employees' wages for employment tax purposes.<sup>5</sup>

Employers may also provide health coverage in the form of an agreement to reimburse medical expenses of their employees, their spouses, their dependents, and adult children under age 27, not reimbursed by a health insurance plan, through arrangements which allow reimbursement for medical care not in excess of a specified dollar amount (either elected by an employee under a cafeteria plan or otherwise specified by the employer). An employer may agree to reimburse expenses for medical care of its employees (and their spouses and dependents), not covered by a health insurance plan, through a flexible spending arrangement ("FSA") which allows reimbursement for medical expenses not in excess of a specified dollar amount. The amounts available for reimbursement must be exclusively for reimbursement for medical care because the exclusion does not apply to amounts which the employee would be entitled to irrespective of whether he or she incurs expenses for medical care.<sup>6</sup>

Such dollar amount is either elected by an employee under a cafeteria plan ("Health FSA") or otherwise specified by the employer under a health reimbursement arrangement ("HRA"). Reimbursements under these arrangements are also excludable from gross income as reimbursements for medical care under employer-provided health coverage.<sup>7</sup>

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<sup>3</sup> Sec 106.

<sup>4</sup> Sec. 105(b).

<sup>5</sup> Secs. 3121(a)(2), 3231(e)(1) and 3306(a)(2).

<sup>6</sup> Treas. Reg. sec. 1.105-2.

<sup>7</sup> Sec. 106.

## Cafeteria plan

### General rules

A cafeteria plan is a separate written plan of an employer under which all participants are employees, and participants are permitted to choose among at least one permitted taxable benefit (for example, current cash compensation) and at least one qualified benefit (generally an employer-provided benefit excludable from gross income, such as employer-provided health coverage). If an employee receives a qualified benefit based on his or her election between the qualified benefit and a taxable benefit under a cafeteria plan, the qualified benefit generally is not includible in gross income.<sup>8</sup> However, in order to be excludable, any qualified benefit elected under a cafeteria plan must independently satisfy any requirements under the Code section that provides the exclusion. The amount of the cash compensation forgone pursuant to an election under a cafeteria plan is generally referred to as a salary reduction contribution. However, if a plan offering an employee an election between taxable benefits (including cash) and nontaxable qualified benefits does not meet the requirements for being a cafeteria plan, the election between taxable and nontaxable benefits generally results in gross income to the employee, regardless of what benefit is elected and when the election is made.<sup>9</sup> A cafeteria plan generally may not provide for deferral of compensation.

### Health flexible spending arrangement under a cafeteria plan

A flexible spending arrangement for medical expenses under a cafeteria plan (commonly called a “Health FSA”) is health coverage in the form of an arrangement under which employees are given the option to reduce their current cash compensation and instead have the amount of the salary reduction contributions made available for use in reimbursing the employee for his or her medical expenses.<sup>10</sup> For years before 2013, there is no statutory limit on the dollar amount of salary reduction contributions that an employer may permit to be contributed to a Health FSA under its cafeteria plan. Beginning with 2013, the maximum amount of salary reduction contributions for a year is limited to \$2,500.<sup>11</sup>

Health FSAs are subject to the general requirements for cafeteria plans, including a requirement that amounts remaining under a Health FSA at the end of a plan year must be forfeited by the employee (referred to as the “use-it-or-lose-it rule”).<sup>12</sup> A Health FSA is permitted to allow a grace period not to exceed two and one-half months immediately following the end of the plan year during which unused amounts may be used.<sup>13</sup> A Health FSA can also

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<sup>8</sup> Sec. 125(a).

<sup>9</sup> Prop. Treas. Reg. sec. 1.125-1(b).

<sup>10</sup> Sec. 125 and Prop. Treas. Reg. sec. 1.125-5.

<sup>11</sup> Sec. 125(i).

<sup>12</sup> Sec. 125(d)(2) and Prop. Treas. Reg. sec. 1.125-5(c).

<sup>13</sup> Notice 2005-42, 2005-1 C.B. 1204, and Prop. Treas. Reg. sec. 1.125-1(e).

include employer flex-credits which are nonelective employer contributions that the employer makes for every employee eligible to participate in the employer's cafeteria plan, to be used only for one or more excludable qualified benefits (but not as cash or a taxable benefit).<sup>14</sup>

### **Health reimbursement arrangement**

Rather than offering a Health FSA through a cafeteria plan, an employer may specify a dollar amount that is available for medical expense reimbursement. These flexible spending arrangements are commonly called health reimbursement arrangements ("HRAs"). Some of the rules applicable to HRAs and Health FSAs are similar (e.g., the amounts in the arrangements can only be used to reimburse medical expenses and not for other purposes), but the rules are not identical. In particular, HRAs cannot include salary reduction contributions and the use-it-or-lose-it rule does not apply. Thus, amounts remaining at the end of the year may be carried forward to be used to reimburse medical expenses in following years.<sup>15</sup>

### **Description of Proposal**

Under the proposal, a flexible spending arrangement to reimburse medical expenses (either a Health FSA under a cafeteria plan or an HRA) is permitted to provide that any amount remaining at the end of the plan year (or grace period if applicable) that is not used to reimburse medical expenses incurred during the plan year (plus the plan's grace period, if any) may be distributed to the employee. The distribution must be made no later than the end of the seventh month after the close of the plan year.

Providing for distribution of unused amounts under a flexible spending arrangement will not cause the amounts that are used for reimbursement for medical expenses under the arrangement to not qualify for income exclusion based on being available for purposes other than reimbursement for medical expenses. Further, providing for these distributions will not cause a cafeteria plan and Health FSA to violate the use-it-or-lose-it rule. The amount of any distribution of unused amounts under this proposal is includible in gross income for the year in which the distribution is made and is taken into account as wages for employment tax purposes.

### **Effective Date**

The proposal is effective for plan years beginning after December 31, 2012. In the case of plan years that begin before the date of the enactment of this proposal, the proposal includes a transition rule under which a cafeteria plan may allow an individual to make a new salary reduction election with respect to a Health FSA or to revise an existing salary reduction election under such arrangement so long as the new or revised election is made within 90 days after the date of the enactment.

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<sup>14</sup> Prop. Treas. Reg. sec. 1-125-5(b).

<sup>15</sup> Guidance with respect to HRAs, including the interaction of FSAs and HRAs in the case of an individual covered under both, is provided in Notice 2002-45, 2002-2 C.B. 93.

## B. Revenue Effect of the Proposal

The following presents the estimated Federal fiscal year budget effects of the proposal.

Fiscal Years [Millions of Dollars]												
<u>Item</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2013-17</u>	<u>2013-22</u>
Permit cash out of amounts under Health FSA or HRA not used to reimburse medical expenses incurred during plan year (plus any grace period) [1].....	-609	-886	-888	-910	-939	-968	-999	-1,031	-1,065	-1,092	-4,233	-9,388

**NOTE:** Details do not add to totals due to rounding.

[1] Estimate includes the following off-budget effects:

	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2013-17</u>	<u>2013-22</u>
	-181	-254	-250	-253	-258	-264	-270	-276	-282	-289	-1,196	-2,577