DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

December 23, 2004

The Honorable Charles E. Grassley
Chairman
Committee on Finance
United States Senate
Washington, DC 20510

Dear Chairman Grassley:

Thank you for your letter of August 23, 2004, in which you request that the Treasury Department examine its authority to modify the "use it or lose it" rule for health flexible spending arrangements (FSAs) in cafeteria plans under section 125 of the Internal Revenue Code. This "use it or lose it" rule is contained in regulations issued by the Treasury Department and the Internal Revenue Service in 1984.

Under the "use it or lose it" rule, salary reduction amounts made to fund an FSA which are not used to reimburse expenses in the plan year are forfeited at year end and may not be carried forward to reimburse expenses in later years. The "use it or lose it" rule was imposed in order to fulfill the Congressional mandate that cafeteria plans not provide for the deferral of compensation. The regulations interpret that requirement as prohibiting participants from carrying over unused benefits or contributions from one plan year to another.

Some have maintained that Treasury and the IRS should propose new regulations that either eliminate the "use it or lose it" rule or modify the rule so that only amounts in a flexible spending account in excess of $500 would be subject to the rule. Absent Congressional action, Treasury believes we do not have sufficient legal authority to administratively change this longstanding rule. Congress has addressed cafeteria plans once since the rule was promulgated in the Deficit Reduction Act of 1984. In that Act, Congress provided a special transition rule with respect to the "use it or lose it" rule. By addressing the application of the "use it or lose it rule" on only a transitional basis, Congress has effectively ratified the regulation's application of this rule on FSAs maintained after the transitional relief ended.

Treasury has also concluded that elimination of the "use it or lose it" rule will impact other important health care priorities of the Congress and this Administration. Treasury economists have estimated that there may be a reduction of up to 10 percent of the number of health savings accounts (HSAs) established if the "use it or lose it" rule is eliminated. HSAs also are used for individuals to pay for medical expenses in a tax advantaged manner and unused amounts in an HSA in one year can be used in subsequent years. However, amounts cannot be contributed to an HSA unless the HSA owner is participating in a high deductible health plan, an important policy goal which, combined with the financial incentives of the HSA, will help reduce overall health care spending. There is no such requirement for a high deductible health plan for those who have an FSA. Consequently, we have concerns that allowing rollovers of FSA amounts by eliminating the "use it or lose it" rule will result in fewer HSAs being established, with significantly fewer high deductible health plans being established and less containment of overall health care spending.

Treasury continues to look for creative solutions to resolving this issue that are consistent with an appropriate reading of the law and regulations. One possible approach, consistent with other deferred compensation rules, may be to provide a brief administrative grace period in the application of the "use it or lose it" rules, effectively extending the period slightly beyond one year before amounts are forfeited. I will keep you and your staff informed of our progress in this regard. Thank you for sharing your thoughts on this important health policy issue. I look forward to working with you to develop a solution that meets our mutual policy objectives.

Sincerely,

John W Snow

John W. Snow