



AMERICAN BENEFITS  
COUNCIL

August 17, 2012

*Submitted electronically via e-mail to Notice.Comments@irsounsel.treas.gov*

Internal Revenue Service  
CC:PA:LPD:PR (Notice 2012-40)  
Room 5203  
P.O. Box 7604  
Ben Franklin Station  
Washington, DC 20044

**Re: Notice 2012-40 – Comments on Potential Modification of “Use-or-Lose” Rule**

Sir or Madam:

We write on behalf of the American Benefits Council (“Council”) to provide comment in response to the request for comments set forth in Notice 2012-40 regarding potential modification of the “use-or-lose” rule applicable to health flexible spending arrangements (“Health FSAs”).

The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council’s members either sponsor directly or provide services to health and retirement plans that cover more than 100 million Americans.

The Council appreciates the opportunity to provide comment regarding potential modification of the Health FSA use-or-lose rule. We believe the current rule discourages Health FSA participation and, for those that do participate, it incents inefficient health care purchasing decisions.

Under the use-or-lose rule, employees forfeit amounts that remain in their accounts at the end of a plan year (or, if applicable, at the end of up to a 2 ½ month grace period thereafter). Many employees do not participate in Health FSAs given the possibility of forfeiting unused funds, while some employees that do participate in Health FSAs may find themselves having to make unnecessary health-related purchases (*e.g.*, extra eyeglasses) at the end of the year (or grace period, if applicable) in order to avoid forfeiture of such amounts.

We support modification of the use-or-lose rule, and we believe the Internal Revenue Service and the Department of the Treasury (collectively, the “Service”) have sufficient authority to modify the use-or-lose rule in the manner described below.

### **REGULATORY AUTHORITY TO MODIFY THE USE-OR-LOSE RULE**

Section 125 of the Internal Revenue Code of 1986, as amended (“Code”), generally prohibits a cafeteria plan from providing for a deferral of compensation. It is our understanding that the Service established the use-or-lose rule to minimize the opportunity for a Health FSA offered as part of a cafeteria plan to provide for a deferral of compensation by allowing employees to roll unused amounts in the Health FSA from one year to the subsequent year.

We believe the Service has the authority to permit carryover of unused Health FSA amounts from one year to a subsequent year. The Service’s 2007 cafeteria plan proposed regulations already allow in certain instances for amounts to be used to provide benefits over more than one plan year, *e.g.*, payment of long-term disability benefits, payment for orthodontics, and through the use of a 2 ½ month grace period.

There currently is no statutory or regulatory limit on the amount of salary reduction contributions that may be made to a Health FSA. Effective for plan years beginning on or after January 1, 2013, however, the Patient Protection and Affordable Care Act (“Affordable Care Act”) (together with Notice 2012-40) limits the amount of employee salary reduction contributions to a Health FSA to no more than \$2,500 per year. Placing such a limitation on the amount of salary reduction contributions to a Health FSA for a year significantly reduces the potential for a Health FSA to result in a deferral of compensation in violation of Code section 125.

### **RECOMMENDATIONS FOR REVISION**

The Council recommends that the Service provide additional flexibility with respect to the operation of the use-or-lose rule by permitting a Health FSA account holder to carry over unspent amounts to subsequent Health FSA plan years.

Most importantly, we recommend that the adoption of any such modifications to the use-or-lose rule be at the discretion of the plan sponsor. This flexibility would allow plan sponsors of Health FSAs to implement a Health FSA design that best serves the unique needs of their employees and dependents/beneficiaries. In this regard, we propose that the Service adopt three options, any of which could be utilized by an employer plan sponsor at its election to facilitate the carryover of unused amounts.

***Option #1: Permit the Carryover of the Full Amount of Unspent Health FSA Funds***

We urge the Service to modify the current use-or-lose rule to allow a Health FSA accountholder to carry over the full amount of unspent Health FSA balances at the end of a plan year (or grace period, if applicable) for use in the subsequent Health FSA plan year.

Specifically, we propose modifying the use-or-lose rule so that the default rule continues to be that unspent funds are forfeited at the end of a plan year (or grace period, if applicable). However, we believe that employers should be able to implement plan provisions that provide for the carryover of the full amount of unused Health FSA balances to the subsequent year.

We recommend the Service allow for the carryover of up to the full amount of unspent Health FSA balances from a prior year subject to an adjustment for current year Health FSA salary reduction contributions such that the total amount available for use in the current year does not exceed the \$2,500 statutory cap for Health FSAs (or the plan's annual contribution limit if less). Under such a rule, the employee does not suffer a forfeiture of any unused amounts; however, the employee does lose his or her ability to elect to salary reduce in subsequent years the full \$2,500 statutory limit to the extent of any carryover (or the plan's annual contribution limit if less).

To enable the administration of Option #1, we recommend that the Service permit an employer to determine the extent of any adjustment to the subsequent year's salary reduction election as late as the start of the second quarter of the subsequent plan year (after any grace period and runout period have expired). We believe this is a more workable rule than requiring employees and employers to attempt to determine any adjustment during open enrollment periods, when Health FSA salary reduction elections for the following year are typically made, or during the pendency of any grace period. This is because open enrollment periods occur prior to the end of the plan year (and any grace period), and an employee may not have an accurate sense as to the amount of Health FSA funds that will be unspent and thus available for carryover at the end of the plan year, including the grace period to the extent applicable. By determining any adjustment in the second quarter of the subsequent plan year, plan sponsors will be able to successfully adjust the salary reduction amount (for example, by reducing salary reduction contributions for the remainder of the plan year) such that

the total amount available for reimbursement for the subsequent plan year is limited to the maximum statutory limit of \$2,500.

**Example:** During open enrollment for the 2013 calendar year plan year, Employee A elects to make a salary reduction contribution to his Health FSA equal to \$2,500. During open enrollment for the 2014 calendar year plan year (i.e., prior to the end of the 2013 plan year), Employee A elects to make a salary reduction contribution to his Health FSA for 2014 equal to \$2,000. At the start of the second quarter of 2014 (i.e., after the close of the Health FSA's grace period and runout period), Employee A has \$1,000 in unused 2013 Health FSA funds.

Employer has elected to utilize Option #1 with respect to carryover of unused Health FSA funds. Under this proposed rule, Employee A would be permitted to carry over the full \$1,000 in unused funds from 2013 for use in 2014, but his salary reduction contribution for 2014 would be adjusted downward for the remainder of 2014 such that he only salary reduces a total of \$1,500 for 2014.

***Option #2: Permit the Carryover of Unspent Health FSA Funds Subject to Adjustment of Carryover Amount***

We urge the Service to also modify the use-or-lose rule so that employers are permitted to implement plan provisions that provide for the carryover of unused Health FSA balances to the subsequent year, subject to adjustment of such carryover amount so that the total amount available with respect to the subsequent year does not exceed \$2,500. Pursuant to this Option #2, employees' salary reduction elections for the subsequent year would not be adjusted; rather, the carryover amount would be adjusted to the extent necessary. As mentioned above, employers should have the flexibility to decide whether they wish to utilize Option #1, Option #2, or Option #3 (discussed below).

To enable administration of Option #2, we recommend that the Service permit an employer to determine the extent of any adjustment to the amount that will be carried over as late as the start of the second quarter of the subsequent plan year (after any grace period and runout period have expired). As with Option #1, employees and employers will not be able to determine the total amount available for carryover until after the expiration of any grace period and runout period. By determining any adjustment in the second quarter of the subsequent plan year, plan sponsors will be able to successfully adjust the carryover amount such that the total amount available for reimbursement for the subsequent plan year is limited to the maximum statutory limit of \$2,500.

**Example:** During open enrollment for the 2013 calendar year plan year, Employee B elects to make a salary reduction contribution to his Health FSA equal to \$2,500. During open enrollment for the 2014 calendar year plan year (i.e., prior to the end of the 2013 plan year), Employee B elects to make a salary reduction contribution to his Health FSA for 2014 equal to \$2,000. At the start of the second quarter of 2014 (i.e., after the close of the Health FSA's grace period and runout period), Employee B has \$1,000 in unused 2013 Health FSA funds.

Employer has elected to utilize Option #2 with respect to carryover of unused Health FSA funds. Under this proposed rule, Employee B would be permitted to carry over only \$500 of his unspent Health FSA funds from 2013 for use in 2014, and \$500 of excess unused funds from 2013 would be permanently forfeited. Employee B's salary reduction contribution for 2014 would remain unchanged at \$2,000, for a total available amount of \$2,500 in 2014.

***Option #3: Permit the Carryover of a Limited Amount of Unspent Health FSA Funds without Adjustment***

The Council recommends that any modification of the use-or-lose rule also include an approach that permits carryover of a reasonable amount of unspent Health FSA funds from a prior plan year without requiring any corresponding reduction in an employee's Health FSA election for the current plan year. As mentioned above, employers should have the flexibility to decide whether they wish to utilize Option #1, Option #2, or Option #3. The maximum amount of such limited carryovers could be determined by the Service and correlate with a national average of Health FSA forfeitures, e.g., \$300-\$500. To the extent the limitation on carryovers under this Option #3 results in unspent Health FSA amounts from one plan year not being permitted to be rolled over into the subsequent plan year, such amounts would be permanently forfeited.

Although many employers may want to adopt a carryover approach with adjustment as described above, others may find that requiring an adjustment is too administratively burdensome or costly or too confusing for plan participants. Including an approach that allows carryover without adjustment will help ensure that a modified use-or-lose rule is available to the broadest number of plan sponsors and participants.

**Example:** During open enrollment for the 2013 calendar year plan year, Employee C elects to make a salary reduction contribution to his Health FSA equal to \$2,500. During open enrollment for the 2014 calendar year plan year (i.e., prior to the end of the 2013 plan year), Employee C again elects to make a salary reduction contribution to his Health FSA equal to

\$2,500. At the start of the second quarter of 2014 (i.e., after the close of the Health FSA's grace period and run-out period), Employee C has \$1,000 in unused 2013 Health FSA funds.

Employer has elected to utilize Option #3 with respect to carryover of unused Health FSA funds. Under this proposed rule, Employee C would be permitted to carry over up to a maximum amount (e.g., \$300-\$500) in unused funds from 2013 for use in 2014, and any excess unused funds from 2013 would be permanently forfeited. Employee C would be permitted to retain his full \$2,500 salary reduction contribution election for 2014.

#### GUIDANCE ON OTHER AFFORDABLE CARE ACT ISSUES URGENTLY NEEDED

While we appreciate the opportunity to comment on possible modifications to the Health FSA use-or-lose rule, we also want to reiterate and underscore the urgent need for proposed regulations implementing Code section 4980H - Employer Shared Responsibility - and other key provisions of the Affordable Care Act. As indicated in prior comment letters, employers need implementation guidance that provides sufficient time to make plan design and operational and system changes necessary to achieve compliance with 2014 statutory effective dates.

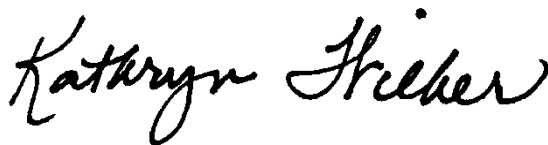
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Thank you for considering these comments submitted in response to the request for comments set forth in Notice 2012-40 regarding potential modification of the use-or-lose rule applicable to Health FSAs. If you have any questions or would like to discuss these comments further, please contact us at (202) 289-6700.

Sincerely,



Paul W. Dennett  
Senior Vice President,  
Health Care Reform



Kathryn Wilber  
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Health Policy