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

Re: Comments on Notice 2012-40 and Possible Modification of "Use-or-Lose" Rule for Health FSAs

To Whom It May Concern:

Thank you for the opportunity to comment on Notice 2012-40 and the possible modification of the "use-or-lose" rule for Health FSAs.

Based in Coldwater, Michigan, Infinisource, Inc. is a third party administrator that provides services related to human capital management, payroll, flexible benefits, online benefits enrollment and eligibility, COBRA and HIPAA. Our client base numbers more than 17,000 employers nationwide. We have more than 900 Health FSA clients.

Notice 2012-40 does an excellent job of clarifying rules for Health FSAs and the $2,500 limit on salary reduction contributions for plan years starting on or after January 1, 2013, which was added by §9005 of the Affordable Care Act (ACA).

In Section VIII of the Notice, the IRS posed three questions for comment:

I. Should current regulations be modified to provide additional flexibility with respect to the operation of the use-or-lose rule for Health FSAs?
II. If so, how should such flexibility be formulated and constrained?
III. How would any modifications interact with the $2,500 limit?

I. Should current regulations be modified to provide additional flexibility with respect to the operation of the use-or-lose rule for Health FSAs?

We think the answer is clearly yes. The use-or-lose rule is not part of the Internal Revenue Code or any other statutory provision. It was created by IRS/Treasury regulation and can be modified or eliminated via the same method. Deferred compensation in §125(d)(2) of the Code is not defined. There is no mention of use-or-lose in §125.

Here are 12 major reasons to eliminate the use-or-lose rule:

1. <u>Positive effect on participation and election amounts.</u> Use-or-lose is typically the number one reason employees give for not participating or for participating at very minimal amounts. A common phenomenon is that once a participant has forfeited Health FSA

money, the participant never participates again. This change would benefit both employees and employers because of the tax savings. It has always been a challenge to explain that the FICA and federal income tax savings might be greater than the forfeited funds at the end of the plan year (or grace period).

2. Increased availability of funds to pay expenses. Eliminating use-or-lose would make more money available and soften the blow for unexpected, unplanned out-of-pocket medical care expenses in future years.
3. Benefits to hospitals and other health care providers. Having more Health FSA funds readily available would help health care providers in collecting amounts payable by the patient for deductible and copayment expenses.
4. Reduced stress related to elections. A common complaint among employees is that the Health FSA election is a very stressful decision at open enrollment. It is difficult to predict next year's out-of-pocket medical expenses. Eliminating use-or-lose would reduce unnecessary employee confusion and pressure.
5. Precedent has already been set. In Notice 2005-42, the IRS allowed a two-month, 15-day grace period, which made an exception to the use-or-lose rule. Eliminating it all together is an easier step than might have been contemplated before Notice 2005-42.
6. Consistency with the overall purpose of the ACA. An underlying premise of the ACA is to encourage healthy choices without limitation on the benefits that individuals receive. Eliminating use-or-lose helps accomplish this purpose because contributions ultimately will be used to pay for medical care instead of forfeitures being used by the employer to defray reasonable plan administrative expenses or even retained by the employer.
7. Consistency with HRAs. HRAs and Health FSAs have several features in common. In Notice 2002-45, HRAs are permitted to have a carryover. Health FSAs should have the same flexibility.
8. Benefit for costly medical expenses (e.g., orthodontia, durable medical equipment). Eliminating use-or-lose would enable participants to better cover the costs of big ticket medical expenses. For example, orthodontia benefits are typically capped under a dental plan, leaving the employee to pay the balance.
9. Removal of Health FSA disincentive for healthy individuals. Young and healthy individuals often are reluctant to make a Health FSA election for fear of use-or-lose. As a result, they are less protected when unexpected medical issues arise. Eliminating use-or-lose would allow them to have a safety net that could be carried over from year to year.
10. Mirrors attractive feature of HSAs. Eliminating use-or-lose would give Health FSAs one of the most popular aspects of HSAs (i.e., the ability to carry over funds year to year). With Health FSAs, participants need not be burdened with having to enroll in a high-deductible health plan (HDHP), which is required for HSA participation.
11. Improves employer-employee relationship. Use-or-lose creates an unnecessary level of distrust between employers and employees because forfeitures usually revert to the employer.
12. Balances effect of the §125(i) limit. The $2,500 limit (indexed for inflation after 2013) will constrain the election amounts of many participants. Eliminating use-or-lose would help to offset the consequences of §9005.

II. How should such flexibility be formulated and constrained?

Several suggestions have already been made on how to formulate and constrain a Health FSA carryover. We believe that the following ideas are impractical, ineffective and/or prohibited:

- Allowing a cashout of the prior year's balance. This approach would clearly violate the spirit and letter of the deferred compensation prohibition in §125(d)(2) of the Code.
- Allowing a cashout of the Health FSA balance upon termination of employment. Other than what is permitted for Qualified Reservist Distributions under the HEART Act (see §125(h) of the Code), we do not see that such a cashout is permitted. To the extent that a Health FSA is underspent, COBRA allows continuation of such coverage.
- Allowing employers to recoup overspent Health FSA balances upon termination of employment. In our view, this would be impermissible risk-shifting and would undermine the purpose of the Uniform Coverage Rule. It would be helpful for the IRS to explicitly state that such a practice is prohibited because we sometimes receive questions requesting clear confirmation of this fact.
- Increasing the length of the current grace period of two months, 15 days. This approach would not allow a carryover but simply extend the current grace period. Administratively, the grace period is a challenge to communicate and manage because a plan administrator must coordinate balances from two different plan years. We recommend that if a carryover is permitted, the grace period should be eliminated. It will no longer serve its intended purpose and cause confusion.
- Reducing the next year's salary reduction contribution by the amount of the carryover. It has been recommended that the next plan year's salary reduction should be reduced by the amount of the carryover in order to ensure that the account balance does not exceed the annual limit for salary reduction contributions in §125(i), which is $2,500 in 2013. From a payroll standpoint, this recommendation would be difficult to administer and unnecessary.

  For example, assume a calendar plan year, and a Health FSA election of $2,500 for the 2013 plan year. Assume also that the employer has 25 pay periods in 2013 and a 90-day run-out period for the Health FSA. In January, the employer would start deducting $100 per pay period. Any carryover balance would not be known until early April. Let's say the carryover balance from the 2012 plan year is $250, and the balance is not known until the eighth pay period in 2013. Thus, $700 has already been reduced from salary with $1,800 remaining for the last 18 pay periods. However, the additional $250 reduction would mean only $1,550 would need to be deducted. This would require payroll administrators to recalculate the salary reductions every year for every participant with a carryover amount. This would be burdensome.

  In our view, the limit in §125(i) is honored by simply allowing the carryover amount to be added to the next year's election amount. It was already subject to the applicable limits from the prior plan year and may include employer contributions, which are not subject to the §125(i) limit at all.

Therefore, we would advocate that elimination of use-or-lose should contain the following features:

- Eliminating the grace period. It serves the same purpose as the carryover and would cause confusion, especially if an employer adopted both. The grace period was adopted in Notice 2005-42 as an exception to the rule. If the rule is eliminated, there is no further need for the exception.

- Permitting the carryover to be added to the next year's election amount. This would be the easiest method to administer and communicate.
- Allowing employers flexibility on implementation. Some employers may want to retain use-or-lose because it helps to offset the risk of the Uniform Coverage Rule and to defray reasonable plan administrative expenses. The new rule should allow employers to opt out of the carryover by plan design. In addition, employers should have the ability to cap the carryover amount by plan design. This flexibility would be consistent with rules that apply to HRAs.

As a practical matter, the IRS should clarify the effect of the carryover on the HIPAA-excepted benefit status of Health FSAs. In particular, §54.9831-1(c)(3)(v) of the HIPAA Portability Regulations excepts Health FSAs as long as the "*arrangement is structured so that the maximum benefit payable to any participant in the class for a year cannot exceed two times the participant's salary reduction election under the arrangement for the year (or, if greater, cannot exceed $500 plus the amount of the participant's salary reduction election).*" In our view, any carryover amount should not count toward the maximum benefit payable because it was contributed in a prior plan year. This also affects COBRA administration as to when you must offer a Health FSA, per §54.4980B-2, Q/A-8. The IRS should clarify the effect of carryovers on COBRA administration.

III. How would any modifications interact with the $2,500 limit?

Based on the analysis above, our recommendation would be that the carryover has little or no effect on the §125(i) limit, which is $2,500 for 2013. Allowing participants to accumulate balances in excess of the §125(i) limit would best address many of the major concerns with use-or-lose. For example, additional funds would be available for unexpected major medical issues and traditionally high-cost procedures.

We want to thank the IRS for this opportunity to comment on Notice 2012-40. If you have any questions or concerns, please feel free to contact me or Connie Gilchrest, our Research and Compliance Specialist, who assisted with these comments, at 800-300-3838 or via e-mail at rglass@infinisource.com or cgilchrest@infinisource.com.

Thank you for your consideration.

Respectfully Submitted,

Rich Glass, JD
Chief Compliance Officer
Infinisource, Inc.

Via e-mail (sent to Notice.Comments@irscounsel.treas.gov)