



July 24, 2012

VIA ELECTRONIC MAIL

William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224
notice.comments@irscounsel.treas.gov

Re: Notice 2012-40, Potential Modification of Use It or Lose It Rule

Dear Mr. Wilkins:

The Office of Advocacy (Advocacy) submits the following comments in response to Internal Revenue Service (IRS) Notice 2012-40.¹ The IRS notice requests comments on the potential modification or elimination of the “use it or lose it rule” for health flexible spending accounts (health FSAs). Advocacy commends the IRS for issuing Notice 2012-40 and considering eliminating a rule that burdens small business. As described more fully below, because the use it or lose it rule negatively impacts small business employers offering health FSAs, and because recent changes to tax law no longer makes the rule necessary, Advocacy recommends that the IRS eliminate this rule.

Advocacy was established pursuant to P.L. 94-305 to represent the views of small business before Federal agencies and Congress.² Advocacy is an independent office with the Small Business Administration (SBA), so the views expressed in this letter do not necessarily reflect the views of the SBA or the Administration. Section 612 of the Regulatory Flexibility Act (RFA) also requires Advocacy to monitor agency compliance with the RFA, as amended by the Small Business Regulatory Enforcement Fairness Act.³ Advocacy takes its direction from small businesses and regularly hosts roundtables to receive input on what issues are of greatest importance to small business.

Background

Under an employer-sponsored Internal Revenue Code (Code) section 125 cafeteria plan, employees may select between permitted taxable benefits (such as cash) and certain qualified benefits. If an employee makes the election before the start of the plan year, and other Code section 125 requirements

¹ <http://www.irs.gov/pub/irs-drop/n-12-40.pdf>.

² 15 U.S.C. § 634a (1976). http://www.sba.gov/advo/laws/law_sta.html#634a.

³ Pub. L. No. 96-354, 94 Stat. 1164 (1981) (codified at 5 U.S.C. §§ 601-612) amended by Subtitle II of the Contract with America Advancement Act, Pub. L. No. 104-121, 110 Stat. 857 (1996). 5 U.S.C. §612(a).

are satisfied, the employee's election of one or more qualified benefits does not result in gross income to the employee. Additionally, employees may establish a health FSA through a cafeteria plan to pay medical expenses not paid for by health insurance, such as deductibles.

In 1984, the IRS issued proposed regulations to implement Code section 125. The proposed regulations included the "use it or lose it" rule for health FSAs. The use it or lose it rule prohibits any contribution or benefit under an FSA from being used in a subsequent plan year or period of coverage.⁴ Thus, under this rule, unused amounts in the health FSA are "forfeited" at the end of the plan year.

In 2005, the IRS issued Notice 2005-42 to provide some relief for the use it or lose it rule whereby a qualified cafeteria plan could allow participants an additional grace period of 2 months and 15 days after the end of the plan year to continue to incur claims against the just-concluded plan year.⁵ Under this notice, if the plan provides for a grace period, an employee may use amounts remaining from the previous plan year to pay for expenses incurred for certain qualified benefits during the grace period.

The Patient Protection and Affordable Care Act of 2010 (Act), Pub. L. No. 111-148, added section 125(i) to the Code setting forth a \$2,500 limit on salary reduction contributions under a health FSA. Prior to the enactment of the Act, the IRS permitted employers to enact any maximum annual election for their employees. Code section 125(i) provides that, for taxable years beginning after December 31, 2012, that a health FSA is not treated as a qualified benefit unless the cafeteria plan "provides that an employee may not elect for any taxable year to have salary reduction contributions in excess of \$2,500 made to such arrangement."

On March 21, 2012, Advocacy hosted a roundtable meeting where small business stakeholders, and staff from the IRS and Department of Treasury met to discuss pension-related issues impacting small business. At the roundtable, small business representatives discussed the burdens associated with the use it or lose it rule. For example, one small business stakeholder spoke about the time-consuming "year-end dance" that small business employers face to remind employees to spend remaining money in health FSAs that would otherwise be forfeitable.

On May 30, 2012, the IRS issued Notice 2012-40 to provide guidance on health FSAs. Among other things, the IRS notice requests comments on the potential modification or elimination of the use it or lose it rule for health FSAs. The IRS notice states that the \$2,500 limit set forth in Code section 125(i) limits the potential for using health FSAs to defer compensation. The IRS explained that, due to the \$2,500 limit, it is considering whether the use it or lose it rule for health FSAs should be modified or eliminated.

Recommendation

We are pleased that the IRS listened to the concerns of small business and is considering eliminating the use it or lose rule it. Advocacy recommends that the IRS revoke this rule. Instead of requiring the forfeit of unused amounts in a health FSA at the end of a plan year, the IRS should permit an employer

⁴ See Prop. Treas. Reg. § 1.125-1, Q&A-7(b) (1984); Prop. Treas. Reg. § 1.125-2, Q&A-5 & Q&A-7 (1989); Prop. Treas. Reg. § 1.125-5(c) (2007).

⁵ See http://www.irs.gov/irb/2005-23_IRB/ar11.html/.

to give plan participants the choice of receiving the unused taxable cash or making a tax-deferred contribution to the employer's Code section 401(k), section 403(b), or section 457(b) plan.

This recommendation would not violate the provisions of Code section 125. Moreover, as the IRS observed, the enactment of the new Code section 125(i) \$2,500 limit on health FSA contributions limits the potential to use health FSAs to defer compensation, and therefore, the need for the use it or lose it rule no longer exists.

Thank you again for your efforts on behalf of small businesses. Advocacy looks forward to working with the IRS in the future to determine ways to reduce the burdens faced by small businesses. If you have any questions or require additional information please contact me or Assistant Chief Counsel Dillon Taylor at (202) 401-9787 or by email at Dillon.Taylor@sba.gov.

Sincerely,

A handwritten signature in black ink that reads "Winslow Sargeant". The signature is written in a cursive style with a large, sweeping initial "W".

Winslow Sargeant, Ph.D.
Chief Counsel for Advocacy

A handwritten signature in blue ink that reads "Dillon Taylor". The signature is written in a cursive style with a large, sweeping initial "D".

Dillon Taylor
Assistant Chief Counsel Advocacy