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August 17, 2012

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

Re: “Use it or Lose It” and “Risk Shift” Rules Under IRC §125
Submitted electronically to notice.comments@irs.counsel.treas.gov

Dear Sir or Madam:

The undersigned employers and associations kindly ask you to please consider these comments in your review of IRS Notice 2012-40 and the elimination and/or revision of the “use it or lose it” and “uniform availability/employer risk-shift” provisions in the regulations of Section 125. In reviewing the legislative and regulatory history of Internal Revenue Code Section 125, we believe that Treasury has the authority to abolish or amend both the “use it or lose it” and “risk shift” rules, providing plan participants and sponsoring employers with increased flexibility while at the same time protecting both groups from financial gain or loss.

Background

Prior to 1978, the IRS applied the constructive receipt doctrine to an employer offering an employee the choice of a nontaxable benefit or receiving taxable cash in its place. That is, regardless of an employee’s choice, the IRS interpretation was that all such dollars were fully taxable to the employee since the employee could have received cash, even if that employee took the otherwise-nontaxable benefit (*e.g.* health insurance).

The Revenue Act of 1978 created a new Tax Code section—Section 125—dealing with this constructive receipt issue when a choice between a nontaxable benefit and taxable cash was offered to an employee. In essence, Section 125 did nothing more than apply the correct taxable status not due to having a choice of benefit, but rather to the actual choice made. Thus, in a plan that otherwise comported with Section 125’s statutory requirements, when eligible employees were offered a simple choice between health insurance or an opt-out payment, Employee A’s choice of health insurance resulted in no taxation (exempted under Sections 105 and 106 of the Code) while Employee B’s choice of the opt-out cash was fully taxable.

Prior to 1984, there was an abusive form of FSA known as a Zero Balance Reimbursement Account (ZEBRA), whereby participants did not make an election of an FSA amount at the beginning of the plan year. Instead, as participants incurred claims, they submitted such claims to the plan administrator who then reduced their pay for that pay period by the claim amount, thus recharacterizing an otherwise-taxable event into a nontaxable one. In 1984, the IRS issued its first set of Proposed Regulations for Section 125. Among other requirements, it singled out health care and dependent care FSAs—and in particular ZEBRAs—for special treatment. Invoking the statute which said that there could be no deferred compensation in a Section 125 plan other than 401(k) monies, the Service imposed a requirement that all cafeteria plan elections must be made in advance of the coverage period and must be irrevocable (with some exceptions) during the plan year. In addition, a brand-new “use it or lose it” rule for FSAs was introduced. That rule stated that after the end of the plan year and a short administrative period whereby participants could continue to submit claims incurred during the just-closed plan year, any monies left in an FSA must be forfeited.

In 1987, the IRS issued a second set of Proposed Regulations. This time, it characterized health care FSAs as a form of insurance, and as such introduced the “Uniform Availability/Employer Risk Shift” rule whereby a plan participant must have the entire annual election available for reimbursement on any day of the plan year. The Service’s rationale was that if the employee was at-risk under the “use it or lose it” rule, the employer should bear some risk as well.

In 2005, the IRS issued Notice 2005-42 providing some very limited relief of the “use it or lose it” rule whereby a qualified cafeteria plan could allow participants an additional 2-½ months after the end of the plan year to continue to incur claims against the just concluded plan year. For example, a plan utilizing this grace period could enable Employee C to incur and submit claims for the 2012 plan year at any time from January 1, 2012 through March 15, 2013.

Lastly, the Patient Protection and Affordable Care Act of 2010 (PPACA) introduced a new limit for health care flexible spending accounts under Section 125, limiting the employee contributions to such accounts to no more than \$2,500 per employee per plan year. Proposed Regulations earlier this year provided some guidance as to the requirements of this new provision. In addition, the PPACA also eliminated over-the-counter drugs without a prescription from eligibility for reimbursement under a health care flexible spending account, beginning in 2011.

Use it or Lose It Rule

The “use it or lose it” rule is counterproductive to all parties (the participant, the plan sponsor, and even the Treasury). It requires participants who have not utilized all of their plan contributions into their FSA to do a year-end dance of finding eligible items on which to spend the amounts that would otherwise be forfeitable. We even now see providers directly appealing to FSA participants to spend their soon-to-be-unused dollars with them (*e.g.* two or three pairs of prescription sunglasses, contact lenses, and additional prescription drugs, among many others). This goes against any public policy or plan sponsor attempt to try to link health care spending with better consumerism. In fact, it is anti-consumerism, sending a message to participants to go spend money indiscriminately before you lose it. Further, since participants tend to view these dollars as their own, and since employers are precluded by current law and

regulation from returning these monies to them, they tend to resent forfeiting these dollars back to their employer.

If Treasury were to repeal the “use it or lose it” rule (which does not exist in the statute), at year-end (or after any allowable grace period or runoff period) participants could be given a choice to either take taxable cash or make a tax-deferred contribution to the plan sponsor’s 401(k), 403(b), or 457(b) plan. This would not violate the rule against deferred compensation in a §125 plan and in fact would result in greater FICA/Medicare/income tax revenue to the Treasury for those participants electing cash and greater payroll tax revenues for those electing the retirement plan option. A cash option is statutorily required since all three Code sections (401(k), 403(b), and 457(b)) require a cash-or-deferred election.

While this cash-out approach may be preferable, an alternative that would also address participants’ concerns with the “use it or lose it” rule would be a carryover of unused FSA amounts into the subsequent plan year. From a technical basis, since Treasury already considers these amounts to be employer contributions, it should not necessarily count against the PPACA’s new \$2,500 limitation. Thus, just as today an employer can make contributions to a health care FSA, following the existing thinking at the IRS these amounts could be added to the \$2,500. Administratively, this would be the easiest solution for both employers and employees. Of course, if that thinking has changed, the rolled-over amounts could instead be offset against the \$2,500 limit. This would cause some administrative issues since for most health care FSA plans elections are made months before the grace and/or runoff periods end. However, a proposed solution would be to allow the rollover calculation to automatically reduce the participant’s remaining election (and thus deduction) amounts over the rest of the plan year.

A “use it or lose it” repeal would return consumerism to FSA plans, since participants would not spend indiscriminately at year-end in order not to forfeit their monies. Instead, they would spend wisely throughout the year knowing that any unused money would be received in either taxable cash or as a retirement plan contribution, or alternatively be rolled over to the following year’s account.

The Uniform Availability/Risk Shift Rule

This rule hinges on a strained interpretation by the Service. By determining that a health care FSA is insurance and a purchaser of insurance may submit a claim for reimbursement at any point during the coverage period, the Service requires that all health care FSAs allow participants the ability to submit eligible claims for up to the full annual election at any point during the plan year and receive immediate reimbursement. If the participant terminates eligibility or coverage, the plan sponsor is prohibited from recovering any negative balance.

The problem with this reasoning is that a health care FSA bears absolutely no relationship to any insurance product of any kind. What form of insurance would any individual buy where the most that could be reimbursed under the plan is the “premium” paid during the year, and if claims for reimbursement are not incurred then that “premium” is forfeited at year’s end? Of course, the answer is none.

The Service's explanation at the time of "risk shift" rule's inception was that there was employee risk in the "use it or lose it" rule, and a balancing employer risk was also necessary. With the proposed repeal or rethinking of the "use it or lose it" rule, the balancing "risk shift" rule would also need to be repealed. If the alternative carryover solution offered above was adopted, then corresponding changes to the risk shift rule would need to be made. Since an FSA participant can elect COBRA coverage on a positive account balance at termination, we would propose that an employer be explicitly allowed to deduct any negative amount in a terminating participant's last paycheck(s). This would require a change whereby the employer deduction is not the difference between the annual election amount and the amount already reimbursed during the plan year, but rather the difference between the amount already reimbursed and the amount of contributions already made to-date—that is, the participant's negative balance. The analog here is to one of the three Family and Medical Leave Act (FMLA) rules allowing for a pre-pay of employee contributions to a health plan, including an FSA. Of course, the other two mechanisms in the FMLA are not applicable to a terminating participant ("pay-as-you-go" and "pay-upon-return").

Summary

Both of these Section 125 rules provide a measure of counterbalance for participants and plan sponsors, and thus both must be repealed and/or amended to maintain that balance. The undersigned respectfully requests that the Service issue Regulations making such changes. If any additional information is needed, please do not hesitate to contact us as we'd be happy to discuss these proposals further in more detail.

Very truly yours,



Gary B. Kushner, SPHR, CBP
President and CEO

GBK/ab

SUBMITTED ON BEHALF OF THE FOLLOWING ORGANIZATIONS:

Kushner & Company
Society for Human Resource Management
Small Business Council of America
Small Business Association of Michigan