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By first-class mail and electronic delivery
[*Notice.comments@irscounsel.treas.gov*]

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

RE: Notice 2012-40
Application of Dollar Limit on Health Care Flexible Spending Arrangements
Comments on Possible Revisions to Use-It-or-Lose-It Rule

Dear Sir or Madam:

The Employee Benefits and Executive Compensation Committee of the New York City Bar Association[1] ("Committee") is pleased to respond to the request of the Internal Revenue Service ("Service") and the Department of the Treasury in Notice 2012-40[2] for comments regarding whether the use-it-or-lose-it rule

[1] This letter was prepared by a working group of a subcommittee of the Committee on Employee Benefits and Executive Compensation of the New York City Bar Association consisting of J. Stewart Borrow, Kathleen Drapeau, Matthew L. Eilenberg, David Gallai and Jill Weinberg. J. Stewart Borrow was the primary author of this letter. This letter is presented by the Committee on Employee Benefits and Executive Compensation on behalf of the New York City Bar Association, and represents its views as a committee; it does not necessarily represent the views of any individual members of the Committee on Employee Benefits and Executive Compensation or their respective law firms or employer organizations.

[2] 2012-26 I.R.B. 1046 (June 25, 2012, released June 7, 2012).

("Rule"), as applied to health care flexible spending arrangements ("Health FSAs"), should be modified in light of the $2,500 annual limit ("Annual Health FSA Limit"). Our comments are limited to responding to the Service's request for comments on the application of the Rule after the Annual Health FSA Limit becomes effective. Therefore, with respect to plan years beginning after December 31, 2012, the Committee believes that the Rule should be modified in the following respects:

1. Modify the Rule to Extend the Grace Period in Which to Incur Eligible Expenses ("Grace Period") to the End of the Following Plan Year.

It is respectfully submitted that, in light of the Annual Health FSA Limit becoming effective in plan years after December 31, 2012, the potential for using salary reduction contributions to Health FSAs as a means for deferring compensation is greatly attenuated.[3] In this regard, it is noted that the Rule has been articulated in several iterations of proposed cafeteria plan regulations and was intended to limit both the potential for using Health FSAs to defer compensation and the accumulation of FSA balances over time.[4] Therefore, the Rule should be revised to provide for a maximum permissible Grace Period extending to the close of the plan year following the plan year for which such salary reduction contributions were elected and contributed. Thus, assuming that an employer has a cafeteria plan with a calendar plan year and the maximum permissible Grace Period, and that an employee elects, for the plan year beginning January 1, 2013, to make salary reduction contributions to a Health FSA up to the Annual Health FSA Limit, the employee would have until December 31, 2014 to use up the full $2,500 amount elected for the 2013 plan year.

2. Allow Full Carryover of Unused Salary Reduction Contributions from the Preceding Plan Year Without Reducing the Annual Health FSA Limit in Effect for the Following Plan Year.

If the Service extends the Grace Period to the close of the following plan year, this raises the issues, for purposes of complying with the Annual Health FSA Limit requirement, of whether and to what extent any unused amounts may be carried over from one plan year, i.e., with or without offsetting salary reduction contribution limits for the following plan year. It is respectfully submitted that, for purposes of complying with the Annual Health FSA Limit requirement, the unused salary reduction contributions from the earlier plan year should be carried over in full, i.e., they should not reduce the employee's salary reduction limit for the following plan year. Applying our previous example, let's assume that, as of the end of the 2013 plan year, the employee has $1,000 of unused salary reduction contributions. This unused amount should not reduce the employee's $2,500 limit for the 2014 plan year. Notice 2012-40 indeed adopts this approach: unused 2012 Health FSA contributions are not taken into account for purposes of determining compliance with the $2,500 limit during 2013. Continuing this approach would

[3] Notice 2005-42, 2005-1 C.B. 1204, which first approved the creation of a Grace Period, was issued when there was only preliminary guidance concerning section 409A of the Internal Revenue Code of 1986, as amended ("Code"). Now that proposed and then final regulations under Code section 409A have been issued, it is well established that the reimbursement of medical expenses should generally not be treated as the deferral of compensation. See Treas. Reg. § 1.409A-1(a)(5) (medical reimbursement arrangement) and Treas. Reg. § 1.409A-1(b)(9)(v)(B) (separation pay plan providing for reimbursement of medical expenses for up to the COBRA continuation period). Similarly, the small amount of the reduced Annual Health FSA Limit should allay concerns about the potential for deferred compensation. See Treas. Reg. § 1.409A-1(b)(9)(v)(D) (separation pay plan providing payments that do not in the aggregate exceed the dollar amount under Code § 402(g)(1)(B) are not deferred compensation).

[4] See Prop. Reg. §§ 1.125-1(o) and 1.125-5(c) (2007); see also Prop. Reg. § 1.125-1, Q&A-7 (1984) and Prop. Reg. § 1.125-2, Q&A-5 and Q&A-7 (1989).

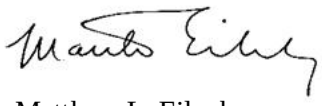
allow computer systems to extend current programs into future years without costly system changes. This approach avoids complex offsets that add traps for the unwary and unsophisticated.[5] The Committee views a full carryover as promoting stability of Health FSA rules for employers and simplicity of FSA rules for individuals. Finally, the proposed approach of allowing full carryover without offset should be substantially easier to administer and would tend to avoid special transition rules.

3. Prohibit the Cashout of Unused Salary Reductions to a Health FSA.

In issuing guidance on the modification of the Rule, the Service should nevertheless continue to prohibit cashouts of unused salary reduction amounts, except to the limited extent such cashouts are permitted by law. Therefore, Health FSA salary reduction contributions should continue to "conform to the generally applicable rules under sections 105 and 106 in order for the coverage and reimbursements under such plans to qualify for tax-favored treatment under such sections . . . . A health FSA is only permitted to reimburse medical expenses as defined in section 213(d)." Prop. Reg. § 1.125-5(k)(1).

Members of the Committee would be pleased to answer any questions you might have regarding our comments and to meet with the Service if that would assist your efforts.

Respectfully submitted,



Matthew L. Eilenberg

cc: J. Stewart Borrow, Esq.
Kathleen Drapeau, Esq.
Jill Weintraub, Esq.
Alan Rothstein, Esq.

[5] As with the current maximum Grace Period of 2½ months, there would be a need for ordering rules in the case of an expense for a period in which the Health FSA contains both carryover amounts and amounts attributable to current-year contributions, e.g., a first-in-first-out method.

THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK
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* Ms. La Londe, an Investigator at the Employee Benefits Security Administration, U.S. Department of Labor, did not take part in the discussion of this letter and neither supported nor dissented from the positions in this letter.