



For your information

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IRS Provides Guidance Regarding \$2,500 Limit on Contributions to Health Care Flexible Spending Accounts

On May 30, 2012 the Internal Revenue Service (IRS) issued Notice 2012-40, which addresses several issues regarding the \$2,500 limit on contributions to health care flexible spending accounts (health FSAs) established by the Patient Protection and Affordable Care Act (PPACA). The Notice also includes a request for comments regarding the “use-it-or-lose-it” rule currently applicable to FSA plans.

Background

Currently the Internal Revenue Code (Code) imposes no annual limit on the amount that an employee may contribute to a health FSA. However, employers typically include an annual limit in their programs to reduce their risk of loss if an employee terminates midyear and to limit forfeitures of employee contributions under Section 125’s “use-it-or-lose-it” rule, which requires the forfeiture of FSA balances that were not used to reimburse eligible expenses incurred during the plan year. PPACA added Code Section 125(i), which imposes an annual limit of \$2,500 on salary reduction contributions made to health FSAs for taxable years beginning after December 31, 2012. Because individuals pay taxes on a calendar-year basis, it was generally assumed that the \$2,500 limit applied to calendar years beginning on and after January 1, 2013. For plans that operate on other than a calendar-year fiscal basis, this posed administrative problems in applying the limit and would force some plans to impose the new limit before the effective date. [Notice 2012-40](#) provides welcome relief for these plans.

Notice 2012-40

Notice 2012-40 clarifies the effective date for application of the annual health FSA limit imposed by PPACA. It also sets out the deadline for amending cafeteria plan documents and describes available relief for inadvertent contributions that exceed the limit.

Plan and Taxable Year

Recognizing that individuals make salary reduction elections on a “plan year” basis, the Notice clarifies that for purposes of applying the \$2,500 limit, the term “taxable year” refers to the health FSA’s plan year. Further, it confirms that the limit only applies to plan years that begin or after January 1, 2013. Finally, it notes that the \$2,500 limit will be indexed for cost-of-living adjustments for plan years beginning on or after January 1, 2014.

INSIGHT

Employers sponsoring non-calendar-year health FSAs no longer have to worry about complying with the new annual limit requirement for plan years beginning in 2012.

Section 125 requires a plan sponsor to have a valid business purpose for changing the plan year of its cafeteria plan. The Notice provides that the desire to delay implementation of the annual limit is not a valid business purpose, and that if a change is made for that reason, the cafeteria plan year will remain as it was before the change. The Notice also provides that if a cafeteria plan has a short plan year (less than 12 months), the \$2,500 limit must be prorated on the basis of the number of months in the short plan year.

Application of the \$2,500 Limit

The \$2,500 annual limit applies only to health FSA contributions attributable to employee salary reductions; it does not apply to non-elective employer contributions made to the health FSA. It also does not apply to other salary reduction contributions such as those made to dependent care FSAs, or those made to pay the employee's share of the cost of health coverage or to contributions to health savings accounts. The Notice also clarifies that the limit does not apply to "flex credits" unless the employee has the choice of receiving the employer contributions either as cash or as a nontaxable benefit.

The Notice clarifies that the \$2,500 limit is imposed on an employee-by-employee basis and that the limit does not increase based on the number of individuals whose expenses may be reimbursed through the health FSA. If both spouses are eligible to contribute to eligible FSA plans, the limit for each spouse is \$2,500 even if the spouses are employed by the same employer and participate in the same health FSA sponsored by that employer.

All employers in a controlled group or affiliated service group under the Code are treated as a single employer for purposes of the annual limit; an employee who works for several companies and participates in multiple health FSAs sponsored by members of the group may contribute only \$2,500 in total. However, an employee who works for two unrelated employers may contribute \$2,500 under each employer's plan.

Grace Period

Currently, any balances remaining in an individual's account at the end of the plan year are forfeited under the "use-it-or-lose-it" rule. A plan sponsor may adopt a plan feature that permits a balance remaining at the end of the year to be used to reimburse an individual for claims incurred during a "grace period" of up to two and one-half months after the end of the plan year. The Notice clarifies that such reimbursements do not count toward the \$2,500 limit for the following plan year.

Plan Amendment.

The [proposed cafeteria plan regulations](#) issued in 2007 require that a cafeteria plan specify the maximum amount of salary reduction contributions that may be made to a health FSA. They also provide that cafeteria plans generally may not be amended retroactively. Under this Notice, plan sponsors have until December 31, 2014 to adopt conforming plan amendments, even though the plan must comply with the annual limit requirements beginning with the 2013 plan year.

COMPLIANCE ALERT: Although the plan sponsor may amend the plan document retroactively, the plan must operate in compliance with the Code. That is, in no event may an individual be permitted to contribute more than \$2,500 for a plan year beginning after December 31, 2012.

Erroneous Contributions

Beginning with the 2013 plan year, a cafeteria plan that permits an employee to make salary reduction contributions in excess of \$2,500 will not satisfy the requirements of Section 125; consequently, the value of taxable benefits that an employee could have elected for the plan year will be included in the employee's gross income, even if the employee elected nontaxable benefits. The Notice provides that where one or more employees were permitted to elect salary reductions above the \$2,500 annual limit in error, the plan may still be treated as a cafeteria plan if the following conditions are met:

- The plan timely complied with the written plan amendment requirement noted above and the terms of the plan apply uniformly to all participants.
- The error is the result of a reasonable mistake by the employer or the employer's agent and is not due to willful neglect by the employer or agent.
- Contributions in excess of \$2,500 are paid to the employee and reported as taxable wages on the employee's W-2 for the taxable year in which the correction is made.
- The employer has not received notification from the IRS that its federal tax return is under examination and that Section 125(i) is an issue under consideration.

Use-It-Or-Lose-It Rule

With the limited exception of the grace period discussed earlier, the use-it-or-lose-it rule prevents a cafeteria plan from including benefits that permit an employee to defer taxable compensation. The IRS recognizes that the \$2,500 limit reduces the opportunity for an employee to use an FSA to defer compensation and is considering whether the rule should be modified to provide administrative relief in place of, or in addition to, the grace period.

The IRS requests comments on whether the proposed cafeteria plan regulations should be modified to provide additional flexibility in the operation of the rule. It also is soliciting comments on how this flexibility could be designed and limited, and how it would interact with the \$2,500 limit. Comments must be submitted by August 17, 2012.

Conclusion

Notice 2012-40 offers welcome clarification regarding several issues pertaining to the new annual limit on permitted contributions to health FSAs. A plan sponsor with a non-calendar-year plan that may have been considering applying the limits before January 1, 2013 has the opportunity to revise its approach if desired. The Notice provides ample time to comply with the written amendment requirements as well.

Buck prepared a [Health Care Reform Timeline](#) and [Health Care Reform Comparison in Brief](#) that provide an overview of the health care reform requirements, reflecting current guidance.

Buck Can Help

- Communicate the limit to plan participants
- Prepare any necessary plan amendments
- Prepare comments to the IRS on the use-it-or-lose-it rule
- Employers with plans that offer flex credits comply with the limit requirement