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Guidance on \$2,500 Health FSA Limit

The Affordable Care Act (ACA) imposes a \$2,500 annual limit on an employee's salary reduction contributions made to a health flexible spending account (FSA). The IRS has provided guidance on various issues pertaining to this limit, including relief for non-calendar year FSAs for plan years beginning before January 1, 2013. Information contained in the IRS Notice is briefly discussed below.

Plan Year Basis

There had previously been some confusion because the ACA ties the effective date of the FSA limit to the taxable year and not specifically to the plan year, so those with non-calendar year plans were faced with certain difficulties. The IRS Notice states that the limit applies with respect to the first plan year that begins after December 31, 2012. In addition, while the ACA stated that an employee may not elect for any taxable year to have a salary reduction in excess of \$2,500 (which amount will be adjusted for inflation in subsequent years), the IRS has taken an expansive approach to defining the term "taxable year" to mean the plan year, as opposed to the calendar year. This is welcome news to many employers and employees covered by non-calendar year FSAs and simplifies the administration of this limit for them.

Plan Amendment

The ACA requires cafeteria plans with FSAs to be amended to include the \$2,500 limit. Generally, cafeteria plan amendments cannot be made retroactively. The IRS Notice provides that employers have until December 31, 2014 to adopt a retroactive amendment to conform the plan to the new requirement, provided the plan timely operates in accordance with the \$2,500 limit beginning with the effective date. Although this eases the burden of amending the documents, it does not delay the date participants become subject to the new FSA limit.

Grace Period

Cafeteria plans are permitted to allow a grace period of up to two months and 15 days immediately following the end of a plan year for employees to use FSA amounts remaining from a previous year to pay for medical expenses incurred during the grace period. The Notice provides that for employers with a grace period, the timing of reimbursement will not cause a plan sponsor to exceed the \$2,500 FSA limit; those amounts will not count against the limit for the subsequent plan year.

Noncompliance

The IRS Notice provides that a cafeteria plan that is not amended, or fails to comply with the \$2,500 limit is not a cafeteria plan and the entire value of benefits that an employee could have elected to receive under the plan during the plan year is includible in the employee's gross income, regardless of the benefits elected by the employee.

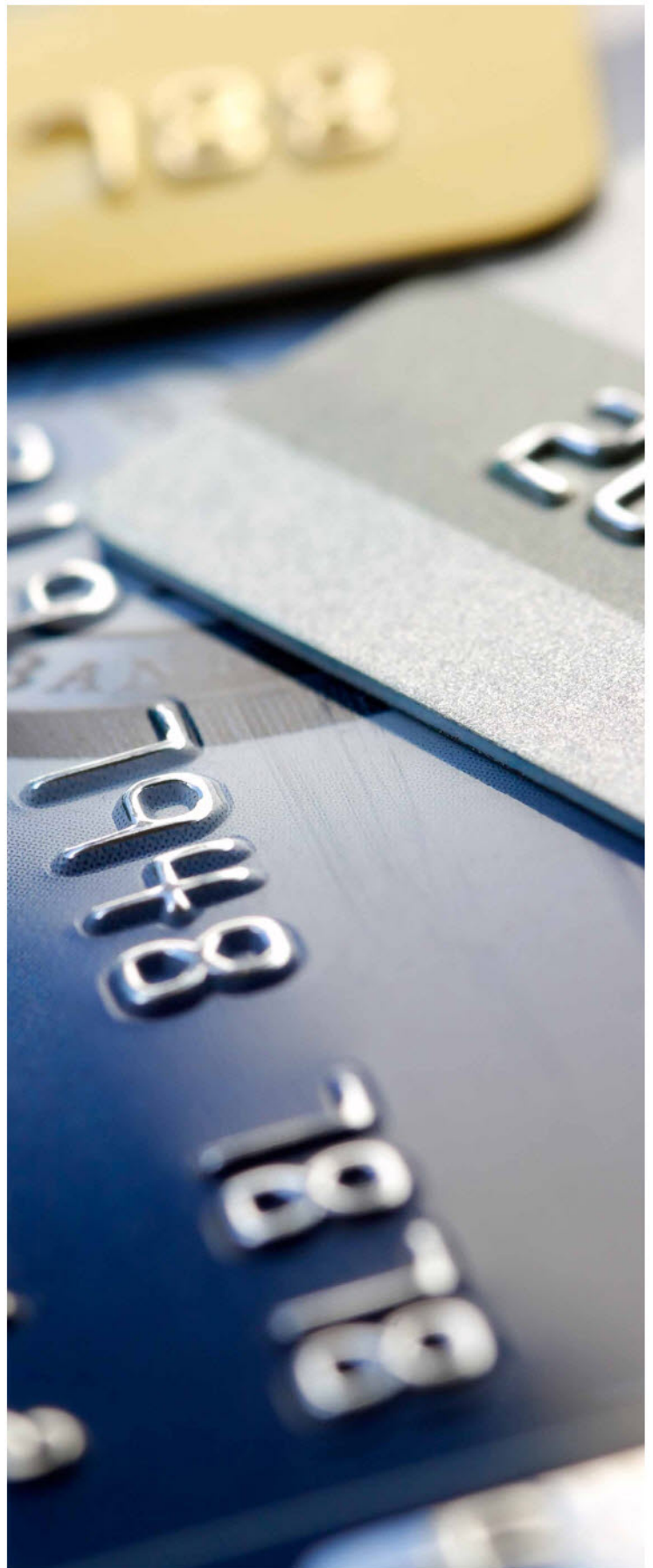
If a cafeteria plan timely complies with the written plan requirement limiting the FSA salary reduction contribution to \$2,500, but an employee is erroneously allowed to elect a larger salary reduction, the cafeteria plan will continue to be a cafeteria plan as long as:

- the terms of the plan apply uniformly to all participants;
- the error is a result of a reasonable mistake by the employer; and
- the excess salary reduction contributions are paid to the employee and reported as wages for income tax withholding and employment tax purposes for the employee's taxable year in which the cafeteria plan error was made.

The above relief is not available if the employer is under IRS examination for its cafeteria plan for the plan year during which the failure to comply occurred.

Changing Plan Year/Short Plan Year

Some employers may consider changing their plan year to delay the application of the FSA limit. However, the Notice provides that a plan year is permitted to be changed only for a valid business purpose. If a principal purpose of changing from a calendar year to a fiscal year is to delay the application of the \$2,500 limit, the change is not for a valid business purpose. If the employer tries to do this, the IRS will treat the plan as if it still had the original plan year, resulting in additional taxable income of the election amounts employees might have made, even if none were made. If a cafeteria plan has a short plan year (that is, fewer than 12 months) that begins after 2012, the \$2,500 limit must be prorated based on the number of months in that short plan year.



Spousal Health FSA Limits

The FSA limit applies on an employee-by-employee basis. The Notice provides that if each of two spouses is eligible to elect to make a salary reduction contribution of up to \$2,500 to his/her FSA based on his/her own employment, each spouse may make up to a \$2,500 election, even if both spouses are employed by the same employer.

Multiple Health FSAs

The Notice provides that if an employee participates in multiple health FSAs maintained by members of a controlled group or affiliated service group, salary reductions to the health FSAs are aggregated and a single \$2,500 limit applies. However, if the employers are not related, the employee may make salary reductions of up to the \$2,500 limit under each health FSA.

Flex Credits

An employer may make flex credits available to an employee who is eligible to participate in the cafeteria plan, to be used (at the employee's election) only for one or more qualified benefits. The Notice provides that any employer flex credits to the FSA do not count against the \$2,500 salary reduction limit for the plan year unless the employer's flex credits may be received as cash or a taxable benefit, in which case those flex credits are counted.

Other Cafeteria Programs

The Notice clarifies that the \$2,500 limit is only imposed on salary reduction contributions to a health FSA in a cafeteria plan and does not limit the amount permitted for reimbursement under other employer-provided coverage, such as employee salary reduction contributions to an FSA for dependent care assistance or adoption care assistance. The limit also does not apply to salary reduction contributions to a cafeteria plan that are used to pay an employee's share of health coverage premiums (or the corresponding employee share under a self-insured employer-sponsored health plan), sometimes referred to as "premium conversion" salary reduction contributions, nor does it apply to salary reduction or any other contributions to a health savings account (HSA) or to amounts made available by an employer under a health reimbursement arrangement (HRA).

Request for Comments on Possible Future Modification to Use-it-or-lose-it Rule

The use-it-or-lose-it rule generally prohibits any amount in a health FSA from being used to reimburse expenses in a later period of coverage – unused amounts are forfeited (with the exception of the grace period). The IRS notes that the new \$2,500 cap limits the potential for using a health FSA to defer compensation and the extent to which salary reduction amounts may accumulate over time. The IRS is therefore requesting comments and is considering whether the use-it-or-lose-it rule should be modified to provide a different form of administrative relief, instead of or in addition to the grace period.

What Should Employers Do?

Employers will need to comply with the \$2,500 limit, effective the first plan year that begins after December 31, 2012. They will need to begin communicating this change to plan participants well before the effective date. Additionally, employers need to coordinate with FSA vendors to appropriately modify plan documents by December 31, 2014 to reflect the new limitations.