

Health Care Reform: IRS Releases Guidance on \$2,500 Health FSA Contribution Limit

June 4, 2012

On May 30, 2012, the Internal Revenue Service ("IRS") released Notice 2012-40 (the "Notice"), which provides guidance on the application of the Affordable Care Act's \$2,500 limit on employee pre-tax contributions to health flexible spending arrangements ("health FSAs"). The Notice clarifies the effective date of the \$2,500 limit and the deadline for amending cafeteria plans that offer a health FSA to comply with the limit. The Notice also provides relief for certain contributions that mistakenly exceed the \$2,500 limit. Employers sponsoring health FSAs may rely on the guidance provided in the Notice pending issuance of future Treasury regulations.

In summary, the Notice provides that:

- the \$2,500 limit on employee pre-tax health FSA contributions applies on a plan year basis and is effective for plan years beginning after December 31, 2012;
- plans may adopt the required amendments to reflect the \$2,500 limit at any time through the end of calendar year 2014, provided they have operationally complied with the limit for plan years beginning after December 31, 2012;
- if the health FSA provides a grace period, amounts carried over will not count against the \$2,500 limit for the subsequent plan year; and
- there is relief with respect to certain employee pre-tax health FSA contributions that exceed the \$2,500 limit, due to a reasonable mistake and not willful neglect, and that are corrected.

When is the \$2,500 limit effective?

Under the Affordable Care Act, starting in 2013, a cafeteria plan must limit employee contributions to a health FSA to \$2,500, as adjusted for inflation in future years. The Notice clarifies that the \$2,500 limit applies based on a health FSA's plan year.

To whose contributions does the \$2,500 limit apply?

The \$2,500 limit applies only to employee pre-tax salary reduction health FSA contributions. For example, if an employer contributes \$500 to each employee's health FSA for the 2013 plan year, each eligible employee may still elect to make salary reduction contributions of \$2,500 to the health FSA for that plan year. However, if an employer provides flex credits that employees may elect to receive as cash or as a taxable benefit, those flex credits are treated as employee salary reduction health FSA contributions for purposes of the \$2,500 limit.

Which types of arrangements are affected by the \$2,500 limit?

The \$2,500 limit applies only to health FSAs. The limit does not apply to dependent care flexible spending accounts, health savings accounts, health reimbursement arrangements, and salary reduction contributions for premiums under an employer's group health plan (referred to as premium payment plans).

Are changes to a cafeteria plan's plan year permitted?

Generally, a cafeteria plan's plan year may be changed only for a valid business purpose. The Notice provides that 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. The IRS may disregard a change in plan year that fails to satisfy this requirement, in which case the plan year that was in effect before the attempted change remains in effect.

Are short plan years permitted?

Short plan years are permitted; however, if a cafeteria plan has a short plan year that begins after 2012, the \$2,500 limit must be prorated based on the number of months in that short plan year.

When must a cafeteria plan be amended to comply with the \$2,500 limit?

A cafeteria plan offering a health FSA will likely need to be amended to comply with the \$2,500 limit. The Notice provides an exception to the general rule that cafeteria plan amendments may be effective only prospectively. Under the Notice, a cafeteria plan may be amended retroactively to comply with the \$2,500 limit as long as the amendment is adopted on or before December 31, 2014, provided that the cafeteria plan operates in compliance with the \$2,500 limit for plan years beginning after December 31, 2012. If a cafeteria plan is not timely amended, it fails to qualify as a cafeteria plan and all employee elections of nontaxable benefits under the plan (e.g., health FSA salary reductions and health plan premium payments) must be included as gross income to the employees.

How does the \$2,500 limit affect spouses?

The \$2,500 limit on salary contributions to a health FSA applies on an individual basis, meaning that a married couple may each elect to contribute up to \$2,500 (as indexed for inflation) under their respective employer's health FSA, even if both are employed by the same employer and participate in the same employer's health FSA.

How does the \$2,500 limit affect persons with more than one job?

An employee employed by two or more employers that are not members of the same controlled group may elect to contribute up to \$2,500 (as indexed for inflation) under each employer's health FSA. If an employee is employed by two or more employers that are members of the same controlled group, the employee's health FSA salary reduction contributions under all of the cafeteria plans maintained by the controlled group members are limited in total to \$2,500 (as indexed for inflation).

Do cafeteria plan "grace periods" affect the \$2,500 limit?

Some cafeteria plans provide for a "grace period" after the end of a plan year (of up to 2 ½ months) during which participants may continue to incur claims against contributions made in the prior year. For purposes of the \$2,500 limit, unused salary reduction contributions to a health FSA that are carried over to a subsequent year under the plan's grace period do not count against the \$2,500 limit applicable for the subsequent plan year.

What relief is available for inadvertent mistakes?

Generally, if a cafeteria plan fails to operate in compliance with Section 125 of the Internal Revenue Code, all employee elections of nontaxable benefits under the plan become taxable. However, under the Notice, if a cafeteria plan that is in written compliance with the \$2,500 limit erroneously allows one or more employees to elect salary reduction contributions of more than \$2,500 (as indexed for inflation) for a plan year, the plan will continue to qualify as a cafeteria plan for that plan year (as long as it is not under examination for any year of failure) if: (1) the terms of the plan apply uniformly to all participants; (2) the error results from the employer's (or its agent's) reasonable mistake and is not due to willful neglect; and (3) excess salary reduction contributions are paid to the employee and included as income on Form W-2 (or Form W-2c) for the year in which, or with which, ends the cafeteria plan year in which the correction is made.

Please contact your Proskauer lawyer or any member of our Health Care Reform Task Force should you have any questions regarding this or any other aspect of health care reform.

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