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LEGISLATIVE UPDATE

Eye on Washington



IRS PROVIDES HEALTH FSA SALARY REDUCTION CONTRIBUTION LIMIT GUIDANCE

The Affordable Care Act (ACA) enacted in March of 2010 limited the annual amount of salary reductions that an employee may contribute to a health flexible spending arrangement plan (health FSA plan) to \$2,500. The new limit is effective for taxable years beginning after December 31, 2012.

On May 30, 2012, the Internal Revenue Service (IRS) released Notice 2012-40 (Notice) which provides guidance on the \$2,500 salary reduction contribution limit. Employers with fiscal year health FSA plans will be especially pleased to receive this guidance.

Interpretation of Term “Taxable Year”

The ACA stipulated “that an employee may not elect for any **taxable year** to have salary reduction contributions in excess of \$2,500 made to such arrangement.” The IRS has interpreted “taxable year” in this context to mean the plan year of the cafeteria plan (rather than the tax year of the participant, which would generally run from January 1 through December 31) “as this is the period for which salary reduction elections are made.” For example, an employee whose employer’s cafeteria plan runs from April 1, 2013 through March 31, 2014 may make salary reduction contributions to the health FSA plan during this period in an amount not exceeding the \$2,500 limit.

Effective Date of Limit

The Notice confirms that the \$2,500 limit does not apply to cafeteria plan years that commence prior to January 1, 2013. Consequently, a plan year for a health FSA plan beginning July 1, 2012 and ending on June 30, 2013 would not be subject to the \$2,500 salary reduction contribution limit. Such a plan would be subject to the limit with the plan year beginning July 1, 2013.

Deadline to Amend Plan Documents

The Notice stipulates that a cafeteria plan which includes a health FSA coverage option must amend its plan documents (plan document and summary plan description) to reflect the \$2,500 limit or at the employer’s discretion, a lower limit specified under the terms of the plan. Although the cafeteria plan regulations provide that cafeteria plan amendments must be effective prospectively, the IRS states that amendments to conform to the \$2,500 salary

reduction contribution limit that are adopted on or before December 31, 2014 may be effective retroactively as long as the cafeteria plan implements the \$2,500 limit for plan years beginning on or after January 1, 2013.

Impact of Limit on Grace Period

The cafeteria plan regulations provide that a plan may implement a period of up to two and one-half months following the end of the plan year to allow participants to incur and be reimbursed for expenses from contributions made in the previous plan year. The IRS in its guidance has stated that where a plan provides such a grace period, unused salary reduction contributions to the health FSA plan for plan years beginning in 2012 or later that are carried over into the grace period for the next plan year will not count against the \$2,500 limit for the subsequent plan year.

Limit Applies to Salary Reduction Contributions and Certain Flex Credits, but Not Employer Non-Elective Contributions

The \$2,500 limit applies to salary reduction contributions under a health FSA plan, but does NOT apply to employer non-elective contributions. However, if an employer provides flex credits that employee may elect to receive as cash or a taxable benefit, those flex credits are treated as salary reduction contributions and would count towards the \$2,500 limit.



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Impact of Short Plan Years

The cafeteria plan regulations allow that a plan may implement a “short plan” year (i.e. a plan year of less than twelve months) but “only for a valid business purpose.” The Notice provides that if the 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.” Consequently, the change to the plan year does not take effect and the plan year for the cafeteria plan “remains the plan year that was in effect prior to the attempted change.”

Further, 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 of that short plan year. For example, a nine month plan year is required to have a health FSA salary reduction contribution limit of \$1,875 ($\$2,500/12 = \$208.33 \times 9 = \$1,875$).

Limit Applies on Employee-by-Employee Basis

The Notice provides that the \$2,500 limit in effect for plan years commencing on or after January 1, 2013 applies on an employee-by-employee basis regardless of the number of individuals (e.g., spouse, child of employee) whose medical expenses are reimbursable from the health FSA plan.

However, if two spouses work for the same employer and participate in the same health FSA plan, the limit applies separately to each participant.

Inadvertent Excess Salary Reduction Contributions

The IRS guidance provides that if a cafeteria plan offering a health FSA is timely amended to limit the amount of health FSA salary contributions to \$2,500, but one or more employees is erroneously allowed to contribute in excess of the limit, the cafeteria plan will not be disqualified for the plan year in which the excess contributions were made IF:

1. the terms of the plan apply uniformly to all participants;
2. the error is based on a “reasonable mistake by the employer (or the employer’s agent)” and is not due to willful neglect by employer or its agent; and
3. salary reductions made in excess of the limit are paid to the employee and reported as wages subject to withholding on the employee’s Form W-2 or W-2c for the employee’s taxable year “in which, or with which, ends the cafeteria plan year in which the correction is made.”

For example, if the employer’s cafeteria plan year ends on June 30, 2014, any excess salary reduction contributions made to a health FSA plan must be reported as wages on the Form W-2 or W-2c issued for the taxable year ending December 31, 2014.

Limit to Be Adjusted for Inflation

The Notice also provides that the \$2,500 health FSA plan salary reduction contribution limit will be adjusted annually for “cost-of-living” for plan years beginning after December 31, 2013.

For a copy of Notice 2012-40 please visit:
<http://www.irs.gov/pub/irs-drop/n-12-40.pdf>.

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