

June 5, 2012

\$2,500 FSA Contribution Limit Guidance issued

IRS Notice 2012-40 has just been released by the IRS providing guidance on the effective date of the \$2,500 limit on employee salary reduction contributions to health FSAs. Yes, this is good news, especially for those employers sponsoring fiscal year FSAs, but I think this guidance could have saved much anxiety and gnashing of teeth for some if it had been issued just a few months earlier. Further, it appears that the IRS is also reconsidering the fate of the use or lose rule and has asked for public comment on the issue – no kidding (more on that below).

Prior to the ACA there were no statutory limits on contributions to health FSAs. This changed when the ACA created a statutory limit on health FSA contributions within section 125 of the Internal Revenue Code, effective for taxable years beginning after December 31, 2012. Section 125 now provides that a health FSA is not a qualified benefit that may be elected under section 125 unless the cafeteria plan “provides that an employee may not elect for any taxable year to have salary reduction contributions in excess of \$2,500 made to such arrangement.” “Taxable year” was not specified in the ACA amendment to section 125, but most assumed it was the employee’s taxable year, which meant the calendar year and this was a problem for fiscal year FSA plans.

So here is the big news:

- **According to Notice 2012-40 the \$2,500 limit on health FSA salary reduction contributions applies on a plan year basis and is effective for plan years beginning in 2013.** The term “taxable year” has been interpreted by the IRS to mean the plan year of the cafeteria plan since this is the period for which salary reductions are made. The limit does not apply for plan years beginning before 2013. This means that fiscal year health FSA plans will apply the \$2,500 limit according to the plan’s fiscal year plan year, which will be easier and will save administrative time and expense.

Other helpful guidance contained in the Notice includes:

- If a cafeteria plan has a short plan year beginning after 2012, the \$2,500 limit must be prorated based on the number of months in the short year.
- The \$2,500 limit does not apply to any employer non-elective contributions or “flex credits” that are allocated to an employee’s health FSA, unless the

employee may elect to receive those flex credits as either cash or a taxable benefit.

- In the case of a cafeteria plan that provides a “grace period” (of up to 2½ months after the close of the plan year) during which incurred claims may still be reimbursed from the prior year’s contributions, any FSA balance carried over into the grace period will not count against the \$2,500 limit for the following plan year.
- The \$2,500 limit applies on an employee-by-employee basis, regardless of the number of dependents who might have medical expenses reimbursed from the health FSA. Therefore, a husband and wife may each contribute up to \$2,500 to his or her own health FSA, even if both participate as employees in the same health FSA sponsored by the same employer.
- An employee who is employed by two or more *related* employers may contribute only a total of \$2,500 to *all* health FSAs, but an employee who is employed by two or more *unrelated* employers may contribute up to \$2,500 to *each* health FSA.
- All plans have until the last day of calendar year 2014 to adopt any plan amendment required to reflect the \$2,500 limit (including a retroactive amendment, regardless of their plan year, provided the plan operates in accordance with the new \$2,500 limit for plan years beginning after December 31, 2012.
- Relief is provided for certain salary reduction contributions exceeding the \$2,500 limit that are due to reasonable mistake – not willful neglect – and that are corrected by the employer in accordance with the guidance.

Finally, the health FSA sacred cow known as the use-or-lose rule may get a makeover. The Notice states that, given the \$2,500 limit, the Treasury Department and the IRS are considering whether the use-or-lose rule for health FSAs should be modified to provide a different form of administrative relief (instead of, or in addition to, the current 2½ month grace period rule). The Notice requests comments on whether the proposed 2007 cafeteria plan regulations should be modified to provide additional flexibility with respect to the operation of the use-or-lose rule for health FSAs and, if so, how any such flexibility might be formulated and constrained. Comments are also requested on how any such modifications would interact with the \$2,500 limit.



Please contact me if you have any questions.

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