

Significant Transition Relief for \$2,500 Health FSA Limit

May 31, 2012

In [Notice 2012-40](#) the IRS has provided meaningful transition relief on the effective date of the \$2,500 annual spending limit, for employers whose health flexible spending arrangements (“health FSAs”) follow a fiscal year. Most significantly, it makes clear that employers with fiscal year health FSAs may keep higher reimbursement limits in effect through the end of their 2012-2013 plan year, and that all employers may adopt retroactive amendments to impose the \$2,500 limit at any time before December 31, 2014.

Currently the tax code does not impose a dollar limit on reimbursements under a health FSA. The Affordable Care Act limits annual reimbursements – for the first time – to \$2,500, effective for taxable years beginning after December 31, 2012. Specifically, cafeteria plans must provide that an employee “may not elect for any taxable year” to make salary reduction contributions in excess of \$2,500. As individuals are calendar year taxpayers, it was assumed that “taxable year” meant the calendar year, and thus that the \$2,500 limit went into effect January 1, 2013. This in turn generated confusion on applying the limit over a fiscal year that bridged that date. The Notice resolves this matter, and provides additional guidance as outlined below:

- The term “taxable year” refers to the plan year of the cafeteria plan, not the individual participant’s tax year.
 - This means that reimbursement budgets that exceed \$2,500 can remain in effect for a calendar year beginning any time in 2012, including a December 1, 2012 – November 30, 2013 plan year. The \$2,500 dollar limit goes into effect for plan years beginning after December 31, 2012, meaning all calendar year plans as of January 1, 2013, and fiscal year plans beginning February 1, 2013 and subsequent.
 - This is a desirable result, but the Notice does not make the reasoning behind it very clear. Basically it says that because the Affordable Care Act did not expressly state that the employer’s taxable year governed, the Service may now interpret “taxable year” to refer to plan years, including fiscal years.
- The \$2,500 dollar limit will be indexed for cost of living adjustments for plan years beginning after December 31, 2013.
- Employers whose health FSAs currently follow a calendar plan year may not change to a fiscal year “primarily” in order to delay application of the \$2,500 reimbursement limit.
- The Notice reminds that plan year changes must be for a “valid business purpose” (e.g., as a result of a merger or acquisition transaction) and any switch meant to delay application of the reimbursement cap will be disregarded (the original calendar year format will remain in effect).
- The \$2,500 limit must be prorated over a short plan year that begins after 2012. For instance, a plan year beginning April 1, 2013 and ending December 31, 2013 may allow reimbursement of only \$1,875 ($\$2,500 \times .75$)

- The \$2,500 limit applies on an employee-by-employee basis. Thus, an employee who covers a spouse and several dependents under a group health plan must fit reimbursements for the whole family within a single \$2,500 budget. Conversely, if each of two spouses may participate in a health FSA as employees, they each are entitled to a \$2,500 budget even if they both participate in the same health FSA sponsored by the same employer.
- The \$2,500 limit applies on a “controlled group” basis. If an employee performs services for several corporations elated by ownership (e.g., parent – subsidiary) and participates in multiple health FSAs, the employee’s total health FSA budget under all cafeteria plans within the “controlled group” of corporations is limited to \$2,500. The same would be true if the related businesses were partnerships or LLCs under “common control,” and also under “affiliated service group” rules.
- Conversely, if an employee performs services for several employers that are not related by ownership at the requisite “controlled group” levels, the employee may enjoy a separate \$2,500 budget under each employer’s health FSA.
- With regard to employer contributions under a cafeteria plan, often called “flex credits,” the flex credits will count towards the \$2,500 (and reduce the employee’s salary deferral limit) if the employee can elect to receive the flex credits as cash or as a taxable benefit. Flex credits that are only usable in the health FSA for reimbursed medical expenses will not offset the \$2,500 limit, however.
- The \$2,500 limit only applies to health FSA reimbursements and not to salary reduction contributions to any of the following:
 - Dependent care reimbursement accounts
 - “Premium only” or premium conversion portions of a cafeteria plan
 - Health Savings Accounts
 - Health Reimbursement Accounts (technically, treated as employer contributions).
- Unused salary reduction contributions to a health FSAs that are carried over after the end of a plan year into a grace period (not to exceed 2 ½ months into the subsequent plan year) do not count against the \$2,500 limit applicable for the subsequent plan year.
- The Notice provides a self-correction procedure that an employer may use when, despite timely amendment of the plan to impose the \$2,500 limit, one or more employees exceeds the limit. The conditions for self-correction are as follows:
 - The terms of the plan apply uniformly to all participants (a requirement of proposed cafeteria plan regulations from 2007).
 - The excess reimbursements were the result of a reasonable mistake by the employer and not due to willful neglect.
 - Reimbursements that exceed the \$2,500 limit are paid to the employee as wages and reported on Form W-2 for the calendar year that includes the end of the cafeteria plan year in which the correction takes place.
 - The employer’s federal tax return must not be under audit for cafeteria plan issues for any plan year in which the dollar limit was exceeded.

- Self-correction presumably will be on an “honor system,” for, as I noted in an [earlier post](#), the IRS will not be able to track health FSA reimbursement amounts via Form W-2 reporting of health care costs.
- A retroactive cafeteria plan amendment to impose the \$2,500 reimbursement limit may be adopted at any time before December 31, 2014, provided that the plan has been operated in compliance with the dollar limit during the interim period. Illustrations in the Notice make clear that his relief is available even to employers with calendar year health FSAs; i.e. an amendment could be adopted on December 31, 2014 that takes effect January 1, 2013.

The Notice requests public comment on whether modifications to the “use-it-or-lose-it” rule are in order given the new dollar limit on annual reimbursements. The use-it-or-lose-it rule was meant to prohibit (mis)use of a flex plan to defer compensation from one year to another but that goal largely is served by the cap on reimbursements. Thus the Service seeks comments on “different form[s] of administrative relief” from the use-it-or-lose-it rule, instead of or in addition to the 2½ month grace period rule.