IRS ISSUES GUIDANCE ON IMPLEMENTATION OF $2,500 HEALTH FSA LIMIT

The 2010 Affordable Care Act (ACA) set a $2,500 maximum annual limit on employee contributions to health flexible spending accounts (health FSAs), effective in 2013. For a calendar-year health FSA, it was already clear that this limit would take effect as of January 1, 2013. Thus, the sponsor of a calendar-year FSA must simply apply the $2,500 limit to employees' 2013 elections - and presumably communicate the change to employees in advance of those elections.

For a non-calendar year health FSA, however, certain questions remained unanswered until now. The ACA provides that the $2,500 limit applies for taxable years beginning after 2012. In the benefit plan context, the phrase “taxable year” is commonly read to mean a participant's taxable year - i.e., the calendar year. Thus, sponsors of non-calendar year FSAs were not certain how the new limit might affect plan years beginning in 2012 and carrying over into 2013. There was even some speculation that non-calendar year FSAs might have to implement this limit sooner than January 1, 2013 - in order to ensure that the $2,500 limit was not exceeded during calendar-year 2013.

Fortunately, the IRS has just issued guidance, in Notice 2012-40, clarifying that the $2,500 limit does not apply for plan years beginning before 2013. Instead, the IRS has interpreted the ACA's reference to “taxable year” to mean the FSA's plan year. This means that employers will not have to worry about enforcing this new limit until the first plan year that begins in 2013.

Other notable aspects of Notice 2012-40 include the following:

- 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 regardless of the number of dependents who might have medical expenses reimbursed from the health FSA.

- A husband and wife may each contribute up to $2,500 to his or her own health FSA, even if both participate 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.
- The $2,500 limit does not apply to any employer “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.
- All plans have until December 31, 2014, to adopt an amendment required to reflect the $2,500 limit—as indexed for inflation—regardless of their plan year.

The Notice provides transition relief for contributions in excess of the $2,500 limit that are due to a reasonable mistake (and not willful neglect) and that are later corrected by the employer. To accomplish this correction, the employer must refund the excess amount to the employee as taxable wages and then report that amount on the employee’s W-2 for the year the refund is made.

Interestingly, the Notice also requests comments on whether the IRS should modify the “use it-or-lose it” rule applicable to health FSAs. Although the request for comments doesn’t explicitly state this, the IRS seems to be looking for ways to soften the tax blow associated with the $2,500 limit. They may also be trying to head off legislative proposals along the same lines. Stay tuned for developments on this topic.

Julia M. Vander Weele, Partner
Spencer Fane Britt & Browne LLP

Stephens Insurance Arkansas Insurance Agency Number 301051