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IRS Provides Guidance on \$2,500 Health FSA Limit

The Affordable Care Act (ACA) imposes a **\$2,500 limit** on salary reduction contributions to a health flexible spending account (FSA) offered under a cafeteria plan. This limit is applicable to grandfathered and non-grandfathered health FSAs. ACA provides that this change is effective for **taxable years beginning after Dec. 31, 2012**. The \$2,500 limit will be indexed for cost-of-living adjustments for 2014 and later years.

Prior to the ACA change, the law did not limit employees' health FSA contributions. It has been common, however, for employers to limit employee contributions to health FSAs. Employers may continue to impose limits on employee health FSA contributions, as long as the employer's limit does not exceed the \$2,500 maximum limit under ACA.

Because ACA ties the effective date of the health FSA limit to the taxable year, and not specifically to the plan year, there has been some confusion regarding when the limit becomes effective for non-calendar year plans. In addition, the deadline for amending cafeteria plans to include the health FSA limit has also been unclear. On May 30, 2012, the Internal Revenue Service (IRS) issued [Notice 2012-40](#) to provide guidance on these issues and some others related to the \$2,500 limit for health FSAs.

EFFECTIVE DATE

The IRS Notice states that the \$2,500 FSA limit **does NOT apply for plan years that begin before 2013**. Instead, the IRS has clarified that the limit applies on a plan year basis and is effective for **plan years beginning after Dec. 31, 2012**. Thus, for a calendar year plan, the limit will become effective on **Jan. 1, 2013**.

This guidance has the most significant impact on non-calendar year cafeteria plans. Under the IRS's interpretation of the law, a health FSA with a July 1 plan year will not need to comply with ACA's limit until the plan year beginning July 1, 2013. Having the health FSA limit tied to the plan year, and not to an individual's taxable year, simplifies the administration of this limit for non-calendar year plans.

If a cafeteria plan has a short plan year (that is, fewer than 12 months) that begins after 2012, the \$2,500 limit must be prorated based on the number of months in that short plan year.

A health FSA's plan year may only be changed for a valid business purpose. If a principal purpose of a change from a calendar year plan to a non-calendar year plan is to delay the application of the \$2,500 limit, the change is not for a valid business purpose.

PER EMPLOYEE LIMIT

The health FSA limit applies on an employee-by-employee basis. Each employee may elect only up to \$2,500 in salary reductions, regardless of whether or not he or she also has family members who benefit from the funds in that FSA.

However, each family member who is eligible to participate in his or her own health FSA will have a separate limit. For example, a husband and wife who have their own health FSAs can both make salary reductions up to \$2,500 per year (subject to any lower employer limits).

If an employee participates in multiple cafeteria plans that are maintained by employers under common control, the employee's total health FSA salary reduction contributions under all of the cafeteria plans are limited to \$2,500.

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However, if an individual has health FSAs through two or more unrelated employers, he or she can make salary reductions up to \$2,500 under each employer's health FSA.

SALARY REDUCTION CONTRIBUTIONS

ACA imposes the \$2,500 limit on health FSA salary reduction contributions, and not on other employer contributions. The limit does not impact contributions under other employer-provided coverage. For example, employee salary reduction contributions to an FSA for dependent care assistance or adoption care assistance are not affected by the \$2,500 health FSA limit.

The limit also does not apply to salary reduction contributions to a cafeteria plan that are used to pay for an employee's share of health coverage premiums, to contributions to a health savings account (HSA) or to amounts made available by an employer under a health reimbursement arrangement (HRA).

GRACE PERIOD

A cafeteria plan may include a grace period of up to two months and 15 days immediately following the end of a plan year. If a plan includes a grace period, an employee may use amounts remaining from the previous plan year, including amounts remaining in a health FSA, to pay for expenses incurred for certain qualified benefits during the grace period.

If a health FSA is subject to a grace period, unused salary reduction contributions that are carried over into the grace period do not count against the \$2,500 limit applicable to the following plan year.

PLAN AMENDMENTS

A cafeteria plan with a health FSA must be amended to include ACA's \$2,500 limit (or a lower limit at the employer's option). In general, cafeteria plan amendments cannot be made retroactively. However, the IRS sometimes provides exceptions to this rule. **Cafeteria plans with health FSAs must be amended for ACA's \$2,500 limit on or before Dec. 31, 2014.** To take advantage of the delayed amendment deadline, the cafeteria plan must comply in operation with ACA's limit for health FSAs for plan years beginning after Dec. 31, 2012.

COMPLIANCE MISTAKES

Compliance relief is provided for certain salary reduction contributions exceeding the \$2,500 limit that are due to a reasonable mistake and not willful neglect and that are corrected by the employer. More specifically, if one or more employees are mistakenly allowed to elect a salary reduction of more than \$2,500 for a plan year, the error may be corrected without causing the cafeteria plan to lose its preferential tax status if:

- The plan's terms apply uniformly to all participants;
- The error results from a reasonable mistake by the employer (or its agent) and is not due to the employer's (or agent's) willful neglect; and
- Salary reductions in excess of the \$2,500 limit are paid to the employee and reported as wages for income tax withholding and employment tax purposes on the employee's Form W-2.

USE-OR-LOSE RULE

The "use-or-lose" rule generally prohibits any contribution or benefit under a health FSA from being used in a following plan year or period of coverage. According to the IRS, the \$2,500 limit reduces the potential for using health FSAs to defer compensation and limits the extent to which salary reduction amounts may accumulate over time. The IRS requests comments on whether the use-or-lose rule should be modified in light of the \$2,500 limit for health FSA contributions. Comments must be submitted by Aug. 17, 2012.