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# Clarification On \$2,500 Health FSA Limit For 2013

Health care reform has brought many changes to insurance plans and flexible spending arrangements—and *more are on the horizon*. One change that employers found particularly worrisome was the \$2,500 cap on employee contributions to health flexible spending accounts (FSAs) that will be in place for taxable year 2013.

Employers with plans that start January 1, 2013 didn't have many questions, but for those with fiscal plan year starts, the numbers just didn't make sense.

For instance, let's say that a cafeteria plan started September 1, 2012, and had a \$5,000 annual salary reduction limit. For the portion of the plan year from September 1, 2012 to December 31, 2012, participants would generally contribute \$1,667. That leaves \$3,333 to be salary deducted from January 1, 2013 through August 31, 2013, which could result in salary deductions in excess of the \$2,500 limit for employees' taxable years. And that's not even considering the new plan year that would start again September 1, 2013.

In Notice 2012-40 (May 30, 2012), the Internal Revenue Service (IRS) cleared the confusion about how the limit applies and provided detailed information concerning everything from cafeteria plan grace periods to plans that cover controlled groups and affiliated service groups.

## Background

Cafeteria plans, in general, have always required plan sponsors to indicate a plan maximum but have never imposed a statutory limit on what that maximum could be. In addition, cafeteria plans may include a

"grace period" of up to 2½ months after the end of a plan year for participants to incur expenses and use amounts remaining from previous plan years.

The Affordable Care Act of 2010 added Internal Revenue Code (IRC) Section 125(i) that imposed a limit of \$2,500 for salary deductions by participants for any "taxable year" beginning after December 31, 2012. "Taxable year" to all accountants and benefit experts means calendar years starting January 1. And that's when speculation and doubts concerning fiscal year plans began to create anxiety for plan sponsors.

## Clearing the Way for Fiscal Plan Years

It's all a matter of perception. The notion that statutory language referred to the usual meaning of a tax year that starts January 1 was quickly debunked by Notice 2012-40. Because employees make salary reduction elections based on a plan year, the term "taxable year" is defined in the notice as the plan year of the cafeteria plan, *not a calendar year*.

This means that plans starting on or after January 1, 2013 must adhere to a health FSA maximum benefit limit of \$2,500. Plans with start dates after January 1 will begin the \$2,500 limit with their first plan year that begins after January 1, 2013. Off-calendar plan years do not have to change health FSA limits for years starting in 2012.

## Nuts and Bolts

✓ The \$2,500 limit applies only to employee salary deduction contributions to health FSAs. It does not take into consideration salary reductions to other benefits such as dependent care assistance, adoption

benefits or insurance premium accounts.

- ✓ The new limit does not apply to health savings accounts (HSAs) or health reimbursement arrangements (HRAs).

- ✓ The \$2,500 limit will be indexed for cost-of-living adjustments for plan years beginning after December 31, 2013.

- ✓ Limit applies on an employee-by-employee basis. Married couples, dependents or adult children working for the same company may each elect the \$2,500 maximum.

- ✓ One person working for multiple companies, that are not members of a controlled group, may elect the \$2,500 maximum for each employer's health FSA benefit. Controlled groups are counted as one employer.

- ✓ The limit is not based on underlying insurance coverage. For instance, participants with family insurance coverage may not elect more than those with single insurance coverage.

- ✓ Applies to employee salary reduction contributions only and not to employer non-elective, or flex credit, contributions. For example, if employers fund all or a portion of employees' health FSA benefits, employer flex credits available for only health FSAs do not count toward the statutory plan year limit. However, employer flex credits that participants may elect to receive as cash or a taxable benefit are treated as salary reduction contributions and count toward the plan year limit.

- ✓ Cafeteria plans that provide for a "grace period" following the end of any plan year need not worry about exceeding the \$2,500 statutory limit if leftover contributions are rolled forward into the following plan year. The funds carried forward into the grace period do not count against the \$2,500 limit applicable for the subsequent plan year.

### The Next Steps for Employers

**Employers need to determine their current health FSA annual plan limits and verify if a plan amendment is needed.** If the current plan document states a limit of \$2,500 or less on salary reductions for the health FSA, then no plan amendment is

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necessary to conform to this notice. Some plans may want to include flexibility to include an employer contribution.

What if an employer wants to make employer flex credits available? If employer flex credits used by participants in their health FSA are also available in cash, the entire amount—both employee salary reductions and employer flex credits—cannot exceed \$2,500 for the plan year.

**The employee education process must be started prior to enrollment.** Suggest ways for employees to maximize coverage and tax savings by considering spouses', dependents' and adult children's opportunities to enroll in health FSA plans at their places of employment.

**Amend the cafeteria plan, if applicable, by December 31, 2014.** Although the plan must limit salary reductions for any plan that begins on or after January 1, 2013, the plan may be amended in arrears.

An IRS reminder to employers was also in the notice regarding short plan years. A plan year may be changed, but only for valid business purposes. If the principal purpose of changing from a calendar year to a fiscal year is to delay application of the \$2,500 limit, the change is not a valid business purpose. The IRS could rule that the cafeteria plan year remains the same as it was prior to the attempted change.

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 in that short plan year.

What if an enrollment mistake occurs? To resolve an election mistakenly made for more than \$2,500, first, ensure that

the terms of the plan apply uniformly to all participants. If the error results from a reasonable mistake of the employer and not due to deliberate neglect, participants' salary reductions in excess of \$2,500 may be paid to the employee as taxable wages for the year in which the cafeteria plan ends.

### Something Extra

Employers and employees alike have often wished that funds left over at the end of a plan year would not be forfeited to the plan. The new limit imposed by the Patient Protection and Affordable Care Act eliminates the original reasons the "use-it-or-lose-it" rule was established. Attached to Notice 2012-40 is a "bonus" section.

Because of the \$2,500 limit that takes place for plan years beginning on or after January 1, 2013, the IRS is asking for comments on whether the proposed regulations now in place should be modified to provide additional flexibility to the use-it-or-lose-it rule for health FSAs and, if so, how would the modifications work and how would any such changes interact with the \$2,500 limit.

WageWorks is working with industry groups such as the Employers Council on Flexible Compensation in preparing comments regarding modifications to the "use-it-or-lose-it" rule. I invite any interested reader to contact me with questions or to participate in the comment letter. 🌐

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