

IRS Issues Guidance and Requests Comments on \$2,500 Health Flexible Spending Account Limit Effective 2013

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The Internal Revenue Service recently released Notice 2012-40 that provides guidance on the \$2,500 annual limitation on salary reduction contributions to health flexible spending accounts (“FSAs”), effective beginning in 2013. Interestingly, the Notice also requests comments on a possible modification of the use-or-lose rule with respect to FSA contributions.

In sum, the Notice clarifies the following:

- *Effective date:* The \$2,500 limit does not apply to plan years beginning before 2013 and is computed with respect to the cafeteria plan year.
- *Amendment deadline:* Plans may adopt amendments reflecting this change at any time through the end of calendar year 2014. Generally, cafeteria plan amendments may not be made retroactively; however, amendments incorporating the \$2,500 contribution cap adopted on or before December 31, 2014 may be made retroactive to plan years beginning after December 31, 2012, provided the plan has been operating in accordance with the law change.
- *Application of the \$2,500 limit:* The \$2,500 limit applies on an employee-by-employee basis regardless of whether the FSA also covers a spouse or dependents. If an individual is employed by two, unrelated employers, that individual may make salary reduction contributions of up to \$2,500 under each employer’s FSA. For short plan years beginning after 2012, the \$2,500 limit should be prorated based on the number of months in the short plan year. The limit may be indexed for cost-of-living adjustments for plan years beginning on or after January 1, 2014, and can still be written as the maximum applicable to a percentage of compensation contribution formula.
- *Effect of grace period on \$2,500 limit:* For plans that contain a grace period that permits unused FSA salary reduction contributions to be carried into the next plan year (up to two

months and 15 days), these carryovers will not be taken into account when computing the \$2,500 limit.

- *Employer contributions:* Non-elective employer contributions to an FSA, sometimes called “flex credits,” are not taken into account when computing the \$2,500 limit, unless they provide a cash or a taxable benefit option.
- *Corrections available for salary reduction contributions in excess of \$2,500 limit:* If excess salary reduction contributions are a result of a reasonable mistake and are not the result of willful neglect, the Notice provides that the employer may rectify the situation by reporting the excess contributions as wages for income tax withholding and employment tax purposes on the employee’s Form W-2 for the employee’s taxable year in which the correction is made.

Finally, in light of the new \$2,500 annual cap to salary reduction contributions: the IRS has requested feedback on potentially modifying the use-or-lose it rule under which employees forfeit any unused FSA balance at the end of the cafeteria plan year, plus any grace period—the rationale for such a change being that the \$2,500 limit prevents any material abuse in terms of compensation deferrals.

Comments to Notice 2012-40 are due by August 17, 2012. Please let us know if you would like us to submit comments on your behalf.

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