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REFORM Update

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The IRS recently released Notice 2012-40 to address the new statutory limit on medical flexible spending accounts (FSAs). Health care reform placed a $2,500 contribution limit on medical FSAs as of the taxable year beginning January 1, 2013. This recent IRS notice should answer the questions plan sponsors have had regarding how this limit will be applied.

First, the IRS illustrated how the new limit applies to medical FSA plan years that do not run in conjunction with the calendar year. The taxable year is defined as the plan year, which means the $2,500 maximum will apply on the first day of the plan year beginning after December 31, 2012. For calendar-year plans, the limit will apply on January 1, 2013. For an August plan year, the new limit will apply to the plan year beginning August 1, 2013.

Unfortunately, this guidance does not provide relief for plans that adopted the $2,500 limit early. For example, an employer with a March plan year likely adopted the $2,500 limit effective March 1, 2012, to ensure that the $2,500 maximum was in place as of January 1, 2013. This guidance shows that the employer could have waited until March 1, 2013 to comply. Unfortunately, when the IRS clarified their position on this, they did not provide such plans with a way to retroactively adjust their contribution limit prior to the beginning of their next plan year.

The annual limit may be indexed annually for cost of living adjustments. The indexing adjustments will apply to plan years beginning after December 31, 2013.

Next, the guidance confirmed that the limit applies per employee, not per family. Thus, if two married persons each has the ability to contribute $2,500 to a medical FSA, they can both make the maximum election. This applies even to married couples working for the same employer.

Further, the IRS has stated that an individual who works for multiple employers can make elections under each employer's plan. For this example, let's assume an employee works for two different employers. As long as the individual is eligible under both employers' medical FSA plans, the employee can contribute up to the maximum election permitted under each plan. This situation will only apply, however, if the employers are unrelated. If the individual works for separate organizations that are considered a controlled group by the IRS, then the $2,500 limit applies across both plans. In this case, the employee can elect a total maximum of $2,500 between both plans.

The guidance confirms that the $2,500 limit applies only to money set aside in a medical flexible spending account. It does not apply to:

- any premium contributions paid for through a Section 125 plan
- any contributions made to a dependent care flexible spending account
- any contributions made to a health savings account

The $2,500 limit is not offset by any non-elective employer contribution to the employee's medical FSA. The key is that the contribution must be non-elective, which means it can't be redirected to purchase other benefits or be provided as cash.

For example, an employer may contribute $200 to all employees' medical FSAs. In this case, the money is placed in the FSA with no option to receive it in any other manner. The employer who seeds the FSA could still permit employees to elect up to the $2,500 maximum in the medical FSA. In contrast, it is considered an elective contribution if an employer offers each employee $200 to purchase benefits, to direct the funds to a medical or dependent care FSA, or to take the money as cash. This employer's plan would have a $2,500 medical FSA limit, which would be offset by the employer's $200 contribution if the employee makes that election.

It is not uncommon for a medical FSA to have a "grace period" that extends the time frame for a participant to incur a service and have it reimbursed from the FSA. The federal government previously set the maximum grace period at two and a half months. The grace period does not impact the $2,500 limit. For example, let's say a calendar-year plan has a $2,500 limit with a grace period. An employee elects $2,500 for 2013, and uses $2,000 by December 31, 2013. The remaining $500 is then applied to services received in February, 2014. The employee also elects $2,500 for 2014. With the 2013 grace period at the beginning of 2014, the employee actually has $3,000 available to him during the 2014 calendar year. However, the latest guidance clarifies that benefits used during the grace period do not affect the $2,500 annual maximum. This makes sense, because the $500 used during the grace period is actually accounted for in the 2013 year.

All Section 125 plans must be amended to address the new $2,500 annual maximum. Although the plans must operationally apply the maximum as of the effective date, the IRS will give employers more time to formally amend their plan documents. Employers will have until December 31, 2014 to do this. The amendments should be made retroactively to the effective date of the $2,500 limit.

For the first time, the guidance formally allows the correction of excess contributions. The IRS has informally supported the ability for plans to make mid-year changes to correct errors, but it was not officially addressed in the Section 125 regulations. This IRS notice does allow for corrective measures if the excess contributions resulted from a reasonable mistake by the employer. The excess contributions must be refunded to the affected employee and reported as wages. The mistake cannot be due to willful neglect.

The guidance also provides some additional details on short plan years. The IRS makes clear that plans cannot adopt a short plan year for the sole purpose of delaying the application of the $2,500 limit. If an employer has a short plan year that begins after December 31, 2012, the FSA limit must be pro-rated for the number of months in the short plan year.

Finally, the guidance requests comments on the "use it or lose it" rule, which requires a participant to exhaust his or her annual FSA election during the plan year, or forfeit the remaining funds to the plan. The "use it or lose it" rule was diminished slightly by plans adopting the grace period. The grace period effectively provides additional time for an individual to incur eligible expenses. This "use it or lose it" rule has been debated regularly. Some legislators believe it should be eliminated entirely to give more individuals an opportunity to take advantage of the savings offered by medical FSAs.

However, the “use it or lose it” rule does serve an important purpose. The IRS loses tax dollars whenever an individual sets aside funds in a pre-tax account. They support the rule because it prompts individuals to make conservative elections for fear of leaving money in the account at year’s end. The IRS, however, is requesting potential modifications to the rule to allow for more administrative flexibility.

The guidance also notes that the willful failure of a plan to adopt the $2,500 medical FSA limit will result in the plan’s disqualification under Section 125. This means any salary reductions made under the Section 125 plan will lose tax-favored status and must be included in the participants’ taxable income.

Employers have been waiting for this guidance to provide needed clarity on the application of the annual $2,500 medical FSA limit. Although the IRS has requested feedback, employers can rely on these details when planning for 2013.