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Client Alert:
Employee Benefits

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June 2012

IRS Provides Transition Rules for $2,500 Health Flexible Spending Account Limit Beginning in 2013

Currently, employers which sponsor cafeteria plans with health care flexible spending accounts ("FSA") establish the maximum dollar amount their eligible employees are permitted to contribute to their FSAs. These limits often start out low and increase over time and can range from a few hundred dollars to $5,000-10,000 or more. But the government does not impose a statutory limit. In 2013, this will change. The Patient Protection and Affordable Care Act amended the Internal Revenue Code to add a section to the cafeteria plan rules (Section 125(i)) which provides that an employee may not elect for any taxable years beginning after December 31 2012, to have salary reduction contributions in excess of $2,500 made to any health care FSA. In recently issued Notice 2012-40, the IRS has provided implementation guidance for FSA plan sponsors on this new rule.

Operational Transition Rules
In Notice 2012-40, the IRS clarified that:

- "Taxable year" for purposes of the 2013 effective date for the $2,500 salary reduction limit means the cafeteria plan's plan year that begins after December 31, 2012. For a calendar year FSA plan, this means the plan year beginning on January 1, 2013. For a fiscal year plan, the new limit will be effective for the plan year beginning in 2013.
- The $2,500 limit will be indexed for cost-of-living adjustments for plan years beginning after December 31, 2013.
- The $2,500 limit applies to the employee and it applies on an employer by employer basis. This means that regardless of the number of individuals the employee seeks health care reimbursement for (e.g., spouse and dependents), the employee's salary reduction for the taxable year is limited to $2,500. The limit also applies on an aggregated employer basis so that $2,500 is the employee's maximum salary deferral from all health FSAs sponsored by all members of the same controlled group of corporations, trades or businesses under common control or affiliated service groups that are required to be treated as a single employer. However, if an individual participates in health care FSAs sponsored by employers that are not treated as a single employer under the employer aggregation rules, the employee may contribute up to $2,500 to each FSA.
- If a health FSA provides the 2½ month grace period for a plan year, any unused salary reduction to the health FSA for the plan year that is carried over into the grace period does not count against the $2,500 limit that applies for the subsequent plan year. For example, if an employee participating in a calendar year health FSA in 2013 carried over $200 from 2013 into the grace period for that year (January 1 – March 15, 2014), the employee would still be permitted to contribute $2,500 into his or her health FSA for the 2014 plan year.
- The $2,500 limit only applies to a health care FSA. It does not apply to a dependent care or adoption assistance FSA, pre-tax premium salary reduction programs, salary reduction or other contributions to a health savings account or amounts available under a health reimbursement arrangement. It also does not apply to any employer non-elective contributions (e.g., flex credits) under a cafeteria plan unless an employee can elect to receive the amounts in cash or as another taxable benefit.

Written Amendment and Operational Compliance Requirements
The IRS established the last date by which a cafeteria plan with a health FSA must adopt an amendment to reflect the $2,500 limit as December 31, 2014 and stated that the plan must also comply with the limit in operation. A plan which does not satisfy these requirements is not considered a cafeteria plan and the value of the taxable benefits an employee could have elected to receive is includable in the employee's gross income regardless of whether the employee contributed to the amount to the FSA.

Correction of Reasonable Mistakes
The IRS has established a correction process for an employer that makes a mistake in the administration of the salary reduction limit. If the plan timely complied with the written amendment requirement but one or more employees are erroneously allowed to elect a salary reduction of more than $2,500 for a plan year, the plan will continue to be a cafeteria plan for that plan year if (1) the terms of the plan apply uniformly to all participants consistent with proposed treasury regulations (2) the error results from a reasonable mistake by the employer or its agent and not from willful neglect and (3) salary reduction contributions in excess of $2,500 are paid to the employee and reported as wages on Form W-2 for the employee's tax year in which or with which, ends the cafeteria plan year in which the correction is made. This relief is not available if the employer's federal tax return is under examination with respect to cafeteria plan benefits for the year during which the failure occurred.

Use-It-Or-Lose-It Comments Requested
The IRS also asked for comments on whether the use-it-or-lose-it rule that applies to health FSAs should be modified in light of the statutory reduction in the maximum dollar amount any employee can contribute the a health FSA. The IRS noted that the reduced dollar maximum limits the extent to which any employee can accumulate salary reduction over time and because of this the IRS and Treasury Department are considering whether the use-it-or-lose-it rule should be modified to provide a different form of administrative relief (in addition to the existing grace period rule). Written comments are due to the IRS on this issue no later than August 17, 2012.

Conclusion
IRS Notice 2012-40 provides helpful guidance to employers on important open questions involving the upcoming health FSA salary reduction limit. If you have question regarding the health FSA requirements, other aspects of health care reform or other employee benefits matters, please contact the author of this Alert, a member of the Butzel Long Employee Benefits Practice Group, or your regular Butzel Long attorney.

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