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BENEFITS BRIEF

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$2,500 Cap on Salary Reduction Contributions to FSAs Prompts Re-examination of the "Use It or Lose It" Rule

IRS Notice 2012-40, released May 30, 2012, provides guidance on the application of a cap (currently $2,500 but indexed for inflation) on salary reduction contributions to health flexible spending arrangements ("FSAs") imposed by the Patient Protection and Affordable Care Act (the "ACA"). Significantly, the Notice states that due to the imposition of this $2,500 cap on health FSA contributions, the IRS and Treasury Department are re-examining the long-standing "use it or lose it" rule for health FSAs.

Modification of the "Use It or Lose It" rule

Cafeteria plans must follow the requirements established in Section 125 of the Internal Revenue Code, one of which is that the cafeteria plan must not provide for the deferral of compensation. Proposed regulations issued in 1984 introduced the "use it or lose it" rule, which requires that any FSA funds remaining after all reimbursable claims are paid for the plan year must be forfeited. The IRS and Treasury Department took the position that the "use it or lose it" rule was necessary to prevent FSAs from operating in a manner that would defer compensation. The cafeteria plan regulations were expanded in 1989 and re-proposed in 2007 (but not yet finalized) and the "use it or lose it" rule has remained – with minor modifications. Employers and FSA plan administrators point to the "use it or lose it" rule as a major reason why many employees refuse to participate in FSAs that they are eligible for.

The new FSA cap limiting the amount of funds that can be accumulated in a health FSA has allowed the IRS and Treasury Department to reconsider whether the "use it or lose it" rule as presently expressed is necessary to prevent a FSA from being a means of deferring compensation. The IRS and Treasury Department, in Notice 2012-40, request comments as to whether the "use it or lose it" rule should be modified as a result of the imposition of the FSA cap and how any such modifications should interact with the FSA cap. These comments must be submitted by August 17, 2012.

Employers and cafeteria plan administrators have long requested that the "use it or lose it" rule be eliminated or modified and they are preparing comments to provide to the IRS and Treasury Department asking that the rule be modified. We expect the industry will request that employees be able to rollover their unused FSA funds for use in the following year. In order to ensure that the FSA is not a means of deferring compensation, it is likely that the IRS and Treasury would provide that the annual rollover amount would not be permitted to exceed the $2,500 FSA cap amount. Whether the IRS and Treasury Department will modify the "use it or lose it" rule after so many years is unknown; however, the fact that they have asked for comments regarding modification of the rules demonstrates that they are, for the first time, seriously considering the issue. Over the years, there have been numerous proposals in Congress to limit or eliminate the IRS's "use it or lose it" rule. Most recently, on May 31, 2012, the Ways and Means Committee of the U.S. House of Representatives reported H.R.1004, the Medical FSA Improvement Act of 2011, which provides $500 cash out of unused FSA funds. This bill passed in the House on June 7, 2012, as part of H.R. 436, the

Health Care Cost Reduction Act of 2012. It is highly unlikely that this bill will become law, however, since the Obama Administration has stated that the President will veto the bill as presently structured and there seems to be no appetite in the Senate to bring this bill forward for a vote. It appears that if the "use it or lose it" rule is to be modified, it will have to be through the regulatory process.

Implementation of the $2,500 FSA Cap

The ACA's $2,500 FSA cap raised a number of administrative issues, which Notice 2012-40 resolved.

Effective Date of the FSA Cap

The FSA cap under Code Section 125(i) is effective for any *taxable year beginning after December 31, 2012*, but the law did not specify whether the tax year applied to the employer's tax year, the plan's tax year, or the employee's tax year. This ambiguity was problematic for non-calendar year cafeteria plans (e.g., fiscal year plans). Notice 2012-40 provides that the FSA cap applies to plan years beginning after December 31, 2012. This means that for calendar year cafeteria plans, the limit will be applied for the plan year beginning January 1, 2013. For fiscal year cafeteria plans, the limit will apply for the first plan year that begins in 2013. If a cafeteria plan has a short plan year of less than 12 months that begins after December 31, 2012, the Notice states that the annual dollar limit must be prorated based on the number of months in that short plan year.

Application of the FSA Cap

The FSA cap applies to each employee for a plan year, regardless of the number of other individuals whose expenses are reimbursable under the employee's health FSA. Consequently, the cap is not increased even if the employee's health FSA covers a non-employee spouse or other dependents.

If an employee participates in multiple cafeteria plans offering FSAs maintained by members of a controlled group or an affiliated service group, the employee's total health FSA contributions under all such cafeteria plans are limited to a single FSA Cap of $2,500. However, if an employee is employed by two or more employers that are not members of the same controlled group, he or she may elect up to $2,500 under each separate employer's health FSA. If each of two spouses is eligible to elect salary reduction contributions to an FSA, each spouse may elect to make salary reduction contributions of up to $2,500 to his or her health FSA, even if both participate in the same health FSA sponsored by the same employer.

Contributions subject to the Cap

While salary reduction contributions that an employee makes to a FSA are subject to the cap, non-elective employer contributions (such as "flex credits") to the FSA are not subject to the FSA Cap. For example, if an employer contributes a $500 flex credit, each employee may still elect to make salary reduction contributions up to $2,500 to a health FSA for that plan year. However, employer-provided flex credits that employees elect to receive as cash or as taxable benefits will be treated as salary reduction contributions subject to the FSA Cap.

The annual dollar limit does not include employee salary reduction contributions to an FSA for dependent care assistance or adoption care assistance. The limit also does not apply to salary reduction contributions to a cafeteria plan that are used to pay an employee's share of health coverage premiums ("premium conversion" salary reduction contributions) – nor does it apply to salary reduction or any other contributions to a health savings account or to amounts made available by an employer under a health reimbursement arrangement.

If the optional 2-1/2 month grace period is provided under a FSA plan, unused salary reduction contributions to the health FSA for the plan year that are carried over into the grace period will not count against the FSA cap applicable for the subsequent plan year.

Amending plan documents

Cafeteria plans must be formally amended to reflect the FSA cap. Notice 2012-40 provides relief from the rule that amendments to an FSA plan must be made prospectively and will allow retroactive amendments with respect to the cap. Consequently, plan amendments incorporating the new limit do not have to be adopted until the end of calendar year 2014.

Correcting errors

If the cafeteria plan is amended to comply with the new annual dollar limit by December 31, 2014, any errors of allowing employees to contribute amounts in excess of the FSA cap can be corrected if (1) the terms of the plan apply uniformly to all participants; (2) the error results from a reasonable mistake by the employer and is not due to willful neglect by the employer; and (3) the salary reduction contributions in excess of $2,500 are paid to the employee and reported as wages for income tax withholding and employment tax purposes on the employee's Form W-2.