



# Health Flexible Spending Account Changes Under Healthcare Reform

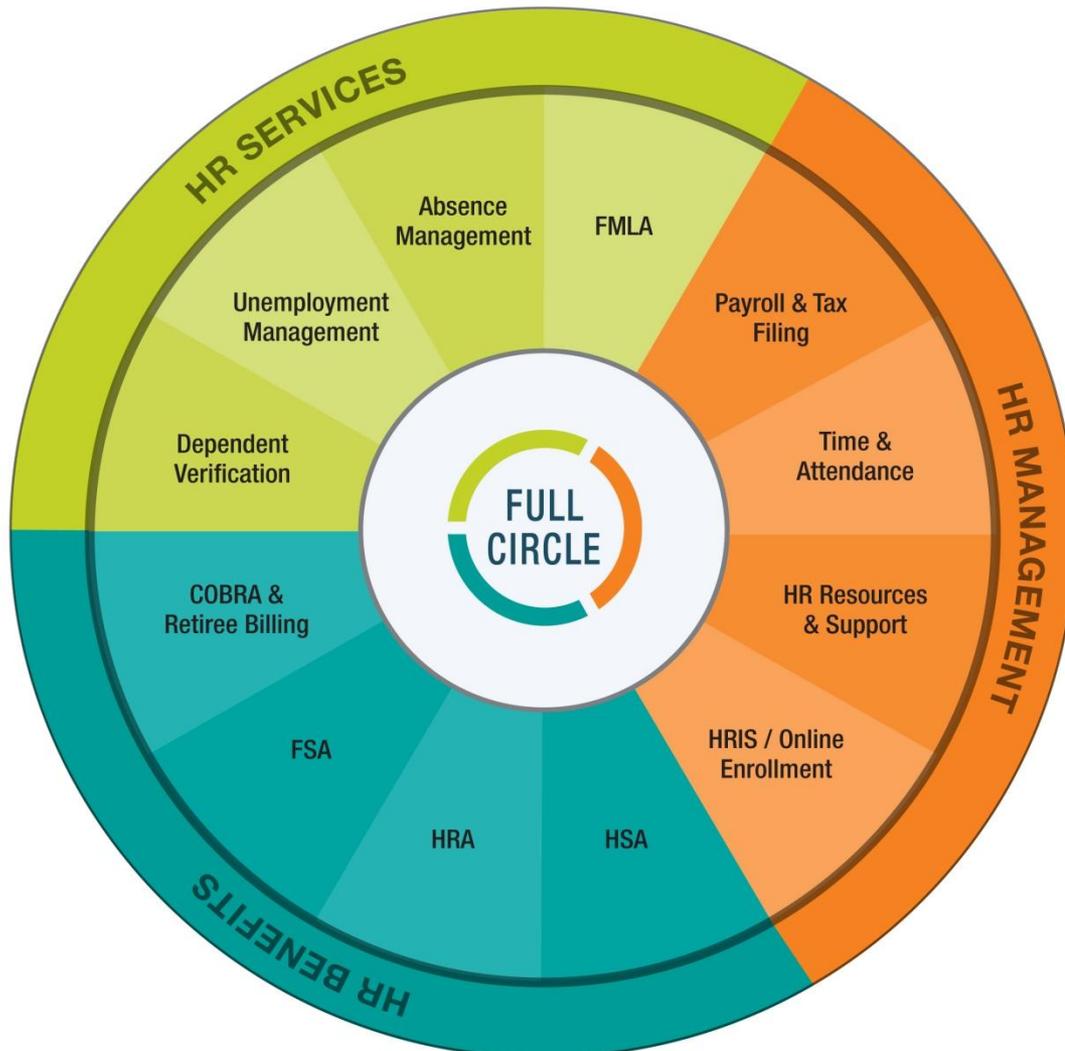
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# Introductions



- The IRS recently issued Notice 2012-40 providing guidance on the \$2,500 limit on salary reduction contributions to health flexible spending arrangements (“health FSAs”) under cafeteria plans.
- The \$2,500 limit is a new requirement that was added by the Patient Protection and Affordable Care Act and many plan sponsors (especially those with non-calendar year plans) have had compliance questions.
- The IRS Notice provides clarifications on several important points.

# Limit Applies for Plan Years that Begin After December 31, 2012



- The guidance specifies that the \$2,500 limit applies on a plan year basis, not on an employer's or employee's taxable year basis, and is effective for plan years that begin after December 31, 2012.
- This resolves an important issue for non-calendar year cafeteria plans.
- For example, a cafeteria plan with a plan year beginning on July 1, 2012 is not required to apply the \$2,500 limit for the plan year that starts on that date.
- Instead, the limit will first apply for the plan year that begins on July 1, 2013.

# Limit Applies Only to Employee Salary Reductions Under Health FSAs



- The guidance also clarifies that the \$2,500 limit applies only to employee salary reduction contributions to health FSAs, not to employer non-elective contributions (sometimes called flex credits) that cannot be cashed out.
- For example, if an employer provides \$1,000 in non-elective contributions that the employee may use for any qualified benefit offered under the cafeteria plan, but cannot be taken by the employee in cash, the \$1,000 will not count against the \$2,500 limit on the employee's salary reduction contributions.
- On the other hand, if the employer's \$1,000 contribution can be taken by the employee in cash, it will count against the limit. In addition, the guidance clarifies that the limit does not apply to arrangements such as employee salary reduction contributions that are used to pay for the employee's share of health coverage premiums (sometimes referred to as premium conversion plans), contributions to health savings accounts or health reimbursement arrangements.

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# Grace Period Carryover Not Affected



- The effect of a grace period on the \$2,500 limit also raised questions that are resolved by the guidance.
- If a cafeteria plan provides for a grace period under which employees may use amounts remaining in the health FSA from the previous plan year to pay for qualified expenses incurred during the grace period, unused amounts that are carried over to the grace period do not count against the \$2,500 limit.

# Short Plan Year



- In the case of a short plan year that begins after 2012, the limit must be prorated based on the number of months in the short plan year.
- The guidance further provides that plans may not change from a calendar to a fiscal plan year if a principal purpose of the change is to delay the limit's application.
- In such cases, the valid business purpose requirement for plan year changes would not be satisfied and the plan year would remain the same as it was before the attempted change

# Plan Amendment Due December 31, 2014



- The guidance also gives plan sponsors until December 31, 2014 to amend their cafeteria plans to set forth the \$2,500 limit (or a lower limit chosen by the sponsor), provided the plan is operated in accordance with the limit for plan years beginning after December 31, 2012.

# Per-Employee & Per-Employer Basis



- The \$2,500 limit applies on an employee-by-employee basis and an employer-by-employer basis.
- For example, if two spouses are employed by the same employer and each spouse is eligible for the same cafeteria plan health FSA, each may contribute \$2,500. But the guidance also requires aggregation of health FSA contributions by all employers in the same controlled group or affiliated service group, because they are considered a single employer.
- For example, an employee participating in two separate cafeteria plan health FSAs that are sponsored by two employers in the same controlled group may contribute a total of only \$2,500 to the two health FSAs.
- But if the two employers are not related, the employee may contribute \$2,500 to each of the two health FSAs

# Excess Contribution Relief



- The Notice provides relief for erroneous excess contributions caused by the plan sponsor's reasonable mistake if certain requirements are met.
- A copy of the Notice is available at <http://www.irs.gov/pub/irs-drop/n-12-40.pdf>.

# Excess Contribution Relief



- A cafeteria plan that fails to comply with the limit will lose its tax-advantaged status.
- Under IRS guidance, however, a cafeteria plan that is timely amended to reflect the limit under which one or more employees are erroneously allowed to elect salary reductions in excess of the limit for a plan year will not fail to qualify as a cafeteria plan for that plan year if the following requirements are met:
  - the terms of the plan apply uniformly to all participants;
  - the error results from a reasonable mistake by the employer or its agent; and
  - salary reductions in excess of the limit are paid to the employee and reported as wages for federal income tax withholding and employment tax purposes for the employee's taxable year in which, or which with, ends the cafeteria plan year in which the correction is made.

# What If the Health FSA & Cafeteria Plan Have Different Plan Years?



- Based on the wording of IRS Notice 2012-40, it seems that the limit applies based on the plan year of the cafeteria plan.
- Sponsors of health FSAs that operate on a plan year that is different from the plan year of the cafeteria plan should ensure that the limit is effective for the cafeteria plan year that begins in 2013, that health FSA salary reductions during this period do not exceed the limit).
- One option is to amend the arrangement so that the cafeteria plan and health FSA have the same plan year. Another option would be to implement the \$2,500 limit for the health FSA plan year immediately preceding the cafeteria plan year that begins in 2013. Further guidance on this issue would be welcome.

## What If Our Non-Calendar Year Plan Implemented the Limit Before IRS Notice 2012-40?



- Some non-calendar-year plan sponsors adopted amendments implementing the \$2,500 limit for the plan year beginning in 2012, before IRS Notice 2012-40 clarified that the limit applies on a plan-year basis.
- If the plan year has not commenced, there may be enough time for these plans to rescind the amendment and allow employees to make new elections.
- But if the plan year is already underway, it appears that without IRS transition relief, employees cannot increase their elections for the remainder of the 2012 plan year.
- While the limit could be raised for the remainder of the plan year for new participants, the permitted election change rules would not allow an election change for employees who have already made a binding health FSA election (absent an event recognized under the permitted election change rules as allowing a midyear change—e.g., a change in status).†

# Practical Tips



- Employers should be careful to communicate to employees when and to what the \$2,500 limit applies, so that employees will not be confused about other amounts that will not count against the limit, such as grace period carryovers, employer flex credits that cannot be cashed out, contributions to HSAs or HRAs, or employee salary reduction contributions to premium conversion plans.

# Practical Tips



- Even though the guidance allows until December 31, 2014 for plan sponsors to adopt the required amendment, an earlier adoption could avoid misunderstandings by participants and prevent the amendment from slipping between the cracks.

# Practical Tips



- Employers that are members of a controlled group of employers or an affiliated service group should review their administrative procedures to ensure that they will be able to identify any employees that are eligible under more than one health FSA sponsored by related employers and limit the employee salary reduction contributions accordingly.



## “Use-or-Lose” Rule:

- IRS Notice 2012-40 also notes that IRS and Treasury are considering whether the long-standing “use-or-lose” rule (which generally prohibits FSA contributions or benefits from being used in a subsequent plan year) should be modified for health FSAs, given that the \$2,500 limit reduces the potential for using health FSAs to defer compensation.
- Comments are requested on whether and how the use-or-lose rule should be modified, including how any modifications would interact with the limit.



## **Restoring Access to Medications Act (H.R. 5842):**

- It repeals the change to the definition of medical care made by the Affordable Care Act for purposes of the exclusion for reimbursements for medical care under employer provided accident and health plans and for distributions from HSAs or Archer MSAs used for qualified medical expenses that requires that over-the-counter medicine (other than insulin) be prescribed by a physician in order for the medicine to be medical care for these purposes.
- The proposal is effective with respect to expenses incurred after December 31, 2012.
- Voted out of Ways and Means Committee of the House on May 31, 2012.

# Proposals



## The Health Flexible Spending Arrangements Improvements Act of 2012 (H.R. 1004)

- It aims to increase participation in FSAs by allowing unused funds to be returned to the employee at the end of the plan year, instead of the current “use-it-or-lose-it” policy.
- Specifically, under the provisions of this bill:
  - Any amount remaining in a Health FSA under a cafeteria plan that is not used to reimburse medical expenses incurred during the plan year (plus the plan's grace period, if any) would be distributed to the employee. The distribution must be made no later than the end of the seventh month after the close of the plan year.
  - The amount of the distribution for any employee would be limited to the lesser of \$500 or the amount of salary reduction contributions for the employee reduced by reimbursements for medical expenses for the plan year.
  - Qualified distributions would not cause a cafeteria plan and Health FSA to violate the use-it-or-lose-it rule or the requirement that amounts available for reimbursement for medical expenses under a Health FSA not be available for any other purpose. The amount of a qualified distribution would be includable in gross income for the year in which the distribution is made and would be considered as wages for employment tax purposes.
- The proposal is effective with respect to expenses incurred after December 31, 2012.
- Voted out of Ways and Means Committee of the House on May 31, 2012.



# Questions



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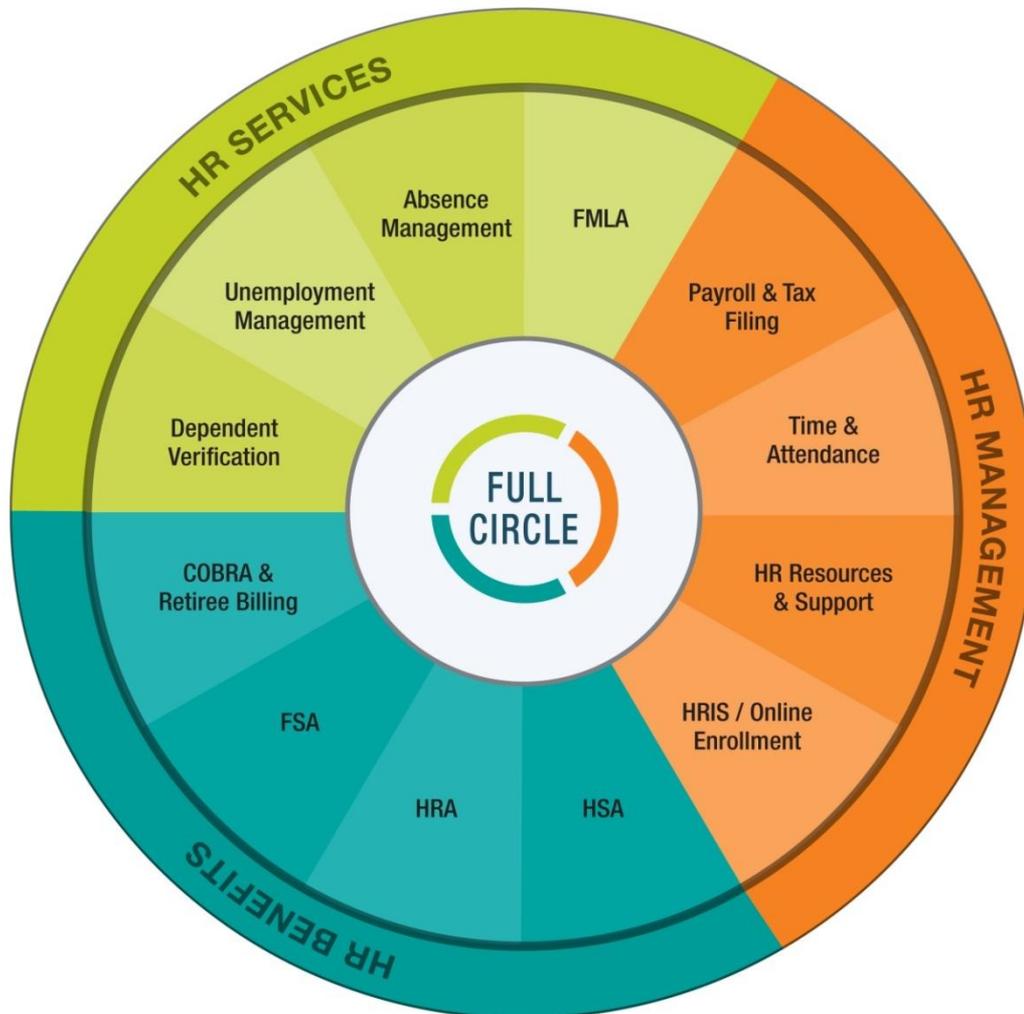
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