

The Affordable Care Act Brings Changes to Health Flexible Spending Arrangements

Dessie Stafford, CPA

I.R.C. §125 Cafeteria Plans allow employees to choose between receiving cash or nontaxable employment benefits. The Affordable Care Act changed some of the provisions of cafeteria plans, including §125(i), limiting health flexible spending arrangements (FSAs). This article addresses various features and changes to health FSAs.

Employee Contribution Limit:

- Prior to the revision, the IRS did not limit FSA contributions, but employers often limited employees to \$5,000 or less per year. No employment or federal income taxes were deducted, and the employee could use the tax-free funds to pay for medical expenses. Under the revised rule, contributions are limited to \$2,500 per year.
- The \$2,500 limit applies to all plan years beginning after Dec. 31, 2012. If a plan year commenced before 2013, the imposed \$2,500 limit does not apply until the following plan year.
- The statutory \$2,500 limit applies only to employee contributions and not to flex credits. Flex credits are payments made by the employer to the employee's FSA account. Employees choose how to allocate the credits among health and other plan options. Employees will still be able to take advantage of the flex credits plus a \$2,500 election.
- The imposed \$2,500 limit does not apply to salary reduction contributions known as "premium conversion" contributions. Premium conversions are made to a cafeteria plan but are used to pay employee's share of health insurance premiums.
- After 2013, the \$2,500 limit will be indexed for cost-of-living adjustments.
- The limit is per employee, not per household. Each family member qualifying to participate may fund a health FSA.

Plan Amendments:

- Although cafeteria plan amendments are allowed only when made prospectively, an exception allows amendments to be made to adopt the \$2,500 limit as late as the end of calendar year 2014.
- Failure to amend a plan by the end of 2014 will cause the employee election to fail. Elected amounts in a failed plan are treated as non-qualifying and must be included in employee's gross income.

- The 2014 deadline for plan amendments applies irrespective of when the plan year commences.
- If the written plan is amended but an employer allows a salary reduction greater than \$2,500 due to a reasonable mistake, the plan still may qualify for purposes of §125 so long as:
 - the terms of the plan apply uniformly to all;
 - the mistake was not willful neglect;
 - the excess is paid to the employee and reported as wages on employee's W-2; and
 - the employer's federal tax return is not under examination with respect to cafeteria plan benefits.

Use-it-or-Lose-it Provisions and Other Risks:

- Another change concerns the use-it-or-lose-it provisions concerning health FSAs. Plans beginning before 2013 were allowed to add a grace period extending the time employees could use their contributions. Extensions up to two months and 15 days were permitted. Contributions not used at the end of the grace period were lost to the employee and returned to the employer. This provision is under review.
- In the first year under the new contribution cap, employees may actually qualify to spend more than the \$2,500 limit if the excess spending is due to proper application of their grace period from the prior year.
- The IRS and Treasury Department are considering whether to continue, end, or modify grace periods. The agencies accepted comments through Aug. 17, 2012.
- Employees may use all of their contribution for the year as soon as the plan year commences, even though the salary reductions are executed ratably over the year. An employee who uses the entire amount, then leaves before the end of the year is not required to reimburse the employer.
- An employee who is laid off or fired before the year end and has not used all of the elected amount loses their money. Employees may submit claims for payment for qualifying expenses incurred before the end of their employment so long as it otherwise qualifies.

Additional coverage of health FSAs may be found in *Notice 2012-40*; *Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans*; *Publication 15, Employer's Tax Guide*; and *Publication 15-B, Employer's Tax Guide to Fringe Benefits and Instructions for 2012 W-2*.

Dessie Stafford, CPA, is an associate professor at Missouri Valley College in Marshall, Mo. She serves on the MSCP Taxation Committee. Dessie may be contacted at staffordd@moval.edu.