Health Care Reform Management Alert Series

IRS Provides Transition Relief for $2,500 FSA Cap; Delays Amendment Deadline

Issue 40

This is the fortieth in our series of alerts for employers on selected topics in health care reform. (Click here to access our general summary of health care reform and other issues in this series.) This series of Health Care Reform Management Alerts is designed to provide an in-depth analysis of certain aspects of health care reform and how it will impact your employer-sponsored plans.

[✔] Applies to grandfathered plans

[✔] Applies to new health plans and plans that lose grandfathered status

Beginning January 1, 2013, the Affordable Care Act limits contributions to a health care flexible spending arrangement (FSA) to $2,500 per year, as adjusted for inflation in subsequent years. See *Issue 4* for more details on the FSA cap. The Affordable Care Act left some confusion as to whether the FSA cap was effective for plan years or calendar years beginning after December 31, 2012. Recent IRS guidance clarifies that the cap is effective for *plan years* beginning after December 31, 2012, meaning off-calendar year plans have a delayed effective date.

Cafeteria plans must be amended to reflect the $2,500 limit. Although cafeteria plan amendments must typically be effective propectively, the guidance permits plan sponsors to retroactively amend their plan document to set forth the FSA cap, provided the amendment is adopted on or before **December 31, 2014**.

The guidance also provided a number of other clarifications, including:

- ***Grace Periods.*** Health care FSAs are subject to a "use-it-or-lose-it" rule, meaning any amounts not spent during the plan year are forfeited. Under cafeteria plan rules, plan sponsors may include a 2 ½ month "grace period" following the end of the plan year, where employees may use amounts remaining from the previous plan year to pay for expenses incurred during the grace period. The IRS guidance provides that any unused amounts that are carried over to the grace period will not count against the next year's $2,500 cap.
- ***Employer Flex Credits.*** The $2,500 FSA cap only applies to employee pre-tax contributions to a health care FSA. Employer "flex credits" or other employer contributions toward health care costs will not apply toward the FSA cap. Employee pre-tax contributions toward health care premiums, health savings accounts (HSAs), health reimbursement arrangements (HRAs) or other similar accounts also do not apply toward the FSA cap.
- ***Correction Method.*** If employees are accidentally permitted to contribute more than $2,500 for a given year, the guidance provides that an employer may correct the error and preserve the plan's status as a cafeteria plan. To do so, the employer must simply pay the excess contributions to the employee as taxable wages and report the wages for income tax withholding and employment tax purposes for the employee's taxable year in which the correction is made. This correction method is not available for willful or intentional over-contributions or for cafeteria plans under audit.

- ***Working Spouses.*** The $2,500 cap applies on a per-employee basis. If an employee and his/her spouse are both eligible to make contributions to a health FSA, each may elect contributions up to the $2,500 limit, even if both participate in the same plan sponsored by the same employer.

Request For Comments on "Use-It-Or-Lose-It," and Potential Future Changes to OTC Rule

As mentioned above, the use-it-or-lose-it rule prohibits employees from carrying over unused FSA balances beyond the close of the plan year (or grace period, if applicable). The original intent behind this rule was to prevent FSAs from being used as an income deferral vehicle. The IRS guidance notes that this sort of abuse will be less likely once the FSA cap becomes effective. As a result, the IRS requested comments on potential modifications to the use-it-or-lose-it rule. Comments are due by August 17, 2012.

Effective as of January 1, 2011, the Affordable Care Act prohibited employees from using amounts in their tax-advantaged accounts (such as FSAs, HRAs and HSAs) to purchase over-the-counter (OTC) medication without a prescription. Congressional testimony indicates this restriction has had the unintended effect of encouraging more people to seek prescriptions for drugs that would otherwise be available over-the-counter. This has resulted in longer waiting times to see primary care providers and increased medical costs. As a result, a bill has been introduced in Congress to remove this restriction. Seyfarth Shaw LLP will continue to monitor this legislation and issue an alert if there are any future developments.

By: Joy Sellstrom and Ben Conley

Joy Sellstrom is senior counsel in Seyfarth's Chicago office, and Ben Conley is an associate in the firm's Chicago office. If you would like further information, please contact your Seyfarth Shaw LLP attorney, Joy Sellstrom at jsellstrom@seyfarth.com, or Ben Conley at bconley@seyfarth.com.