

## Exploring the \$2,500 Cap for Health FSA Salary Reductions

Section 9005 of the Patient Protection and Affordable Care Act (PPACA) amends Internal Revenue Code (“Code”) Section 125 to cap health FSA salary reduction elections for the taxable year at \$2,500. This regulation becomes effective on January 1, 2013.

At first glance, the rules seem clear; however, there are several latent ambiguities regarding application of the rule that have prompted many plan sponsors and third party administrators to ask questions about the new rule. This alert highlights those issues.

### When is the new rule effective?

The rule, which caps the amount of elections made *for a taxable year*, is effective for *taxable years* beginning after December 31, 2012. As the taxable year is typically a calendar year, we could easily say that the rule applies to elections made for tax years starting January 1, 2013.

**Practice Pointer:** Notice that the statute fails to reference the “plan year” of the health FSA, even though health FSA elections are typically made for a plan year. The failure to reference the term *plan year* creates compliance and operational challenges for plan sponsors that maintain health FSAs with a non-calendar (i.e., a fiscal) plan year.

For health FSAs with a calendar plan year, applying the effective date is relatively easy because the plan year and the taxable year are the same. In fact, if you are a plan sponsor that maintains a health FSA with a calendar plan year, you can skip to the next question. The answers are not so clear for non-calendar plan years (or fiscal plan years).

There are three potential interpretations for how the new \$2,500 rule applies to health FSAs with fiscal plan years. To better illustrate the application of each interpretation, we will use an example health FSA sponsored by ABC Company with an April 1 through March 31 plan year.

### Interpretation 1: All Salary Reductions in 2013 Capped at \$2,500

This interpretation is that the rule impacts *any* salary reductions made during the calendar year, without regard to the plan year of the health FSA or when the election was made. Thus, ABC Company’s compliance with the new rule would be measured by looking at an employee’s salary reductions made during the last three months of the 2012 fiscal plan year (January, February, and March 2013) and the employee’s salary reductions for the first nine months of the 2013 fiscal plan (April through December). This interpretation would be consistent with how the equivalent \$5,000 cap for dependent care benefits is administered under Code Section 129.

**Practice Pointer:** ABC Company would either need to do one of the following:

- Amend its plan prior to the start of the 2012 plan year to cap all health FSA salary reductions made during the 2012 plan year at \$2,500; or
- Amend the plan prior to the start of the 2013 plan year and simply limit the salary reduction amount for the 2013 plan year to ensure that the sum of each employee’s salary reductions in the last three months of the 2012 plan year (i.e., January, February, and March 2013) and the salary reductions made by each employee during the first nine months of the 2013 plan year do not exceed \$2,500. While this may seem like a difficult task, it likely isn’t – at least for plan sponsors whose current FSA annual maximum isn’t excessive.

### **Interpretation 2: Capped Salary Reductions for Mid-year Elections Made after December 31, 2012**

This rule interpretation applies only to salary reduction elections made in 2013 without regard to the plan year to which the salary reduction relates. Unlike the first interpretation, elections with an effective date in 2012 would not be subject to the new cap, even though such elections include a coverage period that extends into 2013. However, employees making an election within 2013 (e.g., new hires in 2013 or change in status elections in 2013) would be subject to the \$2,500 cap, even if the election is for the 2012 fiscal plan year.

**Practice Pointer:** Under the second interpretation, ABC Company would need to amend its plan prior to January 1, 2013.

### **Interpretation 3: Capped Salary Reductions for the 2013 Fiscal Plan Year**

The third interpretation applies to plan years beginning on or after January 1, 2013. Thus, the rule would first apply to ABC Company's health FSA on April 1, 2013 for fiscal year 2013. No one making a health FSA election for the 2012 fiscal plan year would be subject to the \$2,500 cap even if the election included coverage months or was first effective in 2013.

**Practice Pointer:** This interpretation likely has some superficial appeal among plan sponsors and administrators because it provides the greatest amount of administrative flexibility. For example, ABC Company would have to amend its plan before April 2013 – not prior to the 2012 plan year or January 1, 2013, as in the first two interpretations. And, employees making an election for the 2012 plan year would not be subject to the \$2,500 cap, thereby delaying application of the rule for ABC Company and other plan sponsors with fiscal plan years. Unfortunately, this interpretation simply isn't consistent with the literal language of the statute, which makes no reference to the *plan year* on which this interpretation is based.

So, you are probably wondering what you need to do. It is our understanding that the IRS is considering guidance that will clarify the effective date of the rule, hopefully in a way that accommodates some of the hardships imposed on fiscal year plans. However, in the absence of formal guidance from the IRS, plan sponsors with fiscal plan years will need to make a decision regarding the appropriate action to take.

In light of how the similar rule applies for dependent care plans, the safest course to take would be to adopt the first rule interpretation and amend the health FSA plan prior to the beginning of the 2012 plan year so that all 2012 elections are subject to the \$2,500 cap. Others may decide to hold off for now. Even if the IRS formally adopts the first interpretation after your 2012 fiscal plan year begins (i.e., the \$2,500 cap applies to salary reductions *made* in 2013 without regard to the plan year), adjustments can be made to the 2013 plan year elections to ensure compliance, which gives plan sponsors some flexibility to take a wait-and-see approach.

#### **Does the new rule require a plan amendment?**

Yes, the new rule requires a plan amendment to the extent that your current health FSA annual salary reduction maximum is greater than \$2,500. Thus, if ABC Company's maximum current annual salary reduction election is \$2,000, no amendment is needed.

**Practice Pointer:** Don't forget that plan amendments must be "formally" adopted by the individual(s) authorized by the company's governing documents to amend plans. Moreover, the formal amendment must be completed prior to the January 1, 2013 effective date.

**Does the cap apply also to any non-elective employer contributions, such as matching contributions?**

The literal language of the statute appears to impose a cap only on health FSA salary reduction elections. Unless the IRS provides further clarification, an employer's non-elective contributions to the health FSA, such as matching contributions, would not be subject to the cap as long as such amounts cannot be received as cash or other taxable benefits.

**Practice Pointer:** If the cap ultimately does not apply to employers' non-elective contributions, the health FSA reimbursement maximum could be higher than \$2,500. For example, an employer who establishes a \$2,500 cap on salary reductions could also provide matching contributions to raise the maximum annual reimbursement to \$5,000.

**Does the new rule affect any other cafeteria plan salary reductions?**

No, the amendments to Code Section 125 made by Section 9005 of PPACA apply only to health FSA elections.