Treasury Releases Important Health Flexible Spending Arrangement Guidance

On May 30, 2012, the U.S. Department of the Treasury issued Notice 2012-40, which interprets the new limit imposed on salary reduction contributions to health flexible spending arrangements (health FSAs) under section 125(i) of the Internal Revenue Code and seeks comments on possible modifications to the longstanding "use-it-or-lose-it" rule for health FSAs.

Section 125(i), which was added to the Code by section 9005 of the Patient Protection and Affordable Care Act, provides that a health FSA is not treated as a qualified benefit under section 125 unless the cafeteria plan "provides that an employee may not elect for any taxable year to have salary reduction contributions in excess of $2,500 made to such arrangement." Employers and others asked many questions about how to implement this contribution limit, particularly with respect to cafeteria plans with a non-calendar plan year.

Notice 2012-40 supplies answers to many important questions. It provides that:

- the $2,500 limit does not apply for plan years that begin before 2013 (i.e., a cafeteria plan with a July 1 plan year does not have to apply the limit until the plan year beginning on July 1, 2013);
- the term "taxable year" in section 125(i) refers to the plan year of the cafeteria plan as this is the period for which salary reduction elections are made;
- despite the general prohibition on retroactive cafeteria plan amendments, plans may adopt the required amendments to reflect the $2,500 limit at any time prior to December 31, 2014 so long as the plan operates in compliance with the section 125(i) limitations for plan years beginning after December 31, 2012;
- if a plan has adopted a grace period of up to 2½ months, unused salary reduction contributions to the health FSA that are carried over into the grace period will not count against the $2,500 limit for the subsequent plan year; and
- if a plan is timely amended to reflect the new $2,500 limit, relief is available for certain excess salary reduction contributions that result from a reasonable mistake and not willful neglect and that are corrected by the employer.

The guidance makes clear that the contribution limit applies only to employee salary reduction contributions to health FSAs. The limit does not apply to non-elective employer contributions, employee salary reduction or other contributions to other types of FSAs, health savings accounts, health reimbursement arrangements or for payment of an employee's share of his or her health care coverage premiums.

Finally, in recognition that a cap on health FSA salary reduction contributions limits the potential for accumulating these contributions and using them to defer compensation to a subsequent year, the Treasury Department and the IRS are seeking comments on whether the "use-it-or-lose-it" rule should be modified. Under the "use-it-or-lose it" rule, any balances remaining in a health FSA after the claims submission deadline following the end of the plan year or grace period are forfeited. The regulators are seeking comments on whether the use-it-or-lose it rule should be modified to provide flexibility in addition to (or instead of) the flexibility already available under the grace period rules and, if so, how such additional flexibility might be formulated or constrained. Comments are also welcome on how any modifications might interact with the $2,500 limit. Comments must be submitted no later than August 17, 2012.

If you have questions about the health FSA limit or wish to discuss any required plan amendments, please contact your usual Ropes & Gray advisor or a member of our employee benefits practice. For other information about federal health care reform implementation, please visit the Ropes & Gray Health Reform Resource Center.