

Section 125 - Cafeteria Plans

Health flexible spending arrangements not subject to \$2,500 limit on salary reduction contributions for plan years beginning before 2013 and comments requested on potential modification of use-or-lose rule.

Notice 2012-40

I. PURPOSE AND OVERVIEW

This notice provides guidance on the effective date of the \$2,500 limit (as indexed for inflation) on salary reduction contributions to health flexible spending arrangements (health FSAs) under § 125(i) of the Internal Revenue Code (Code) (the \$2,500 limit) and on the deadline for amending plans to comply with that limit. This notice also provides relief for certain contributions that mistakenly exceed the \$2,500 limit and that are corrected in a timely manner. Finally, the notice requests comments on whether to modify the use-or-lose rule that is currently set forth in the proposed regulations with respect to health FSAs.

Specifically, this notice provides that –

- the \$2,500 limit does not apply for plan years that begin before 2013;
- the term “taxable year” in § 125(i) refers to the plan year of the cafeteria plan as this is the period for which salary reduction elections are made;
- plans may adopt the required amendments to reflect the \$2,500 limit at any time through the end of calendar year 2014;
- in the case of a plan providing a grace period (which may be up to two months and 15 days), unused salary reduction contributions to the health FSA for plan years beginning in 2012 or later that are carried over into the grace period for

that plan year will not count against the \$2,500 limit for the subsequent plan year;
and

- relief is provided for certain salary reduction contributions exceeding the \$2,500 limit that are due to a reasonable mistake and not willful neglect and that are corrected by the employer.

The statutory \$2,500 limit under § 125(i) applies only to salary reduction contributions under a health FSA, and does not apply to certain employer non-elective contributions (sometimes called flex credits), to any types of contributions or amounts available for reimbursement under other types of FSAs, health savings accounts, or health reimbursement arrangements, or to salary reduction contributions to cafeteria plans that are used to pay an employee's share of health coverage premiums (or the corresponding employee share under a self-insured employer-sponsored health plan).

II. BACKGROUND

A § 125 cafeteria plan is a written plan that allows employees to elect between permitted taxable benefits (such as cash) and certain qualified benefits. Section 125(a), (d)(1). If an employee makes the election before the start of the plan year, and other § 125 requirements are satisfied, the employee's election of one or more qualified benefits does not result in gross income to the employee.

In 2007, the Treasury Department and the Internal Revenue Service (IRS) published proposed regulations under § 125. 72 Fed. Reg. 43938 (Aug. 6, 2007). Taxpayers may rely on the proposed regulations. The proposed regulations require a written cafeteria plan providing a health FSA to specify the maximum salary reduction contribution as a maximum dollar amount, a maximum percentage of compensation, or

other method of determining the maximum salary reduction contribution. See Prop. Treas. Reg. § 1.125-1(c). If a cafeteria plan fails to operate in compliance with § 125 or fails to satisfy any of the written plan requirements for health FSAs, the plan is not a § 125 cafeteria plan and an employee's election of nontaxable benefits results in gross income to the employee. For additional guidance, see Prop. Treas. Reg. § 1.125-1(c)(1), (c)(6) and (c)(7).

A cafeteria plan may include a grace period of up to two months and 15 days immediately following the end of a plan year. If the plan provides for a grace period, an employee may use amounts remaining from the previous plan year (including amounts remaining in a health FSA) to pay for expenses incurred for certain qualified benefits during the grace period. See Notice 2005-42, 2005-1 C.B. 1204, and Prop. Treas. Reg. § 1.125-1(e).

Section 125(i) was added by § 9005 of the Patient Protection and Affordable Care Act (the Act), Pub. L. No. 111-148 (as amended by § 10902 of the Act, and further amended by § 1403(b) of the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152). Section 125(i) is effective for "taxable years" beginning after December 31, 2012. Prior to the effective date of § 125(i), plan sponsors imposed limits on the amount of salary reduction contributions that employees may elect to health FSAs, but there has been no statutory limit.

III. COMPLIANCE WITH THE \$2,500 LIMIT ON SALARY REDUCTION CONTRIBUTIONS TO HEALTH FSAS

Section 125(i) provides that a health FSA is not treated as a qualified benefit 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."

Because employees make salary reduction contribution elections for health FSAs only on a plan year basis (see Prop. Treas. Reg. § 1.125-2), the term “taxable year” in § 125(i) (which does not specify that it refers, for example, to the employee’s taxable year or to the employer’s taxable year) refers to the plan year of the cafeteria plan. Similarly, the reference to “taxable year” in the effective date provision of § 125(i) refers to the plan year of the cafeteria plan. Accordingly, the \$2,500 limit on health FSA salary reduction contributions applies on a plan year basis and is effective for plan years beginning after December 31, 2012. Also, the \$2,500 limit will be indexed for cost-of-living adjustments for plan years beginning after December 31, 2013. See General Explanation of Tax Legislation Enacted in the 111th Congress (2011), Joint Committee on Taxation, at 317.

A § 125 cafeteria plan may offer only qualified benefits. A plan that offers a nonqualified benefit is not a § 125 cafeteria plan. Section 125(d)(1)(B); see also Prop. Treas. Reg. § 1.125-1(q). Accordingly, a cafeteria plan that fails to comply with § 125(i) for plan years beginning after December 31, 2012 is not a § 125 cafeteria plan and the value of the taxable benefits that an employee could have elected to receive under the plan during the plan year is includible in employee’s gross income, regardless of the benefit elected by the employee. See Prop. Treas. Reg. § 1.125-1(b). As explained below, the cafeteria plan must be amended to reflect the \$2,500 limit, and must also comply with the \$2,500 limit in operation.

Consistent with Prop. Treas. Reg. § 1.125-1(d)(2), a plan year is permitted to be changed only for a valid business purpose. If a principal purpose of changing from a calendar year to a fiscal year is to delay the application of the \$2,500 limit, the change is

not for a valid business purpose. If a change in the plan year does not satisfy this valid business purpose requirement, the plan year for the cafeteria plan remains the plan year that was in effect prior to the attempted change.

If a cafeteria plan has a short plan year (that is, fewer than 12 months) that begins after 2012, the \$2,500 limit must be prorated based on the number of months in that short plan year.

The \$2,500 limit on salary reduction contributions to a health FSA applies on an employee-by-employee basis. Thus, \$2,500 (as indexed for inflation) is the maximum salary reduction contribution each employee may make for a plan year, regardless of the number of other individuals (for example, a spouse, dependents, or adult children (see § 105(b)) whose medical expenses are reimbursable under the employee's health FSA. Consistent with this rule, if each of two spouses is eligible to elect salary reduction contributions to an FSA, each spouse may elect to make salary reduction contributions of up to \$2,500 (as indexed for inflation) to his or her health FSA, even if both participate in the same health FSA sponsored by the same employer.

All employers that are treated as a single employer under § 414(b), (c), or (m), relating to controlled groups and affiliated service groups, are treated as a single employer for purposes of the \$2,500 limit. If an employee participates in multiple cafeteria plans offering health FSAs maintained by members of a controlled group or affiliated service group, the employee's total health FSA salary reduction contributions under all of the cafeteria plans are limited to \$2,500 (as indexed for inflation). Section 125(g)(4). However, an employee employed by two or more employers that are not

members of the same controlled group may elect up to \$2,500 (as indexed for inflation) under each employer's health FSA.

As noted, the \$2,500 limit applies only to salary reduction contributions and not to employer non-elective contributions, sometimes called flex credits. Generally, an employer may make flex credits available to an employee who is eligible to participate in the cafeteria plan, to be used (at the employee's election) only for one or more qualified benefits. For further information on flex credits, see Prop. Treas. Reg. § 1.125-5(b). For example, if an employer contributes a \$500 flex credit to each employee's health FSA for the 2013 plan year, each employee may still elect to make salary reduction contributions of \$2,500 (as indexed for inflation) to a health FSA for that plan year. However, if an employer provides flex credits that employees may elect to receive as cash or as a taxable benefit, those flex credits are treated as salary reduction contributions for purposes of § 125(i).

The statute imposes the \$2,500 limit only on salary reduction contributions to a health FSA in a cafeteria plan and does not limit the amount permitted for reimbursement under other employer-provided coverage, such as employee salary reduction contributions to an FSA for dependent care assistance or adoption care assistance. The limit also does not apply to salary reduction contributions to a cafeteria plan that are used to pay an employee's share of health coverage premiums (or the corresponding employee share under a self-insured employer-sponsored health plan) -- sometimes referred to as "premium conversion" salary reduction contributions -- nor does it apply to salary reduction or any other contributions to a health savings account

(HSA) or to amounts made available by an employer under a health reimbursement arrangement (HRA).

If a plan provides for a grace period (which, as noted above, can be no longer than two months and 15 days) for a plan year, unused salary reduction contributions to the health FSA for the plan year that are carried over into the grace period do not count against the \$2,500 limit applicable for the subsequent plan year.

If a cafeteria plan timely complies with the written plan requirement limiting health FSA salary reduction contributions as set forth in section IV, below, but one or more employees are erroneously allowed to elect a salary reduction of more than \$2,500 (as indexed for inflation) for a plan year, the cafeteria plan will continue to be a § 125 cafeteria plan for that plan year if (1) the terms of the plan apply uniformly to all participants (consistent with Prop. Treas. Reg. § 1.125-1(c)(1)); (2) the error results from a reasonable mistake by the employer (or the employer's agent) and is not due to willful neglect by the employer (or the employer's agent); and (3) salary reduction contributions in excess of \$2,500 (as indexed for inflation) are paid to the employee and reported as wages for income tax withholding and employment tax purposes on the employee's Form W-2, Wage and Tax Statement (or Form W-2c, Corrected Wage and Tax Statement) for the employee's taxable year in which, or with which, ends the cafeteria plan year in which the correction is made.

The relief provided in this section III with respect to erroneous excess contributions is not available for an employer if a federal tax return of the employer is under examination with respect to benefits provided under a cafeteria plan with respect to any cafeteria plan year during which the failure to comply with § 125(i) occurred. For

this purpose, an employer is treated as under examination if the employer receives written notification (for example, by plan examination, information document request (IDR), or notification of proposed adjustments to a federal tax return) from the examining agent(s) specifically citing § 125(i) as an issue under consideration.

IV. WRITTEN CAFETERIA PLAN AMENDMENT

A cafeteria plan offering a health FSA must be amended to set forth the \$2,500 limit (or, at the employer's option, a lower limit specified in the plan). Cafeteria plan amendments may be effective only prospectively. See Prop.Treas. Reg. § 1.125-1(c). Notwithstanding this rule against retroactive amendments, an amendment to conform a cafeteria plan to the requirements of § 125(i) that is adopted on or before December 31, 2014, may be made effective retroactively, provided that the cafeteria plan operates in accordance with the requirements of § 125(i) (including the guidance under this notice) for plan years beginning after December 31, 2012. This amendment to the written cafeteria plan may be expressed as a maximum dollar amount or by another method of determining the maximum dollar amount of salary reduction contributions to a health FSA, but in no case may the plan permit a participant to make salary reduction contributions, for a plan year beginning after December 31, 2012, exceeding the \$2,500 limit.

V. EXAMPLES

The rules of this notice are illustrated by the following examples. For all examples, it is assumed that the cafeteria plan otherwise satisfies all of the requirements of § 125 and the proposed regulations, and that the employer is not a member of a controlled group or affiliated service group.

Example 1. (i) Employer W offers a calendar year cafeteria plan including a health FSA. Employer W amends its written cafeteria plan by December 31, 2014, to provide that, effective for the plan year beginning on January 1, 2013, employee salary reduction contributions to a health FSA are limited to \$2,500 (as indexed for inflation).

(ii) Employer W's written cafeteria plan satisfies the requirements of § 125(i).

Example 2. (i) Employer X offers a calendar year cafeteria plan including a health FSA with a grace period of two months and 15 days that complies with Notice 2005-42 and the proposed regulations. Effective for the 2012 plan year, the written plan provides that employee salary reduction contributions for the health FSA are limited to \$5,000. Effective for the 2013 plan year, the written plan provides that employee salary reduction contributions to the health FSA are limited to \$2,500 (as indexed for inflation). Some employees have unused amounts from their 2012 health FSA salary reduction contributions that remain available during the grace period in the first two months and 15 days of 2013.

(ii) The availability during the grace period of amounts attributable to 2012 health FSA salary reduction contributions does not cause Employer X's cafeteria plan to fail to satisfy the \$2,500 limit.

VI. EFFECTIVE DATES

Under the guidance provided in this notice, section 125(i) applies to plan years beginning after December 31, 2012. Indexing of the \$2,500 limit applies to plan years beginning after December 31, 2013.

VII. EFFECT ON OTHER DOCUMENTS

The Treasury Department and the IRS intend to amend the regulations under §§ 1.125-1, 1.125-2, and 1.125-5 to provide for the \$2,500 limit, and taxpayers may rely on the foregoing guidance in this notice pending issuance of the amended regulations.

VIII. REQUEST FOR COMMENTS ON POSSIBLE MODIFICATION OF USE-OR-LOSE RULE FOR HEALTH FSAS

In light of the \$2,500 limit, the Treasury Department and the IRS are considering whether, for health FSAs, the position contained in proposed regulations that is often referred to as the "use-or-lose" rule" should be modified. That rule generally prohibits

any contribution or benefit under an FSA from being used in a subsequent plan year or period of coverage. See Prop. Treas. Reg. § 1.125-1, Q&A-7(b) (1984); Prop. Treas. Reg. § 1.125-2, Q&A-5 & Q&A-7 (1989); Prop. Treas. Reg. § 1.125-5(c) (2007). Thus, under this rule, unused amounts in the health FSA are “forfeited” at the end of the plan year.

The \$2,500 limit, while not addressing the “use-or-lose” rule, limits the potential for using health FSAs to defer compensation and the extent to which salary reduction amounts may accumulate over time. Given the \$2,500 limit, the Treasury Department and the IRS are considering whether the use-or-lose rule for health FSAs should be modified to provide a different form of administrative relief (instead of, or in addition to, the current 2½ month grace period rule). Comments are requested on whether the proposed regulations should be modified to provide additional flexibility with respect to the operation of the use-or-lose rule for health FSAs and, if so, how any such flexibility might be formulated and constrained. Comments are also requested on how any such modifications would interact with the \$2,500 limit.

This section VIII of this notice does not constitute guidance and may not be relied upon by taxpayers.

Comments must be submitted by August 17, 2012. Comments should include a reference to Notice 2012-40. Send submissions to CC:PA:LPD:PR (Notice 2012-40), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered **Monday through Friday** between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2012-40), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC

20044, or sent electronically, via the following e-mail address:

Notice.comments@irscounsel.treas.gov. Please include "Notice 2012-40" in the subject line of any electronic communication. All material submitted will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is Elizabeth Purcell of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice contact Ms. Purcell at (202) 622-6080 (not a toll-free call).