



# Benefit Trends



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## FSA \$2,500 Limit Applies to 2012 Fiscal Plan Year Plans

### LEGISLATIVE BRIEF

January 25, 2012

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Although most Internal Revenue Code (IRC) Section 125 plans (Cafeteria Plans) are calendar year plans, there are some plans that are fiscal years plans (e.g. February 1 – January 31). To the delight of tax lawyers everywhere, the IRC contains traps for the unwary! In this instance, plan sponsors with fiscal plan years (all plan years other than calendar years) whose Cafeteria Plans include Health Care Spending Accounts (HCSA), must institute the \$2,500 pre-tax contribution account maximum beginning with the first day of the 2012 fiscal year.

#### Discussion

**The Law.** The Patient Protection and Affordable Care Act (PPACA) Section 9005 provides that, if a benefit is provided under a Cafeteria Plan through employer contributions to a health flexible spending arrangement, it shall not be treated as a qualified benefit unless the plan provides that an employee may not elect to have salary reduction contributions in excess of \$2,500... for any taxable year beginning after December 31, 2012.

**The Trap.** The taxable year referred to is the employee's income tax filing year (calendar year) not the plan year of the plan. So, if an employee were to elect an amount in pre-tax contributions in excess of \$2,500 (e.g. \$3,000), that would result in the benefit remaining available in 2013, the plan would be disqualified.

**The Result.** Under the PPACA provision, the entire Cafeteria Plan would lose its tax favored status for the 2012 plan year. The penalties would be severe and born by the plan sponsor:

- Underreporting wages;
- Under withholding of income tax, FICA, and FUTA, as applicable;
- Plus interest and other penalties, as accumulated.

**The Solution.** Plan sponsors must amend their fiscal year plans to limit pre-tax contributions to HCSAs to \$2,500. This is especially important for plan sponsors whose plan years begin on February 1, 2012.

**Short Plan Year Alternative.** It may also be appropriate to treat fiscal plan year plans on short plan year basis, ending December 31, 2012. The plan sponsor again would need to amend the plan accordingly prior to the beginning of the 2012 plan year.

**Monitoring the Cap.** Absent further IRS guidance, it is unclear whether a plan sponsor whose HCSA maximum benefit exceeds \$2,500 for fiscal year 2012 could collect pre-tax contributions during the calendar year but administratively cease contributions on a pre-tax basis which are and treat then as after-tax contributions or as employer in excess of \$2,500.

**Other Considerations:**

- The “grandfathered plan” rules do not save fiscal year Cafeteria Plans. The \$2,500 maximum for pre-tax contributions will apply regardless of grandfathered status.
- The \$2,500 maximum is per employee regardless of the number of eligible dependents covered under the plan.
- If a plan has a grace period which allows the employee to collect benefits for up to 2-1/2 months following the end of the plan year for claims incurred following the end of the plan year, grace periods are still permitted since the collection of pre-tax contributions occurred during the plan year in the case of calendar year plans and amended fiscal year plans.
- Some practitioners may suggest front-loading the collection of pre-tax contributions so that they are all taken prior to January 1, 2013. In other words, in the case of a July 1 plan year, an employee electing a \$6,000 benefit would pay \$1,000 for each of the first six months (e.g. July – December) with no pre-tax contributions in 2013. Since employees capable of making the accelerated contributions are most likely Highly Compensated Employees (HCEs), at a minimum the practice may result in the plan being discriminatory in favor of HCEs, resulting in the loss of tax favored status on benefits paid to HCEs. Plan sponsors considering this alternative should seek the advice of counsel prior to implementing such a scheme.
- Some HCSAs contain non-elective employer contributions which can neither be cashed out nor used for any other purpose. According to the PPACA limitation, plan sponsors may continue such a practice. On the other hand, if the plan permits these contributions to be taken as cash, it is likely the contributions would be treated as pre-tax contributions and must be counted toward the \$2,500 maximum.
- On occasion, employees of one employer may have participated in two HCSAs (e.g. change in employment scenarios). Tax practitioners believe that the \$2,500 maximum will apply to the aggregated amounts.

### Action Plan

Employers with fiscal year plans should:

1. Prepare a strategy that will prevent the collection of pre-tax contributions in excess of \$2,500 in 2013.
2. Establish all necessary procedures and safeguards which involve the Cafeteria Plan administrator.
3. Amend the Cafeteria Plan accordingly.
4. Provide notice to all individuals who are eligible to participate in the 2012 fiscal year plan regarding the new \$2,500 pre-tax contribution maximum and the full terms of the 2012 fiscal year plan prior to the close of the plan’s election period.

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