Update on Fiscal Year Health FSAs and the $2,500 Limit

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On January 10, 2011 I posted about how employers with health FSAs that follow a fiscal year might comply with the $2,500 deferral dollar limit going into effect on January 1, 2013. This post updates and corrects the earlier post as follows:

• Notice 2012-9, which provides updated guidance on Form W-2 reporting of the value of group health care, exempts most health FSAs from the reporting requirement. The specific exemption applies to health FSAs that are exempt from HIPAA because they are funded entirely by employee salary deferrals, or because any employer contribution is $500 or less. (W-2 reporting of health care is waived entirely for employers filing fewer than 250 Forms in 2013, based on 2012 employment figures.)

• As a consequence, the IRS will not be able to monitor, through tax returns, any instances in which employee salary deferrals in 2013 exceed the $2,500 limit.

• One of the proposed approaches described in my January 10 post – namely, stopping deferrals at the $2,500 mark – would violate the requirement, set forth in the 2007 Proposed Regulations, that employee salary deferrals be taken in intervals that are uniform for all participants, which in turn potentially could disqualify the plan. (Proposed Treas. Reg. § 125-5(g)(2)). It is possible the IRS will address this method in future guidance but until such time it is not recommended.

• Another proposed method – "front-loading" the 2012-2013 deferral amount so that only $2,500 is deferred in the 2013 portion of the fiscal year – would not expressly violate Section 125 regulations because they do not require deferrals be made in uniform amounts, only uniform intervals. However this method could be viewed as inconsistent with the spirit, if not the letter, of the uniform coverage rule, which prohibits timing deferral payments based on the rate or amount of covered claims incurred. Front-loading is also arguably inconsistent with the uniform deferral rate requirement. An employer could also pro-rate the higher 2012 deferral amount and the lower 2013 deferral amount across the 12 month fiscal year but this would require that the employer reduce deferrals in the first half of the 2013-3014 fiscal year to equal $2,500, when combined with the pro-rated deferrals during the latter half of the 2012-2013 fiscal year. Clearly, timing of the fiscal year start (whether early in 2013, or late in the year) may make the front-loading or pro-rated options unaffordable for some participants.

• Even if unequal deferral amounts are permitted, the actual functioning of the pro-rated or front-loaded method could result in violation of Section 125's nondiscrimination rules, specifically the rule that key employees receive no more than 25% of aggregate tax qualified benefits under a plan in any given year. This easily could occur if, for instance, shareholders and executives of a business typically were the only participants who deferred in excess of $2,500 per year, and continued to defer $5,000 per year under the pro-rated/front-loading method.

• The third method mentioned in my earlier post – imposing the $2,500 deferral cap at the start of the 2012-2013 fiscal year, is the most conservative approach to take but also the approach that will be most unpopular with participants who are accustomed to deferring significant amounts of money in prior plan years.

• At this point, any further guidance from the IRS would only be useful for employers whose fiscal years begin March 1 or later, as February 1 start date plans are almost through open enrollment. It may well be that the Service recognized that sponsors of fiscal year health FSAs would face administrative and legal obstacles to implementing the $2,500 limit and decided that the less the said about the matter, the better.

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