

New directions for health care flexible spending accounts

The IRS has issued new guidance on an important change for flexible spending accounts (FSAs) beginning in 2013. (*IRS Notice 2012-40*)

Alert: A \$2,500 cap will apply to contributions made to health care FSAs. The limit on FSAs for dependent care expenses remains at \$5,000.

This change was included in the Patient Protection and Affordable Care Act of 2010 (PPACA) upheld by the U.S. Supreme Court.

Here's the whole story: With a health care FSA, you and other participating employees can choose to allocate a portion of salary to a separate account. The contributions are exempt from federal income tax and payroll taxes, so both the employer and the employees save money.

Any withdrawals from the account used to pay for qualified medical expenses are tax-free. This includes medical and dental expenses that would qualify for deductions on your personal tax return.

Typically, the participant decides how much he or she wants to contribute before the start of the year.

The contributions are then deducted from the employee's salary on a pro rata basis. For example, if you want to contribute \$5,200 annually and you're paid biweekly, the employer would deduct \$200 from each of your paychecks.

If you don't use up all the funds in your account by the end of the year, the leftover amount is generally forfeited under the "use-it-or-lose-it" rule for FSAs. However, an employer may approve a 2½-month grace period for carrying over unused amounts.

Now the new IRS Notice clarifies the rules relating to the \$2,500 limit on health care FSAs. Here are the main points of interest:

- The \$2,500 limit is effective for tax years beginning after 2012.
- For these purposes, the term "tax year" refers to the plan's tax year, not the employer's or an employee's tax year. Most plans use the calendar year.
- The \$2,500 limit doesn't apply to reimbursements under an FSA for dependent care expenses.
- A plan can't change its tax year in order to delay imposition of the \$2,500 limit for health care expenses.
- The \$2,500 limit applies on an individual basis. In other words, a married couple may contribute up to \$5,000, if they are both eligible to participate in a plan.
- All employers in a controlled or affiliated service group are treated as a single employer for purposes of the limit.
- The \$2,500 limit only applies to salary reduction contributions to an FSA. No limit applies to employer nonelective contributions like flex credits, unless the employee can choose either receiving the flex credits as cash or a taxable benefit.

- In the event the employer uses the optional 2½-month grace period for plan years beginning in 2012 or later, any amount carried over into the next year won't count against the \$2,500 limit for the subsequent year.

Tip: The IRS has requested comments on the use-it-or-lose-it rule. It seems that momentum is picking up for its repeal. We will keep you posted on any developments.

Take out most of the guesswork

Choosing the “right amount” to contribute to a health care spending account is more of an art than a science. It's often difficult to project how much salary to allocate to the plan in order to cover unreimbursed expenses.

Saving grace: For many employees, the new limit makes things easier. For 2013, you can simply take the \$2,500 max, especially if the use-it-or-lose-it rule is repealed.