Sections 125 and 223 – Cafeteria Plans, Flexible Spending Arrangements, and Health Savings Accounts – Elections and Reimbursements for Same-Sex Spouses Following the Windsor Supreme Court Decision

Notice 2014-1

I. PURPOSE

This notice provides guidance on the application of the rules under section 125 of the Internal Revenue Code (Code) (relating to cafeteria plans, including health and dependent care flexible spending arrangements (FSAs)), and section 223 of the Code (relating to health savings accounts (HSAs)), as those two provisions relate to the participation by same-sex spouses in certain employee benefit plans following the Supreme Court decision in United States v. Windsor, 570 U.S. ___, 133 S. Ct. 2675 (2013), and the issuance of Rev. Rul. 2013-17, 2013-38 I.R.B. 201. This notice amplifies the previous guidance provided in Rev. Rul. 2013-17.

II. BACKGROUND

A. Cafeteria Plans, Health and Dependent Care FSAs, and HSAs

Section 125(d)(1) defines a cafeteria plan as a written plan under which all participants are employees and the participants may choose among two or more benefits consisting of cash and qualified benefits. Section 125(f) defines a qualified benefit as any benefit which, with the application of section 125(a), is not includable in the gross income of the employee by reason of an express provision of Chapter I of the Code (with certain exceptions). Qualified benefits include contributions to an employer-provided accident and health plan that are excludable from gross income under section 106.

Under Treas. Reg. § 1.106-1, the gross income of an employee does not include contributions that his employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by the employee, the employee's spouse and dependents, and certain other individuals.

Treas. Reg. § 1.125-4 provides that a cafeteria plan may permit an employee to revoke an election during a period of coverage and make a new election under certain circumstances. One circumstance under which a cafeteria plan may permit an employee to make a new election is a change in status event under Treas. Reg. § 1.125-4(c), including a change in legal marital status. Another circumstance under which a cafeteria plan may permit an employee to make a new election is a significant change in the cost of coverage under Treas. Reg. § 1.125-4(f).

Prop. Treas. Reg. § 1.125-5 defines a FSA as a benefit program that provides

employees with coverage that reimburses specified incurred expenses (subject to reimbursement maximums and any other reasonable conditions). Prop. Treas. Reg. § 1.125-5(h) provides that the benefits that may be offered through FSAs include dependent care assistance programs under section 129 and medical reimbursement arrangements under section 105.

Section 129 provides that the maximum exclusion from gross income under a dependent care assistance program is $5,000 for an individual or a married couple filing jointly or $2,500 for a married individual filing separately.

Section 223(d) defines a HSA as a trust created or organized in the United States as a health savings account exclusively for the purpose of paying the qualified medical expenses of the account beneficiary and that satisfies other delineated requirements. The term "qualified medical expenses" is defined in section 223(d)(2) to include amounts paid by a beneficiary for medical care for that individual and the spouse of that individual. Section 223(a) allows a deduction for an eligible individual in an amount equal to the aggregate amount paid in cash during a taxable year by or on behalf of the individual to a HSA. The maximum deduction for the 2013 taxable year is limited to $6,450 (as adjusted for cost-of-living increases) in the case of an eligible individual who has family coverage under a high-deductible health plan (HDHP); see Rev. Proc. 2012-26, 2012-20 I.R.B. 933. In the case of married individuals either one of whom has family coverage under a HDHP, the HSA deduction limitation is divided equally among the spouses unless they agree on a different division.

B. Defense of Marriage Act

Until the recent decision of the Supreme Court in Windsor found it unconstitutional, section 3 of the Defense of Marriage Act (DOMA) prohibited the recognition of same-sex marriages for purposes of federal tax law. Specifically, section 3 of DOMA (1 U.S.C. § 7) provided that:

> In determining the meaning of any Act of Congress, or of any ruling, regulation or interpretation of the various administrative bureaus and agencies of the United States, the word 'marriage' means only a legal union between one man and one woman as husband and wife, and the word 'spouse' refers only to a person of the opposite sex who is a husband or a wife.

As a result, employers could not permit employees to elect coverage of same-sex spouses on a pre-tax basis under a cafeteria plan unless the spouse otherwise qualified as a tax dependent of the employee.

C. Effect of the Windsor decision and Rev. Rul. 2013-17

In Windsor, the Supreme Court held on June 26, 2013 that section 3 of DOMA is unconstitutional because it violates Fifth Amendment principles. Rev. Rul. 2013-17, interpreting the Windsor decision, held the following:

1. For Federal tax purposes, the terms “spouse,” “husband and wife,” “husband,” and “wife” include an individual married to a person of the same sex if the individuals are lawfully married under state law, and the term “marriage” includes such a marriage between individuals of the same sex;

2. For Federal tax purposes, the IRS adopts a general rule recognizing a marriage of same-sex individuals that was validly entered into in a state whose laws authorize the marriage of two individuals of the same sex even if the married couple is domiciled in a state that does not recognize the validity of same-sex marriages; and

3. For Federal tax purposes, the terms “spouse,” “husband and wife,” “husband,” and “wife” do not include individuals (whether of the opposite sex or the same sex) who have entered into a registered domestic partnership, civil union, or other similar formal relationship recognized under state law that is not denominated as a marriage under the laws of that state, and the term “marriage” does not include such formal relationships.

Rev. Rul. 2013-17 provides that taxpayers may rely on its holdings retroactively with respect to any employee benefit plan or arrangement or any benefit provided thereunder only for purposes of filing original returns, amended returns, adjusted returns, or claims for credit or refund of an overpayment of tax concerning employment tax and income tax with respect to employer-provided health coverage benefits or fringe benefits that were provided by the employer and are excludable from income under sections 106, 117(d), 119, 129, or 132 based on an individual’s marital status. The ruling further provides that, for purposes of the preceding sentence, if an employee made a pre-tax salary-reduction election for health coverage under a section 125 cafeteria plan sponsored by an employer and also elected to provide health coverage for a same-sex spouse on an after-tax basis under a group health plan sponsored by that employer, an affected taxpayer may treat the amounts that were paid by the employee for the coverage of the same-sex spouse on an after-tax basis as pre-tax salary reduction amounts.

Notice 2013-61, 44 I.R.B. 432, contains special administrative procedures for employers who want to make adjustments or claims for refund or credit of employment taxes paid with respect to the value of same-sex spousal benefits that are excludable from the income and wages of an employee under the Windsor decision, as interpreted by Rev. Rul. 2013-17.

The following questions and answers provide further guidance on the application of the Windsor decision with respect to certain rules governing the federal tax treatment of certain types of employee benefit arrangements.

III. QUESTIONS AND ANSWERS

With respect to the following guidance, references to “marriage” or “spouse” refer to individuals who at the relevant date or for the relevant period of time would be treated as married or as spouses under the holdings in Rev. Rul. 2013-17.

Mid-Year Election Changes

Q-1: If a cafeteria plan participant was lawfully married to a same-sex spouse as of the date of the Windsor decision, may the plan permit the participant to make a mid-year election change on the basis that the participant has experienced a change in legal marital status?

A-1: Yes. A cafeteria plan may treat a participant who was married to a same-sex spouse as of the date of the Windsor decision (June 26, 2013) as if the participant experienced a change in legal marital status for purposes of Treas. Reg. § 1.125-4(c). Accordingly, a cafeteria plan may permit such a participant to revoke an existing election and make a new election in a manner consistent with the change in legal marital status. For purposes of election changes due to the Windsor decision, an election may be accepted by the cafeteria plan if filed at any time during the cafeteria plan year that includes June 26, 2013, or the cafeteria plan year that includes December 16, 2013.

A cafeteria plan may also permit a participant who marries a same-sex spouse after June 26, 2013, to make a mid-year election change due to a change in legal marital status.

Any election made with respect to a same-sex spouse (and/or the spouse’s dependents) must satisfy the requirements of the regulations concerning election changes generally, including the consistency rule under Treas. Reg. § 1.125-4(c)(3).

Q-2: May a cafeteria plan permit a participant with a same-sex spouse to make a mid-year election change under Treas. Reg. § 1.125-4(f) on the basis that the change in tax treatment of health coverage for a same-sex spouse resulted in a significant change in the cost of coverage?

A-2: A change in the tax treatment of a benefit offered under a cafeteria plan generally does not constitute a significant change in the cost of coverage for purposes of Treas. Reg. § 1.125-4(f). Given the legal uncertainty created by the Windsor decision, however, cafeteria plans may have permitted mid-year election changes under Treas. Reg. § 1.125-4(f) prior to the publication of this notice.

As noted in Q&A-1 above, such an election change would have been permitted on the basis that the participant experienced a change in legal marital status. Accordingly, for periods between June 26 and December 31, 2013, a cafeteria plan will not be treated as having failed to meet the requirements of section 125 or Treas. Reg. § 1.125-4 solely

because the plan permitted a participant with a same-sex spouse to make a mid-year election change under Treas. Reg. § 1.125-4(f) as a result of the plan administrator's interpretation that the change in tax treatment of spousal health coverage arising from the Windsor decision resulted in a significant change in the cost of health coverage.

Q-3: When does an election made by a participant in connection with the Windsor decision take effect?

A-3: An election made under a cafeteria plan with respect to a same-sex spouse as a result of the Windsor decision generally takes effect as of the date that any other change in coverage becomes effective for a qualifying benefit that is offered through the cafeteria plan.

With respect to a change in status election that was made by a participant in connection with the Windsor decision between June 26, 2013 and December 16, 2013, the cafeteria plan will not be treated as having failed to meet the requirements of section 125 or Treas. Reg. § 1.125-4 to the extent that coverage under the cafeteria plan becomes effective no later than the later of (a) the date that coverage under the cafeteria plan would be added under the cafeteria plan's usual procedures for change in status elections, or (b) a reasonable period of time after December 16, 2013.

The rules set forth in Q&A-1 through Q&A-3 are illustrated by the following examples:

> Example 1. Employer sponsors a cafeteria plan with a calendar year plan year. Employee A married same-sex Spouse B in October 2012 in a state that recognized same-sex marriages. During open enrollment for the 2013 plan year, Employee A elected to pay for the employee portion of the cost of self-only health coverage through salary reduction under the cafeteria plan.
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> Employer permits same-sex spouses to participate in its health plan. On October 5, 2013, Employee A elected to add health coverage for Spouse B under Employer's health plan, and made a new salary reduction election under the cafeteria plan to pay for the employee portion of the cost of Spouse B's health coverage. Employer was not certain whether such an election change was permissible, and accordingly declined to implement the election change until the publication of this notice.
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> After publication of this notice, Employer determines that Employee A's revised election is permissible as a change in status election in accordance with this notice. Employer enrolls Spouse B in the health plan as of December 20, 2013, and begins making appropriate salary reductions from the compensation of Employee A for Spouse B's coverage beginning with the pay period starting December 20, 2013. The cafeteria plan is administered in accordance with this notice.
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> Example 2. Same facts as Example 1, except that Employee A submitted the

election to add health coverage for Spouse B under Employer's cafeteria plan on September 1, 2013. Prior to publication of this notice, Employer implemented the election change and enrolled Spouse B in the health plan as of October 1, 2013, and began making appropriate salary reductions from the compensation of Employee A for Spouse B's coverage beginning with the pay period starting October 1, 2013. The cafeteria plan was administered in accordance with this notice.

Q-4: If a cafeteria plan participant has elected to pay for the employee cost of health coverage for the employee on a pre-tax basis through salary reduction under a cafeteria plan, and is also paying the employee cost of health coverage for a same-sex spouse under a health plan of the employer on an after-tax basis, when, and under what circumstances, must an employer begin to treat the amount that the employee pays for spousal coverage as a pre-tax salary reduction?

A-4 An employer that, before the end of the cafeteria plan year including December 16, 2013, receives notice that such a participant is married to the individual receiving health coverage must begin treating the amount that the employee pays for the spousal coverage as a pre-tax salary reduction under the plan no later than the later of (a) the date that a change in legal marital status would be required to be reflected for income tax withholding purposes under section 3402, or (b) a reasonable period of time after December 16, 2013.

For this purpose, a participant may provide notice of the participant's marriage to the individual receiving health coverage by making an election under the employer's cafeteria plan to pay for the employee cost of spousal coverage through salary reduction (as permitted under Q&A-1) or by filing a revised Form W-4 representing that the participant is married.

Q-5: How does the Windsor decision affect the tax treatment of health coverage for a same-sex spouse in the case of a cafeteria plan participant who had been paying for the cost of same-sex spouse coverage on an after-tax basis?

A-5: In the case of a cafeteria plan participant who elected to pay for the employee cost of health coverage for the employee on a pre-tax basis through salary reduction under a cafeteria plan and also paid for the employee cost of health coverage for a same-sex spouse under the employer's health plan on an after-tax basis, the participant's salary reduction election under the cafeteria plan is deemed to include the employee cost of spousal coverage, even if the employer reports the amounts as taxable income and wages to the participant. Accordingly, the amount that the participant pays for spousal coverage is excluded from the gross income of the participant and is not subject to federal income or federal employment taxes. This rule applies to the cafeteria plan year including December 16, 2013 and any prior years for which the applicable limitations period under section 6511 has not expired.

In general, Q&A-4 and Q&A-5 provide that a cafeteria plan participant may choose to

pay for the employee cost of same-sex spouse coverage on a pre-tax basis through the remaining pay periods in the current cafeteria plan year by providing notice of the participant's marital status to the employer or the cafeteria plan, or to continue paying for these benefits on an after-tax basis. In either case, the participant may seek a refund of federal income or federal employment taxes paid on any amounts representing the employee cost of spousal health coverage that were treated as after-tax and may exclude these amounts from gross income when filing an income tax return for the year.

The rules set forth in Q&A-4 and Q&A-5 are illustrated by the following example:

> Example 3. Same facts as Example 1, except that starting January 1, 2013, Employee A paid for the employee portion of health coverage for Spouse B under Employer's group health plan on an after-tax basis. The value of Spouse B's health coverage was $500 per month, and this amount was included as taxable income and wages to Employee A for payroll purposes with respect to all pay periods starting January 1, 2013.
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> On October 5, 2013, Employee A made a change in status election under the cafeteria plan electing to pay for the employee cost of Spouse B's health coverage on a pre-tax basis through salary reduction. Employer implemented the change in status election on November 1, 2013, and excluded the cost of Spouse B's coverage from Employee A's gross income and wages with respect to all remaining pay periods in 2013 starting November 1, 2013.
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> Employee A and Spouse B file a joint federal income tax return for 2013. The value of Spouse B's health coverage for the full 2013 taxable year (including the $5,000 of coverage ($500 per month for 10 months) that was initially reported by Employer as includable in gross income with respect to all pay periods from January through October) may be excluded from gross income on the couple's joint return for 2013. Employee A may also request a refund of any federal employment taxes paid on account of such coverage.

FSA Reimbursements

Q-6: May a cafeteria plan permit a participant's FSA to reimburse covered expenses incurred by the participant's same-sex spouse during a period beginning on a date that is no earlier than (a) the beginning of the cafeteria plan year including the date of the Windsor decision or (b) the date of marriage, if later?

A-6: Yes. A cafeteria plan may permit a participant's FSA, including a health, dependent care, or adoption assistance FSA, to reimburse covered expenses of the participant's same-sex spouse or the same-sex spouse's dependent that were incurred during a period beginning on a date that is no earlier than (a) the beginning of the cafeteria plan year that includes the date of the Windsor decision or (b) the date of marriage, if later. For this purpose, the same-sex spouse may be treated as covered by the FSA (even if the participant had initially elected coverage under a self-only FSA)

during that period. For example, a cafeteria plan with a calendar year plan year may permit a participant's FSA to reimburse covered expenses of the participant's same-sex spouse or the same-sex spouse's dependent that were incurred during a period beginning on any date that is on or after January 1, 2013 (or the participant's date of marriage if later).

The rules set forth in Q&A-6 are illustrated by the following examples:

> Example 4. Same facts as Example 1, except that Employer's cafeteria plan included a health FSA. For the plan year beginning January 1, 2013, Employee A elected $2,500 in coverage under the health FSA.
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> On October 5, 2013, Employee A elected to add health coverage for Spouse B under Employer's group health plan, and made a new salary reduction election under the cafeteria plan to pay for the employee cost of Spouse B's health coverage. On October 15, 2013, Employee A submitted a reimbursement request under the health FSA including a properly substantiated health care expense incurred by Spouse B on July 15, 2013.
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> Employee A's FSA may reimburse the covered expense.
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> Example 5. Same facts as Example 4, except that Employee A did not elect to add health coverage for Spouse B under Employer's group health plan. On October 15, 2013, Employee A submitted a reimbursement request under the health FSA including a properly substantiated health care expense incurred by Spouse B on July 15, 2013. The reimbursement request included a representation that Employee A was legally married to Spouse B on the date that the health care expense was incurred.
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> Employee A's FSA may reimburse the covered expense.

Contribution Limits for HSAs and Dependent Care Assistance Programs

Q-7: Is a same-sex married couple subject to the joint deduction limit for contributions to a HSA?

A-7: Yes. The maximum annual deductible contribution to one or more HSAs for a married couple either of whom elects family coverage under a HDHP is $6,450 for the 2013 taxable year (as adjusted for cost of living increases). This deduction limit applies to same-sex married couples who are treated as married for federal tax purposes with respect to a taxable year (that is, couples who remain married as of the last day of the taxable year), including the 2013 taxable year.

Q-8: If each of the spouses in a same-sex married couple elected to make contributions to separate HSAs that, when combined, exceed the applicable HSA contribution limit for a married couple, how can the excess contribution be corrected?

A-8: If the combined HSA contributions elected by two same-sex spouses exceed the applicable HSA contribution limit for a married couple, contributions for one or both of the spouses may be reduced for the remaining portion of the tax year in order to avoid exceeding the applicable contribution limit. To the extent that the combined contributions to the HSAs of the married couple exceed the applicable contribution limit, any excess may be distributed from the HSAs of one or both spouses no later than the tax return due date for the spouses, as permitted under section 223(f)(3). Any such excess contributions that remain undistributed as of the due date for the filing of the spouse's tax return (including extensions) will be subject to excise taxes under section 4973.

The rules set forth in Q&A-7 and Q&A-8 are illustrated by the following example:

> Example 6. Same-sex spouses C and D were married in a state recognizing same-sex marriages in December 2012. For the period beginning January 1, 2013, Spouse C elected family coverage under a HDHP and elected to make $6,000 in contributions to a HSA. For the same period, Spouse D separately elected family coverage under a HDHP and elected to make $4,000 in contributions to a HSA.
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> As a result of the Windsor decision and Rev. Rul. 2013-17, Spouses C and D became recognized as legal spouses for federal tax purposes. The spouses remained married for the remainder of the 2013 taxable year.
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> Under section 223(b) (as adjusted for increases in the cost of living), the maximum deductible contribution to a HSA for 2013 for a married couple either of whom elects family coverage under a HDHP is $6,450. The combined HSA contributions made by Spouses C and D for the 2013 taxable year totaled $10,000, which exceeded the allowable deduction limit by $3,550.
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> On February 15, 2014, Spouse C receives a HSA distribution of $3,550, plus an additional $150 in income attributable to the $3,550 excess contribution. The $150 in income on the excess contributions is includable in Spouse C's gross income for 2014, as provided in section 223(f)(3)(A). Because the distribution was made prior to the due date for Spouse C's federal tax return, the $3,550 in excess contributions is not subject to excise taxes under section 4973.

Q-9: Is a same-sex married couple subject to the exclusion limit for contributions to a dependent care FSA?

A-9: Yes. The maximum annual contribution to one or more dependent care FSAs for a married couple is $5,000. This limit applies to same-sex married couples who are treated as married for federal tax purposes with respect to a taxable year (that is, couples who remain married as of the last day of the taxable year), including the 2013 taxable year.

Q-10: If each of the spouses in a same-sex married couple elected to make dependent care FSA contributions that, when combined, exceed the applicable exclusion limit for a married couple, how can the excess contribution be corrected?

A-10: If the combined dependent care FSA contributions elected by the same-sex spouses exceed the applicable contribution limit for a married couple, contributions for one or both of the spouses may be reduced for the remaining portion of the tax year in order to avoid exceeding the applicable contribution limit. To the extent that the combined contributions to the dependent care FSAs of the married couple exceed the applicable contribution limit, the amount of excess contributions will be includable in the spouses' gross income as provided in section 129(a)(2)(B).

The rules set forth in Q&A-9 and Q&A-10 are illustrated by the following example:

> Example 7. Same-sex spouses E and F were married throughout 2013. For the period beginning January 1, 2013, Spouse E elected to make contributions to a dependent care FSA in the amount of $5,000. For the same period, Spouse F separately elected to make contributions to a dependent care FSA in the amount of $2,500.
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> As a result of the Windsor decision and Rev. Rul. 2013-17, Spouses E and F became recognized as legal spouses for federal tax purposes.
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> On November 1, 2013, Spouse E made a change in status election under the cafeteria plan electing to cease all dependent care FSA contributions for the remainder of the year. By December 31, 2013, the total amount of dependent care FSA contributions made by Spouse E was $4,000.
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> Spouses E and F filed separate returns for the 2013 taxable year. Under section 129(b)(2)(A), the maximum exclusion relating to a dependent care assistance program is $2,500 in the case of a separate return by a married individual. Spouse F is permitted to claim the full $2,500 exclusion for contributions to Spouse F's dependent care FSA.
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> Spouse E made contributions to a dependent care FSA in the amount of $4,000, which exceeds the applicable exclusion limit by $1,500. Spouse E must include this $1,500 excess contribution in gross income. The amount of the excess contribution will remain credited to the FSA to reimburse allowable claims in accordance with plan terms (or be forfeited to the extent that allowable claims are not submitted).

IV. WRITTEN PLAN AMENDMENT

A cafeteria plan containing written terms permitting a change in election upon a change in legal marital status generally is not required to be amended to permit a change in

status election with regard to a same-sex spouse in connection with the Windsor decision. To the extent that the cafeteria plan sponsor chooses to permit election changes that were not previously provided for in the written plan document, the cafeteria plan must be amended to permit such election changes on or before the last day of the first plan year beginning on or after December 16, 2013. Such an amendment may be effective retroactively to the first day of the plan year including December 16, 2013, provided that the cafeteria plan operates in accordance with the guidance under this notice.

V. EFFECTIVE DATE

This notice is effective as of December 16, 2013.

VI. EFFECT ON OTHER DOCUMENTS

Rev. Rul. 2013-17 is amplified by extending the relief available to employees who have purchased health coverage for a same-sex spouse by permitting a mid-year cafeteria plan election change.

VII. DRAFTING INFORMATION

The principal author of this notice is Shad C. Fagerland of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice contact Mr. Fagerland at (202) 317-5500 (not a toll-free call).