Can we change our Section 125 Plan Year?

The IRS has regulations regarding what are plan year requirements. Generally, a Section 125 plan requires a 12-month plan year, however there could be a short plan year, but only for a valid business reasons. The plan year cannot exceed 12 months.

If an employer determines there is a valid business reason for a short plan year, then you must inform employees before the beginning of a short plan year.

Below is the regulations with regards to plan years and shortened plan years:

Prop Reg § 1.125-1. Cafeteria plans; general rulesd) Plan year requirements.
PAR. 2 Sections 1.125-0, 1.125-1 and 1.125-2 are added to read as follows:
(d) (1) (1) Twelve consecutive months. The plan year must be specified in the cafeteria plan. **The plan year of a cafeteria plan must be twelve consecutive months, unless a short plan year is allowed under this paragraph (d).** A plan year is permitted to begin on any day of any calendar month and must end on the preceding day in the immediately following year (for example, a plan year that begins on October 15, 2007, must end on October 14, 2008). A calendar year plan year is a period of twelve consecutive months beginning on January 1 and ending on December 31 of the same calendar year. A plan year specified in the cafeteria plan is effective for the first plan year of a cafeteria plan and for all subsequent plan years, unless changed as provided in paragraph (d) (2) of this section.

(d) (2) (2) Changing plan year. **The plan year is permitted to be changed only for a valid business purpose.** A change in the plan year is not permitted if a principal purpose of the change in plan year is to circumvent the rules of section 125 or these regulations. If a change in plan year does not satisfy this subparagraph, the attempt to change the plan year is ineffective and the plan year of the cafeteria plan remains the same.

Below are a couple examples of permitted plan year changes:

Example (1). Employer with calendar year.
Employer G, with a calendar taxable year, first establishes a cafeteria plan effective July 1, 2017. The cafeteria plan specifies a calendar plan year. The first cafeteria plan year is the period beginning on July 1, 2017, and ending on December 31, 2017. Employer G has a business purpose for a short first cafeteria plan year.

Example (2). Employer changes insurance carrier.
Employer H establishes a cafeteria plan effective January 1, 2017, with a calendar year plan year. The cafeteria plan offers an accident and health plan through Insurer X. In March 2018, Employer H contracts to provide accident and health insurance through another insurance company, Y. Y's accident and health insurance is offered on a July 1-June 30 benefit year. Effective July 1, 2018, Employer H amends the plan to change to a July 1-June 30 plan year. Employer H has a business purpose for changing the cafeteria plan year and for the short plan year ending June 30, 2018.

How Does Changing a Plan Year Impact Contribution Limits?

When there is a short plan year, for a valid business purpose, the plan must prorate the Health FSA salary reduction contribution limit for the short plan year.

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Examples:

Short Plan Year 1

The short plan year is from 7/1 to 12/31. New plan year will be 1/1 to 12/31 (calendar plan year).
Employee contribution for the plan for full plan year is $2,650
For the short plan year, contributions from employees to the plan cannot be more than $1,325.

Math to determine this contribution limit:

# of months of short plan divided by 12 (full plan year) = #/12
In this example, we will have 6 months on the shortened plan year (7/1 to 12/31) = 6 months
Math for shortened plan year = 6/12 or 1/2
Contribution amount $2,650/2 = $1,325 (or 1/2X$2,650)

Short Plan Year 2

The short plan year is from 9/1 to 12/31. New plan year will be 1/1 to 12/31 (calendar plan year).
Employee contribution for the plan for full plan year is $2,650
For the short plan year, contributions from employees to the plan cannot be more than $.
Math to determine this contribution limit:

# of months of short plan divided by 12 (full plan year) = #/12
In this example, we will have 4 months on the shortened plan year (9/1 to 12/31) = 4 months
Math for shortened plan year = 4/12 or 1/3
Contribution amount $2,650/3 = $883.33 (1/3X$2,650)

The prorated limit applies to all elections made in that short plan year—even mid-year new hires who never had a previous health FSA election.

Note that the prorated salary reduction contribution limit for a short plan year does not affect the $500 carryover for plans that offer it. Employees may carry over up to $500 into and out of a short plan year.

All of the above rules apply identically to employee contributions for any of the following Section 125 plans: General Purpose Health FSA, Limited Purpose Health FSA or Dependent Care FSA.

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